

# Singapore Industry Focus

## Industrial REITs

Refer to important disclosures at the end of this report

DBS Group Research . Equity

30 Jan 2018

### Size really matters!

- A giant awakes in the industrial mid-cap space
- Short the acquirer, long the acquired? Not this time
- Size matters as the combined entity could see further re-rating on "liquidity" premium

**A giant awakes in the industrial space.** The proposed merger of ESR-REIT (ESR) and Viva Industrial Trust (VIVA) puts the M&A spotlight back into the mid-cap industrial REITs, which have been struggling to grow meaningfully through acquisitions. We remain excited about prospects of the combined entity (ESR-VIVA) as we see both sets of unitholders able to benefit and ride together with a potentially fourth largest industrial REIT (\$S\$1.7bn mkt cap, \$S\$3.1bn AUM) in Singapore, backed by a reputable sponsor in E-shang Redwood, which offers a sizeable pipeline of acquisition prospects and deal flow.

**Short the acquirer; long the acquired? Not this time.** With the target "VIVA" trading at a premium to NAV of 1.24x vs 1.0x for ESR, we see limited upside to play the "acquired" theme. In fact, VIVA's implied portfolio yield of 5.7% is already lower than ESR-REIT's portfolio yield of 6.0%, meaning that to bring about a win-win solution to both unitholders, a delicate balance must be sought. We estimate that a share swap at current price for VIVA (\$S\$0.95/share) and at NAV (\$S\$0.59/share) for ESR-REIT is appropriate as the post consolidated entity will result in (i) higher dividend yields for both sets of unitholders, (ii) minimal dilution to NAVs, and (iii) lower gearing, implying ample capacity to still expand through debt-funded acquisitions. Our call is to BUY ESR-REIT with **TP of \$S\$0.63**; with potential further re-rating upon completion of this M&A.

**Size matters! ESR -VIVA could re-rate by 15%-20% upon completion.** Investors have historically accorded large-cap REITs (1.36x P/NAV) with premium valuations compared to mid-cap industrial REITs (1.05x P/NAV), while ESR-REIT trades at the lower end of 0.96x P/NAV. Upon potential combination of both REITs, we see that ESR-VIVA may trade higher towards the higher multiples that the larger cap industrial REITs are trading at.

**Who is next?** We believe that other mid-cap industrial REITs will be accorded an "acquisition premium" post this M&A as investors speculate the next target. On that front, **Soilbuild REIT** is an interesting targets given similar Sponsor and shareholder structures respectively. However, the timing and certainty of any deal is tough to identify.

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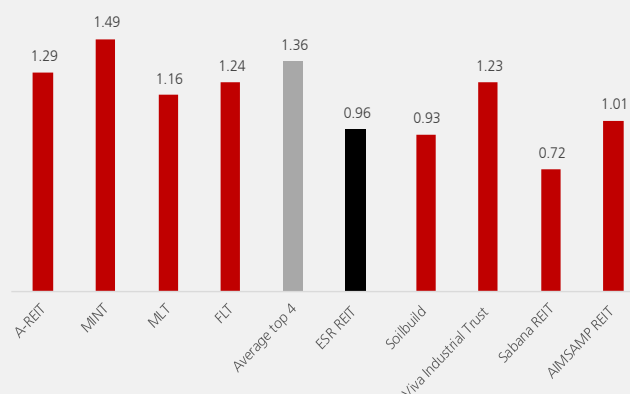
	Price S\$	Mkt Cap US\$m	12-mth Target Price S\$	Performance (%)		Rating
				3 mth	12 mth	
ESR-REIT	0.57	571	0.63	1.8	2.7	BUY
Soilbuild Business Space Reit	0.69	553	0.62	3.0	7.8	HOLD

Source: DBS Bank, Bloomberg Finance L.P.

Closing price as of 29 Jan 2018

#### Potential to close NAV gap Tables or Charts

Price to NAV multiples (x)



Source: DBS Bank

## Our thoughts on the proposed merger

**What's news? A proposed merger between ESR-REIT and VIVA.** Both ESR-REIT and Viva Industrial Trust (VIVA) requested for trading halt on Friday, 26 January. Immediately after, Bloomberg reported that, according to a source from ESR-REIT, the two REITs are in merger talks, the terms are under negotiation and with no certainty that this will lead to a transaction. On Monday, 29 January, announcements from both ESR-REIT and VIT confirmed talks on the proposed merger. According to both managers, the proposed merger will be effected by ESR-REIT acquiring all the issued and paid-up stapled securities of VIT via the issue of new ESR-REIT units.

