# REITs

**Maintain NEUTRAL**

## A paradigm shift?

### KEY INVESTMENT HIGHLIGHTS

- **What does investing in REITs in a low yield environment mean?**
- **Near-term pain due to rent assistance, asset quality matters in the long run**
- **Mall operators may have to be agile to add value to assets to retain customers**
- **Maintain NEUTRAL stance for the sector**

**What does investing in REITs in a low yield environment mean?** Bank Negara Malaysia announced a cut to its Overnight Policy Rate (OPR) of 25bps on 7th of July to a record low of 1.75%. Our house economist expects no further cut this year. The low rate is expected to last for a year until economic improvement is recorded. Therefore, we expect the low-yield environment to extend into 2021. At current level, YTD 10-year MGS average yield is ~3.0%. Based on our estimation, this translates into a yield spread of >2.0%-pt between 10-year MGS and REITs under our coverage. While the yield spread is considerably attractive, we are cautious for the ability of some seemingly high-yielding REITs to be able to sustain dividend payout at previous levels due to the uncertainty in rental income and collection in the near-term.

**Rent assistance may dent top and bottom line in the near-term.** Presently, REITs with hotel and retail assets are the most vulnerable to the Covid-19 pandemic. For the hotel segment, income is likely to be hit by the downturn of the tourism industry as well the reduced number of business traveling, resulting in low occupancy rate as well as average daily rates (ADR). On top of that, cancellation of major events, gatherings, celebrations will also adversely affect income. Hotels that have been designated as quarantine centres may continue to receive income but that will most likely come at the cost of lower ADR. With most countries imposing travel bans or stricter traveling requirements, we believe that recovery for hotel income will take a while. Limiting the downside from hotel assets are the master lease agreements or profit guarantees made with the hotel operators.

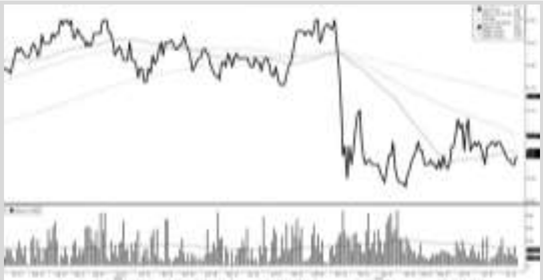
**Retail space being hit by the MCO.** As for shopping malls, the most immediate impact is seen during the closure of premises during the Movement Control Order (MCO) in Malaysia that started from March 18. Some malls have offered rent free period for tenants that cannot operate during the period. Since the conditional MCO, most retailers at shopping malls are back to business with about 70% to 90% of the retailers opening for business one to two weeks after May 4. Most shopping malls are almost fully operating especially since the recovery MCO but we learn that mall traffic has not recovered to pre-MCO level. Based on channel checks some mall owners may continue to offer financial and/or non-financial assistance to their tenants on a case-by-case basis. Due to the differences in terms of rental aid and the on-going negotiation with the tenants, it is difficult at current juncture to quantify the impact to mall owner's rental income.

**COMPANY IN FOCUS**

**Sunway Real Estate Investment Trust**
Maintain **BUY** | Revised Target price: RM1.88
Price @ 20th July 2020: RM1.60

- Sunway REIT derives its rental income from multiple assets located in the integrated Sunway Township.
- The REIT manager looks to expand its portfolio further into the services sector that provides long-term recurring rental income.
- Its main rental income contributor, Sunway Pyramid Shopping Mall, is expected to register positive rental reversion once the pandemic is over. Near-term rental income should hold up well.

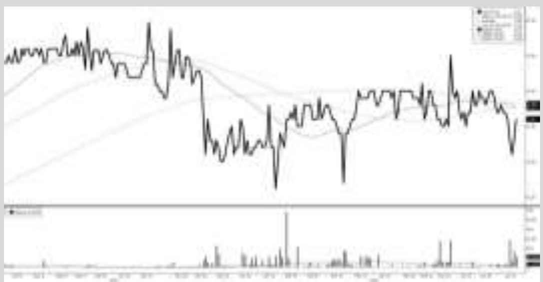
**Share price chart**



**Al-`Aqar Healthcare Real Estate Investment Trust**
Maintain **BUY** | Unchanged Target price: RM1.52
Price @ 20th July 2020: RM1.36

- We expect stable earnings outlook for Al-'Aqar due to rent renewal of 6 and 14 assets in FY20 and FY21 respectively.
- We like Al-`Aqar as it is a defensive healthcare REIT in Malaysia with stable earnings and low earnings downside risk.

