Singapore REITS: latest quarter reporting season update

If you've been to Singapore lately, you may have noticed fewer cranes on the skyline. The figures from the latest reporting season explain why. Since peaking in the first quarter of 2015, rents in the Singapore office market have declined by up to 15%, with expectations of a further 5% fall in 2017.

That's a substantial market readjustment, a reflection of a building boom that led to oversupply. Despite APN's Asian REIT Fund allocating over 30% of the portfolio to the Lion state, the adjustment hasn't been as painful as these figures might indicate.

There are two reasons for this. First, after the fall in office rents, supply and demand is now approaching equilibrium. Second, Singapore's office real estate investment trusts (REITs) saw the oversupply coming and got on the front foot, focussing on tenant retention and lease renewals. As a result, of the office REITs that recently reported, few experienced a negative impact on distributions.

High quality portfolios cushion the fall

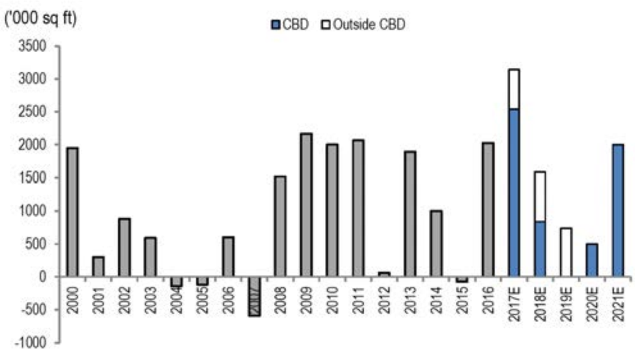
The performance of a key holding in APN's Asian REIT Fund – Capitaland Commercial Trust (CCT) – makes the point. Not only were its earnings unaffected by the slowdown, it managed to deliver 10.1% year-on-year growth in distributions-per-unit (DPU) for the last quarter.

Management acknowledged the challenging environment and that negative rental reversions – where the rent charged when releasing vacant space is at a lower rate than the previous tenant's agreement – increased compared with the previous quarter. But its high quality portfolio cushioned the fall and the well-timed acquisition of CapitaGreen was instrumental in contributing to CCT's better-than expected-earnings.

Despite difficult conditions, CCT is an example of the benefits of high quality management working with a high quality property portfolio. So, despite the apparent turmoil, we think some office SREITs like CCT can sustain distributions over the next few periods, which is good news for our investors, as is the likely end of the oversupply of office space.

Not much in financial markets goes up or down in a straight line. The creation of too much office space inevitably leads to not enough a few years down the track. There's a good chance that office rental growth will bottom by the end of this year, after which landlords should enjoy a few years of below-average supply (see chart above) when rents eventually rise.

Office supply pipeline



Source: URA, CBRE, Credit Suisse estimates

Despite sluggish retail conditions, distributions remain stable and asset values increased

Despite slow sales, the retail sector also remained resilient. Retail sales across Singapore recorded the first month-on–month increase since the start of 2016 and, while retail rents continue to fall slightly, the rate of decline has slowed.

How did retail SREITS fare in this environment? With rent reversions yet to bear a negative number across their portfolios, pretty well. Within APN's Asian REIT portfolio, Mapletree Commercial Trust reported the strongest rental reversion – an increase of 13.5% – and Capitaland Mall Trust most muted at +1.0%.

Tenant sales were mixed with Mapletree Commercial Trust showing growth of 2.0% while Frasers Centerpoint Trust was down 2.4%. More importantly, capital values remained intact. Most retail SREITS enjoyed modest increases in portfolio values, aided by stable capitalisation rates.

Nevertheless, the environment remains sluggish and we are not yet out of the woods. We like the retail SREITS due to their stable distribution profiles but this reporting season again highlights the value of management.

In challenging times, a landlord's property and asset management skills are critical. Our two largest positions in Singapore's retail sector perform well in this regard and, along with superior property locations, performance should hold up better in a downturn.

Industrial REITs hold their ground

Finally, to Singapore's industrial sector. Prices and rentals continued their decline for the seventh consecutive quarter, which has been weaker than the retail and office markets, although not for the reasons you might expect.

Although the economy has been soft, Government intervention has played a role in the fall in industrial rents. The market in Singapore is regulated by a government body known as JTC Corporation. With the intention of keeping a lid on the cost of doing business for small and medium-sized enterprises, it increased industrial property supply to keep prices and rentals down.

Clearly, the policy has worked. Surprisingly though, industrial SREITS managed to hold their ground and deliver a reasonable performance to their investors. Still, the headline figures don't reveal the true story, which is that the smaller players suffered at the expense of the larger ones.

Singapore's largest industrial REIT, Ascendas, is one of the top holdings in APN's Asian REIT Fund. In the most recent quarter, it reported an increase in occupancy from 89.1% to 90.2% and positive rental reversions of 3.0% (year-on-year growth) across all industrial segments – the business park segment had the strongest rent reversion at 6.1%. As a result, Ascendas REIT's distribution per unit or the last quarter rose 1.2% (year-on-year growth).

In contrast, one of the smaller industrial REITs – CACHE Logistics Trust (of which we don't hold a position in the Asian REIT Fund) – reported a 10.8% year-on-year decline in DPU for the most recent quarter. This was due to weak operations, a diluted capital base (the result of a capital raising) and a reduced contribution from capital payments. CACHE also reported revaluation losses due to weaker operating trends that caused gearing to rise to 43.1% – uncomfortably close to the regulatory gearing limit of 45%.

This contrast neatly explains why we have to be careful when investing in the smaller trusts in the sector – risk and reward (in the form of higher yields) have to be assessed and balanced. The bigger trusts tend to own the most attractive properties. In a downturn, they are less impacted and, in some cases, can still perform well. In Singapore as in Australia, all REITs are not created equal. The latest results this reporting season make this point well.

Distributions increase over the year

The high quality SREITS that we hold in APN's Asian REIT Fund delivered an average 1.2%[1] increase (year-on-year) in distributions per unit. That may not sound like much, but in difficult trading conditions where rents are falling, any positive increase is a testament to the good management of high quality assets.

So, despite the anaemic economic backdrop and supply issues in some sectors, the fund, currently yielding 6.55% 1(as at end Jan 2017), has delivered on its promise of income.

1 Current running yield is calculated daily by dividing the annualised distribution rate by the latest entry unit price. Distributions may include a capital gains component. Past performance is not an indicator of future returns.

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