**Potential to be the fourth largest industrial S-REIT.** With mid-cap industrial REITs struggling to deliver inorganic growth over the past years, the consolidation of ESR-REIT and VIT enable two mid-sized REITs to leapfrog onto the "big stage"; closing the gap in terms of asset under management (AUM) with the larger cap industrial REITs like Ascendas REIT (A-REIT), Mapletree Logistics Trust (MLT), and Mapletree Industrial Trust (MINT).

ESR-REIT's market capitalisation was ~S\$742m based on the closing price on Thursday, while VIT was valued at ~S\$912m. The combined portfolio will potentially be the fourth largest industrial S-REIT, with a market cap of S\$1.5bn with an AUM of close to S\$3bn. Meanwhile, the post-merger portfolio will

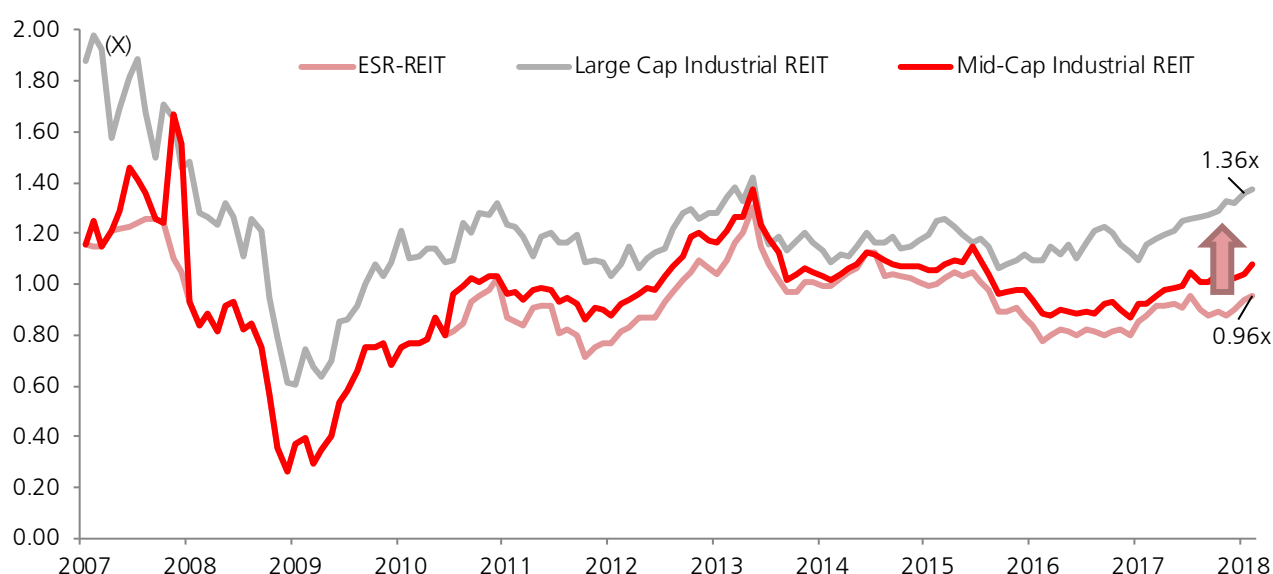
increase ESR-REIT's exposure to business parks from 2% to 30%.

**Multiple expansion; combined ESR-VIVA REIT could trade at lower yields.** Support of a larger Sponsor (e-Shang Redwood) implies better access to debt and capital markets coupled with a visible acquisition pipeline and sourcing capability. This will empower the combined ESR-VIVA with additional firepower to pursue inorganic growth opportunities.

In fact, investors tend to accord a lower cost of capital for REITs with "growth" as seen in the valuation gap between larger cap industrial REITs and mid-cap industrial REITs. On a P/NAV basis, large cap industrial REITs are trading at an average multiple of 1.35x P/NAV, which is a 0.30x premium to the mid-cap industrial REITs, and higher than the long term average of 0.23x. ESR-REIT, which currently trades at a P/NAV of close to 0.96x, could potentially trade closer to the larger cap industrial REITs, implying potential upside of up to 15%-20%.

