Office SREIT

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DBS Group Research . Equity

16 Jun 2021

Return-to-office gains momentum

- Office SREITs leveraged into the re-opening theme not fully appreciated by investors
- Singapore office to regain growth momentum in 2H21 after expected relaxation of work-in-office occupancies
- US Office S-REITs well positioned to ride the longer-term growth of tech within the US
- Top picks are KREIT, MCT and PRIME

Office SREITs' leverage on "re-opening theme" not fully appreciated by the market. Despite keeping DPU relatively stable through FY20, the share prices of SG Office SREITs and US Office SREITs have lagged the recovery compared to other sectors. SG Office SREITs and US Office SREITs are still trading at 13% to 17% below pre-COVID levels, a steeper discount vs SREITs' 7% discount. Keppel REIT (KREIT), a pure office SREITs, is still trading below pre-COVID levels despite delivering DPU growth throughout the pandemic. We believe Office SREITs will play catch up soon.

Singapore office en route towards 'new normal' despite recent setbacks. Singapore office recovery was gaining momentum since January, but this was halted by the implementation of phase 2 (heightened alert). We see this disruption as temporary and do not expect office tenants to undertake major shifts in their office requirements as they plan 2 to 5 years ahead. Overall office metrics in 1Q21 has been stable (URA reported 3% q-o-q increase in 1Q21 rents) and vacancy in core CBD remained low at 3.3% according to CBRE. We believe the recovery will resume come 2H21 as (i) cap on workers returning to office is relaxed, and (ii) companies restart their leasing discussions.

US corporations starting to return-to-office from mid-year onwards. Since April, media reports indicate that more corporates and banking institutions are planning to return-to-office from mid-year onwards, which is positive for overall sentiment of US office plays in 2H21. While occupancies had dipped to c.90% in 1H21, we believe we are nearer the bottom as companies start planning for their longer-term real estate needs. The US Office SREITs' focus on the Sun-belt /18-hr cities provides for a longer-term growth runway for their respective portfolios, driving an upward DPU trajectory.

Top picks are KREIT, MCT for Office SREITs and PRIME for US Office SREITs. We maintain our positive stance on Office SREITs. Our top picks are KREIT, Mapletree Commercial Trust (MCT) for SG Office SREITs and Prime US REit (PRIME) for US Office SREITs for their quality portfolios.

STI : 3,153.14

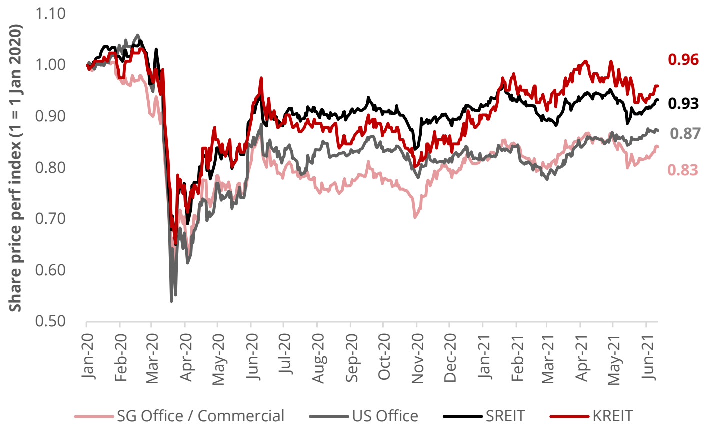
Analyst
Rachel TAN +65 6682 3713
racheltanlr@dbs.com
Derek TAN +65 6682 3716
derektan@dbs.com

STOCKS

	Price S$	Mkt Cap US$m	12-mth Target Price S$	Performance (%) 3 mth	12 mth	Rating
Keppel REIT	1.20	3,248	1.40	(0.9)	1.7	BUY
Mapletree Commercial Trust	2.17	5,247	2.25	1.5	2.5	BUY
Suntec REIT	1.50	3,159	1.85	(5.8)	0.0	BUY
OUE Commercial REIT	0.41	1,664	0.50	6.6	1.3	BUY
Manulife US Real Estate Inv	0.76	1,186	0.90	5.7	(1.3)	BUY
Prime US REIT	0.86	913	1.00	8.2	9.6	BUY
Keppel Pacific Oak US REIT	0.76	696	0.85	6.5	3.5	BUY