**Share price chart**



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**Asset quality matters in the long-run.** In this respect, prime malls are likely to have an advantage over the smaller size neighbourhood malls as we believe that the rebates given by the less popular malls to maintain occupancy rates will be greater. Channel checks reveal that footfall have recovered to 60%-70% of that prior to the MCO. The main concern after footfall started to normalize will be the spending power of consumers as retailers have to brace with weaker consumer sentiment amid uncertainties. We opine that footfall may not recover fully in the near-term mainly due to social distancing. Another concern will be retailers' turnover as whether traffic will translate into sales is yet to be certain given the feeble consumer confidence. Opex-wise, mall operators may have to incur slightly more costs on more frequent sanitization and one-off costs for temperature checking and contact tracking systems. We only expect a larger cost in the event the mall has to be closed by the authorities if any positive cases were detected. However, higher opex costs as a result of sanitisation will be offset by lower utilities bills. That said, some REIT managers have indicated that they will be passing on the cost savings from electricity bills as a form of assistance to its tenants.

**Mall operators may have to be agile to add value to assets to retain customers.** Malls will have to reinvent themselves due to the change in consumer behaviour. How online shopping was going to change shopping malls has been on top of mall owners' minds and the pandemic is accelerating it. Mall owners are strengthening their digital capabilities such as communicating to their customers through social media platforms. Some malls have also come out with their own online shopping platforms where tenants of the mall can sell through the mall website as well. These sites may benefit the smaller tenants who do not have the resources to sell their merchants and goods online. More importantly, mall operators will have to adapt not only to change in consumer behaviours but also to adapt to the needs of their tenants in order to stay relevant. Since the MCO, retailers are likely to strengthen their e-commerce presence while adapting to new distribution channels in order to reach out to their customers. As a result, malls become a place for experience and not just shopping and buying things.

**Rethinking office space.** Although office assets are not directly hit by the MCO, the escalation of the working from home practice may shift the use of office space in the future. This comes as technology development makes working from home even more feasible. In the long-run, this may shift the demand in office space as companies may require to rent less space in order to operate at the same capacity. The trend may in turn negatively impact the office rental market in the medium to long-term. Besides that, there is also a probability of shift in preferred office locations as tenants may choose cheaper rental over prime locations. This can also be spurred by companies' business risk mitigation to have their operations split into different locations.

**Preserving cash is a trend across.** Some REIT managers have resorted to dividend reinvestment plans and/or lower frequency of payout in preparation for the unknown. To a certain extent, we may also be seeing lower dividend payout ratios than before, which poses downside risk to dividend yield. This may be due to the structure of REITs which requires them to fully pay out their income as dividends to shareholder, leaving them with minimal reserves. Two REITs that announced fewer rounds of income distribution are Sunway REIT and Amanahraya REIT from quarterly distribution to semi-annually. Although there are more uncertainties in the rental market, we understand that REIT managers will still be on the lookout for yield-accretive assets that fit their portfolios. That said, due diligence should be more stringent at this point and having commitment from quality tenants before acquiring a new asset is also more crucial than ever.

**Revision in Sunway REIT's earnings.** We also take this opportunity to revise our earnings estimates for Sunway REIT's core net income for FY20E/FY21F by -3.2%/-2.8% to RM275m and RM279m respectively. Previously we have not taken into consideration the possibly lower-than-expected rental income from the retail and hotel segment. We understand that the group may be providing further assistance to some of its retail tenants. As for the hotel segment, we think that the profit guarantee for some of its hotels may be lower than previous years due to the challenging business environment. This comes on the heel of master leases for Sunway Resort Hotel & Spa, Sunway Pyramid Hotel and Sunway Hotel Seberang Jaya which expired earlier this month. On the flip side, we notice that the REIT manager is continuing its effort in balancing its portfolio by adding other non-retail assets. Among others, it has announced to add Sunway Pinnacle, a Grade A office tower with almost full occupancy rate to its portfolio. This may create a more stable income stream in the longer-term. We see Sunway REIT as the proxy to the mature yet vibrant Sunway township which offers integrated infrastructure and facilities.