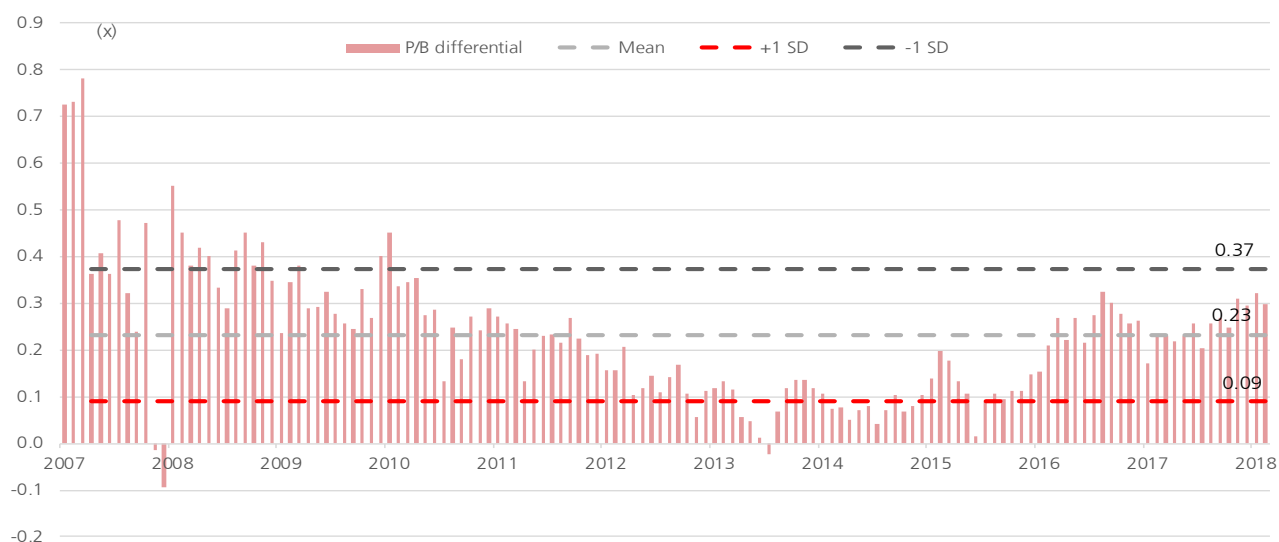
On a yield basis, the larger cap industrial REITs are trading at an average yield of 5.9%, which is more than 1.5% lower than the mid-cap industrial peers, implying there is potential for the post consolidated ESR-VIVA REIT to close that gap in the medium term.

## Premium of Industrial REITs (large cap vs mid-cap and ESR-REIT)



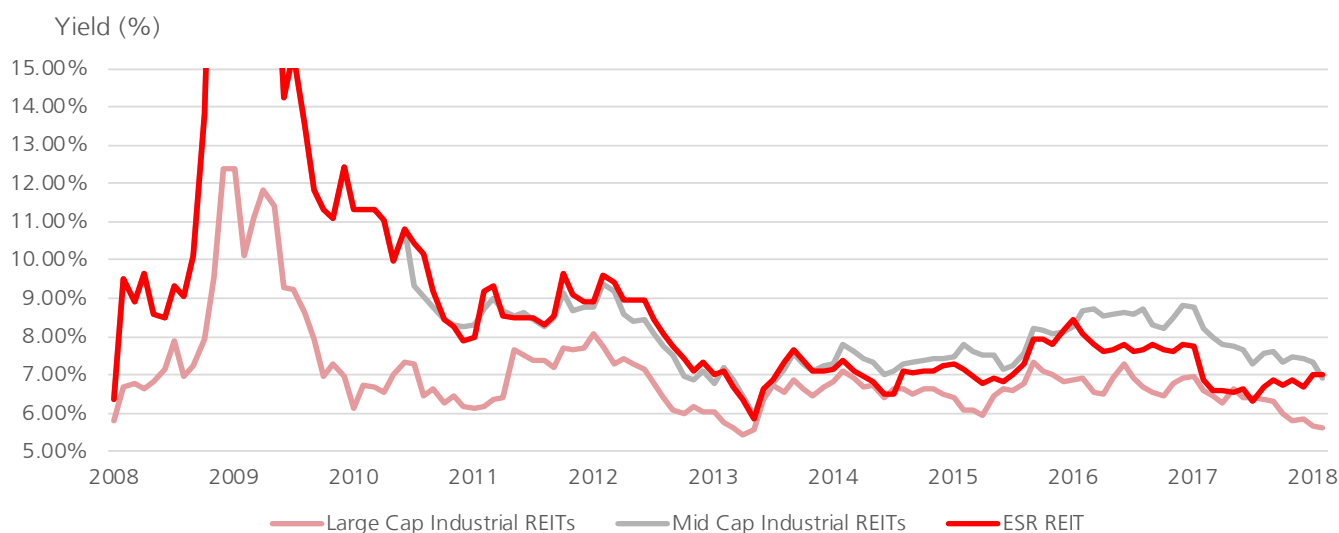
Source:: Bloomberg Finance L.P., DBS Bank