Source: DBS Bank, Bloomberg Finance L.P.
Closing price as of 15 Jun 2021

Share performance of Office / Commercial SREITs and US Office SREITs during the pandemic



Source: DBS Bank

Navigating the new normal of work

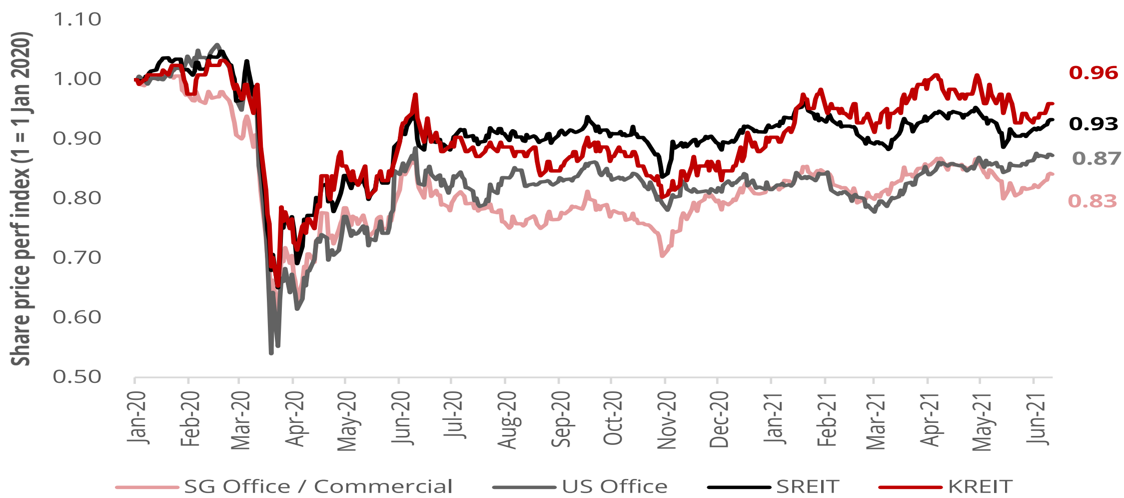
Re-opening play. Since the COVID-19 vaccines were discovered and more evidence of the efficacy of these vaccines, countries that have pushed and accelerated their vaccination rollouts are now preparing to reopen. Singapore and the US are among the countries globally that have achieved more advanced vaccination rates.

As the situation continues to improve, corporates are progressively planning the return of their employees back to the office. However, as the hybrid working model (flexible work arrangement) could be the trend in the near future, corporates will need to strike a balance to maintain an optimal office space as less employees utilize the office at any point in time, versus ongoing expansion in the coming future.

Share price recovery of SG Office SREITs and US Office SREITs have lagged the other sectors despite relatively stable DPUs. Despite maintaining relatively stable earnings, the share price performance of SG Office SREITs and the US Office SREITs have lagged the recovery seen in the other sectors. SG office / commercial SREITs and US Office SREITs are still trading 13% to 17% below pre-COVID levels, which is a steeper discount vs SREITs at 7% below pre-COVID levels. Even Keppel REIT (KREIT), a pure office SREIT, is still trading below pre-COVID levels despite delivering DPU growth throughout the pandemic (please refer to the chart below).

When compared to the pre-COVID share prices (Jan 2020), SREIT share prices are on average c.10% below pre-COVID levels. When we review the share price performance by sectors, industrial SREITs have performed in line with earnings/DPU recovery, with both (earnings & share price) rebounding close to / slightly ahead of pre-COVID levels. The office sector appears to be the biggest laggard. Despite recently reporting DPU growing to 5.9% above the pre-COVID level, the share prices of Office SREITs (KREIT) are still 6.3% below pre-COVID levels. Similarly, the office / commercial sector recorded DPU that is 2.4% below the pre-COVID levels but share prices are showing a deeper discount of -16.4% vs. pre-COVID levels. US office SREIT share prices are showing a deeper discount of -14.4% vs. the pre-COVID levels compared to its latest reported DPU of a 4.4% decline vs. pre-COVID level (please refer to the table below).