**Maintain NEUTRAL stance for the sector.** REITs used to be known for their predictability and ability to pay out dividend consistently but the latest results season proved that in an unprecedented crisis, their rental income may be adversely affected. Although low-yield environment usually bode well for REITs, we think that the underlying asset quality of the REITs will separate the wheat from the chaff in the long-run as good assets will be able to command positive rental reversion and maintain decent occupancy rates. Our top pick for the sector are Sunway REIT. We think that Sunway REIT is a proxy to the long-term sustainable growth of an integrated township while the vision of the REIT manager is to continue to create a balance portfolio across different asset class in order to sustain earnings growth. We also like Al'-Aqar Healthcare REIT due to their relatively visible core net income which comes from the rental of KPJ hospitals.

## Figure 1: Peer Comparison Table

| Stock | FYE | Rec. | Price @ 20 Jul | Target Price (RM) | Core EPU (sen) | | | Core PE (x) | | Net DPU (sen) | | Net Dvd Yield (%) | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | | | FY19 | FY20 | FY21 | FY20 | FY21 | FY20 | FY21 | FY20 | FY21 |
| AXREIT | Dec | NEUTRAL | 2.08 | 1.83 | 9.1 | 9.7 | 10.5 | 21.4 | 19.8 | 8.6 | 9.2 | 4.1 | 4.4 |
| CMMT | Dec | NEUTRAL | 0.74 | 0.69 | 6.6 | 5.4 | 6.3 | 13.6 | 11.7 | 5.7 | 6.5 | 7.7 | 8.8 |
| IGBREIT | Dec | NEUTRAL | 1.80 | 1.70 | 8.9 | 6.6 | 9.7 | 27.3 | 18.6 | 6.1 | 8.9 | 3.4 | 4.9 |
| PAVREIT | Dec | NEUTRAL | 1.62 | 1.73 | 8.2 | 5.3 | 6.8 | 30.6 | 23.8 | 5.0 | 6.4 | 3.1 | 3.9 |
| KLCC | Dec | NEUTRAL | 7.86 | 7.57 | 40.8 | 38.2 | 41.0 | 20.6 | 19.2 | 34.2 | 36.6 | 4.3 | 4.7 |
| SUNREIT | Jun | BUY | 1.60 | 1.82 | 9.6 | 9.7 | 10.6 | 16.5 | 15.1 | 8.6 | 9.6 | 5.4 | 6.0 |
| ARREIT | Dec | NEUTRAL | 0.67 | 0.68 | 5.7 | 5.7 | 6.0 | 11.8 | 11.2 | 5.0 | 5.2 | 7.4 | 7.8 |
| AL-'AQAR | Dec | BUY | 1.36 | 1.52 | 8.6 | 8.6 | 9.2 | 15.9 | 14.8 | 7.2 | 7.8 | 5.3 | 5.7 |
| **Average** | | | | | | | | | | | | **5.1** | **5.8** |

*Source: Company. MIDFR*

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# DISCLOSURES AND DISCLAIMER



| **MIDF AMANAH INVESTMENT BANK : GUIDE TO RECOMMENDATIONS** | |
|---|---|
| **STOCK RECOMMENDATIONS** | |
| **BUY** | Total return is expected to be >10% over the next 12 months. |
| **TRADING BUY** | Stock price is expected to *rise* by >10% within 3-months after a Trading Buy rating has been assigned due to positive newsflow. |
| **NEUTRAL** | Total return is expected to be between -10% and +10% over the next 12 months. |
| **SELL** | Total return is expected to be <10% over the next 12 months. |
| **TRADING SELL** | Stock price is expected to *fall* by >10% within 3-months after a Trading Sell rating has been assigned due to negative newsflow. |
| **SECTOR RECOMMENDATIONS** | |
| **POSITIVE** | The sector is expected to outperform the overall market over the next 12 months. |
| **NEUTRAL** | The sector is to perform in line with the overall market over the next 12 months. |
| **NEGATIVE** | The sector is expected to underperform the overall market over the next 12 months. |