### Historical Premium between large cap industrial REITs (A-REIT, MLT & MINT) vs other industrial REIT peers



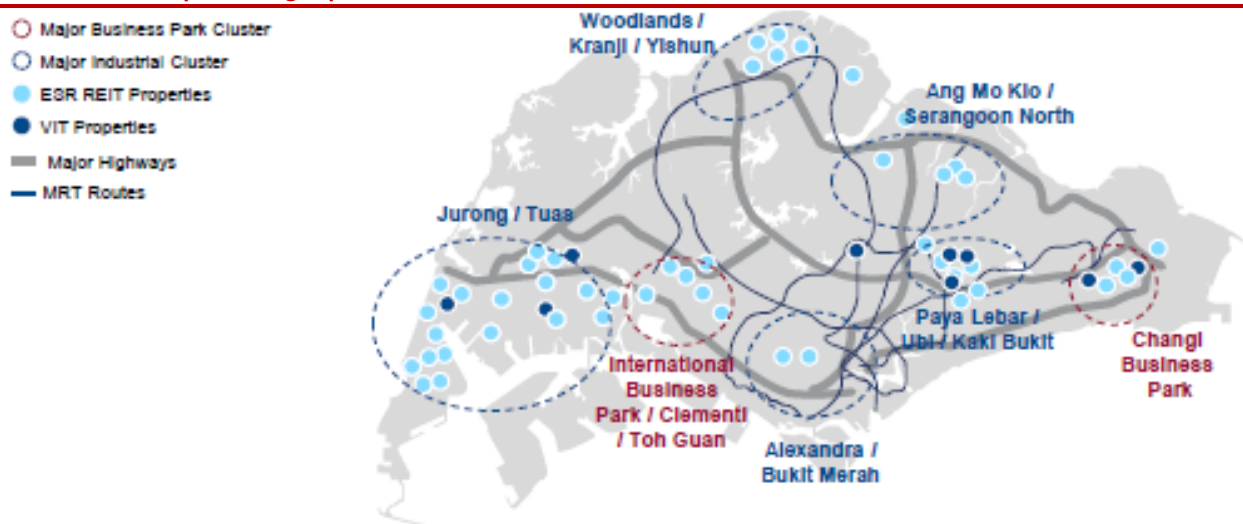
Source: Bloomberg Finance L.P., DBS Bank

### ESR REIT trades at an average of 7.0% yield which is more than 1.5% above large cap REITs



Source: SGX, corporate filings, DBS Bank

## Overview of the post-merger portfolio



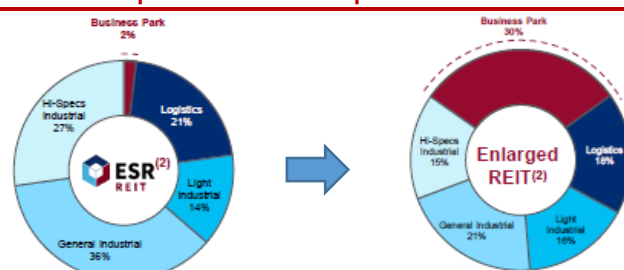
Source: SGX, corporate filings, DBS Bank

## Change in the portfolio matrix

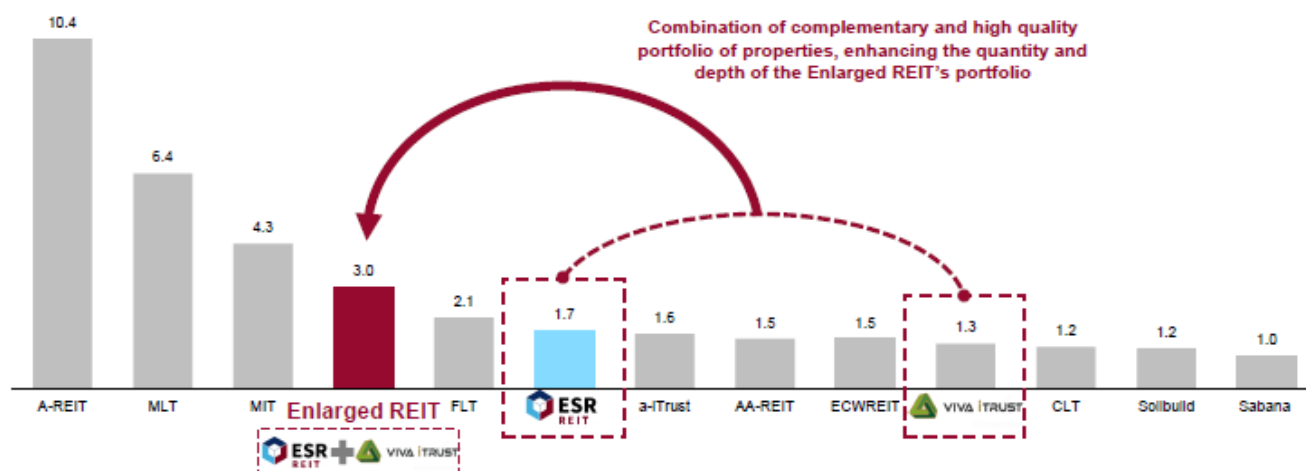
	ESR-REIT <sup>(1)</sup>	VIT <sup>(1)</sup>	Enlarged REIT	
No. of Properties	48	9	57	+18.8% ▲
Total GFA	c. 9.9m sq ft	c. 3.9m sq ft	c. 13.8m sq ft	+39.4% ▲
Property Value	S\$1.7bn	S\$1.3bn	S\$3.0bn	+76.7% ▲
No. of Tenants	207	155	362	+74.9% ▲

Source: SGX, corporate filings, DBS Bank

## Increased exposure to business parks



## Enlarged portfolio will potentially be the fourth largest industrial S-REIT



Source: SGX, corporate filings, DBS Bank

## Potential synergies and benefits

**Potential synergies.** While qualitative benefits of having a combined portfolio size of S\$3bn and potential market cap of S\$1.7bn will certainly put ESR-VIVA up against the big boys, we believe the management team has to work towards gaining investor confidence that they are able to execute and deliver value to unitholders in the medium term.

We note that portfolio matrices are fairly similar; we note that VIVA's portfolio is more concentrated with valuations at close to S\$1.3bn over 9 properties while ESR REIT's S\$1.7bn portfolio is diversified over 48 properties. Occupancy rates are also fairly high at north of 90% with fairly long weighted average lease expiries (WALE). VIVA's WALE is shorter with potential for ESR to negotiate and reposition some of the properties upon expiry of master leases.

While no forecasts are provided at this moment, we believe that potential synergies will hinge on the ability to extract operational cost savings through having 2 portfolios in close proximity, allowing the manager to better manage tenancies

and potentially extract savings through better negotiations on maintenance contracts going forward. The immediate savings in our view is to re-finance VIVA's cost of debt, which as of 30<sup>th</sup> Dec'17, is c.0.45% (45 basis points) higher than ESR-REIT's. We estimate that every 0.5% reduction in interest rate will lead to a 2% improvement in the combined ESR-VIVA REIT's net property income.

**The start of more to come?** We are positive on this potential merger & acquisition (M&A) if it comes to fruition, as we believe this is only the first step for a larger, more capable and more liquid industrial S-REIT in Singapore to emerge. To recap, ESR-REIT also has a 5% stake in Sabana REIT. A series of further M&A steps could emerge if ESR-REIT and Warburg Pincus' partner Mr Tong Jinquan (a significant unitholder of ESR-REIT, Sabana REIT, VIVA and Soilbuil REIT) consolidate their stakes. Please find details in the report published in March 2017: [Catalyst Aboard](#)

## Salient details of ESR and VIVA

Details as of 31st Dec 2017	ESR REIT	VIVA
WALE (Rental)	4.3 years	2.6 years
Weighted Average Land Lease (by valuation)	33.8 years	33.7 years
# of assets in portfolio	48	9
Valuations (SGDm)	1,675.8	1,284.7
Portfolio Occupancies	93.0%	90.6%
Portfolio NLA ('m sqft)	9	3.3
Portfolio GFA ('m sqft)	9.9	3.9
Weighted avg all-in cost of debt	3.55%	3.90%
Debt profile	All unsecured debt	Secured against 7 out of 9 properties
Debt maturities (SGDm) - 2018	155	100
Debt maturities (SGDm) - 2019	107	0
Debt maturities (SGDm) - 2020	160	213
Debt maturities (SGDm) - >2020	250	197
Total Debt (SGD'm)	672	510

Source: company, DBS Bank

### How does the combined REIT look like?

Based on our back of the envelope calculations, we estimate that the combined entity (ESR-VIVA) could potentially see higher distribution yield of c.7.5% and lower combined gearing of 35.6% implying headroom to acquire further. This based on the assumption that the equity share swap is priced at (i) VIVA's current market price and (ii) ESR REIT's NAV.

**The acquired (VIVA) is trading at a higher P/NAV multiple than the acquirer (ESR) - limits upside to VIVA.** VIVA, by virtue of having a portfolio with a higher weighting to business park assets - which are valued higher among industrial asset classes

in Singapore - is trading at a P/NAV multiple of 1.25x, or at an implied yield of 5.7% (net property income / enterprise value). This is slightly lower than ESR REIT's implied yield of 6.0%, and the stock is trading at a slight discount to its NAV.

Therefore, for the deal to be accretive to both sets of unitholders, we believe that a swap price could potentially be close to current prices in order for the math to work. To prevent dilution, the minimum price for ESR-REIT will be likely be set at the REIT's current NAV of S\$0.59/unit as of 31<sup>st</sup> Dec'17, representing an upside of c.4.4% from the last close of S\$0.565/unit.

	VIVA	ESR REIT	Combined	Remarks
Financials	(Annualised)	DBS FY18F Forecast		
<b>Income Statement</b>	<b>S\$m</b>	<b>S\$m</b>	<b>S\$m</b>	
Revenue	113.4	139.2	252.6	
Net Property Income	82.6	98.0	180.6	
Distributable Inc	69.8	62.5	132.3	
<b>Balance Sheet: As of Dec'17</b>	<b>S\$m</b>	<b>S\$m</b>	<b>S\$m</b>	
Total Assets	1,310.1	1,677.0	2,987.1	
Goodwill	-	-	180.4	Difference for paying for VIVA above NAV
Total Cash	8.3	36.0	44.3	
<b>Total Assets</b>	<b>1,318.40</b>	<b>1,713.00</b>	<b>3,211.8</b>	
Total Financial Debt	525.0	620.0	1,145.0	
Other liabilities	46.8	43.0	89.8	
<b>Total Liabilities</b>	<b>571.8</b>	<b>663.0</b>	<b>1,234.8</b>	
<b>Net Assets</b>	<b>746.6</b>	<b>1,050.0</b>	<b>1,977.0</b>	
Total Shareholder equity	746.6	898.5	1,825.5	
Total Perpetual Securities	-	151.5	151.5	
<b>Total Equity</b>	<b>746.6</b>	<b>1,050.0</b>	<b>1,977.0</b>	
Total Shares	975.8	1,533.7	3,115.98	Assumed 1 VIVA REIT = 1.31 ESR share at current price
NAV per share	0.77	0.59	0.59	
NTA per share	0.77	0.59	0.58	Slight dilution
Last traded price	0.95	0.565	-	
<b>Financial Metrics</b>				
<b>Market Cap (S\$m)</b>	927	867	<b>1,761</b>	ESR REIT market cap: assume S\$125m of new equity raised at NAV
<b>Enterprise Value (S\$m)</b>	1,443.67	1,602.03	3,012.73	
Implied Yield (%)	5.7%	6.1%	6.0%	Yield: slight dip
Distribution Yield (%)	7.5%	7.2%	<b>7.5%</b>	Dividend yield improves
Gearing (%)	39.8%	36.2%	<b>35.6%</b>	Gearing level improves

Source: Companies, DBS Bank

DBS Bank recommendations are based on Absolute Total Return\* Rating system, defined as follows:

**STRONG BUY** (>20% total return over the next 3 months, with identifiable share price catalysts within this time frame)

**BUY** (>15% total return over the next 12 months for small caps, >10% for large caps)

**HOLD** (-10% to +15% total return over the next 12 months for small caps, -10% to +10% for large caps)

**FULLY VALUED** (negative total return i.e. > -10% over the next 12 months)

**SELL** (negative total return of > -20% over the next 3 months, with identifiable catalysts within this time frame)

*Share price appreciation + dividends*

Completed Date: 30 Jan 2018 08:27:30 (SGT)

Dissemination Date: 30 Jan 2018 09:11:00 (SGT)

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