Share performance of SG Office / Commercial SREITs and US Office SREITs during the pandemic



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

DPU vs share price decline and recovery during the COVID-19 pandemic

Sectors	Est. DPU decline due to lockdown Lowest quarter in FY20 vs 2019	Est. DPU recovery post Circuit Breaker (Dec20 / Mar21) vs 2019	Trough vs pre-COVID (Jan20 to Oct20)	Before Phase 2 (HA) to trough (Apr21 to May21)	Now vs pre-COVID (Jan20 to Jun21)	Before Phase 2 (HA) vs pre-COVID (Jan20 to Apr21)
Office / Commercial	-22.9%	-12.4%	-28.4%	-7.8%	**-16.4%**	-13.8%
Office (KREIT)	0.7%	5.9%	-19.7%	-6.4%	**-6.3%**	-1.6%
US Office	-3.6%	-4.4%	-21.8%	-2.2%	**-14.4%**	-15.3%
Retail	-67.0%	-16.4%	-28.6%	-7.4%	-14.1%	-13.0%
Industrial	-5.4%	3.9%	-6.8%	-4.6%	1.4%	0.7%
Industrial (ex-KDC)	-10.7%	-0.1%	-10.4%	-4.5%	0.2%	-1.1%
Hospitality	-71.6%	-47.7%	-36.4%	-9.0%	-21.6%	-18.8%
SREIT	-28.3%	-11.8%	-21.8%	-6.8%	-9.8%	-8.1%

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

Marginal decline in office occupancy (both Singapore and the US) throughout the pandemic. Throughout the pandemic, contrary to fears in the market, office occupancy rates have held relatively stable. Overall, office metrics were relatively healthy and we expect downside risks to fade as both Singapore and the US prepare for reopening into a 'new normal'.

The SG Office SREITs saw only a marginal 2.2 ppt decline in overall average occupancy in their respective office portfolios. Despite the decline, average occupancy remained healthy at c.95%. Average rental reversions were positive even though the quantum had declined by more than two-thirds, which would support earnings. The positive office rental reversions have outperformed overall market rents which had declined c.10% throughout the pandemic.

The US Office SREITs saw a slightly bigger impact on occupancy. Average occupancy declined by 3.3ppts, hitting closer to the 90% level. Rental reversions remained positive despite seeing a dip in reversionary quantum.

For both SG Office SREITs and US Office SREITs, gearing inched up marginally but average gearing remained below 40%. A handful of SREITs such as Suntec, OUE Commercial Trust (OUECT) and Manulife US REIT (MUST) saw gearing (as at 1Q21) rise above 40%.

Singapore office sector en-route towards 'new normal' despite recent setbacks. Singapore office sector was en-route towards a recovery when office rents stabilised in 1Q21 (URA reported 3% increase q-o-q in 1Q21) and vacancy in core CBD remained low at 3.3% (based on CBRE). Despite the recent setback from implementation of phase 2 (heightened alert), we do not expect office tenants to undertake major shifts in their office requirements as they plan 2 to 5 years ahead. For Singapore corporations / institutions, the first stage of return-to-office took place when the country moved into phase 3 of reopening at the end of 2020. In our previous report (Darkest before down, published on 30 April 2021), we note that most banks that are expecting to downsize have already announced their plans and the average downsizing was about 20%, below market expectations of 30%. As such, we remain optimistic that we may see a change in sentiment in 2H21.

As the vaccination program is pushed forward, we expect Singapore will be able to overcome the recent new wave of transmissions and move to a 'new normal'. Currently, we understand that c.30% of the population has been fully vaccinated, and the target is at least 75% by Oct 2021. Vaccination is now open to the last age group, which is below age 40.

US corporations starting to return-to-office from mid-year onwards. In the US, vaccinations have substantially reduced the number of daily new cases. Currently, c.43% of the population has been fully vaccinated and more than half has received 1 dose. More than half of its adult population has already been fully vaccinated. As such, the number of daily new cases has fallen to less than 14k cases vs a peak of more than 400k cases.

Since April, we have been hearing news on corporates and banking institutions planning to return-to office from mid-year onwards. The situation remains fluid until corporations and banking institutions firm up their policy on their working models. While the work-from-home / flexible work arrangements may have a greater impact in the US given the larger geographical spread and longer commute to work (as seen in the recent announcement made by Facebook to allow permanent work-from-home globally), we believe sentiment could take a turn in 2H21 as the country progressively returns to normalcy.

Top picks KREIT, MCT for SG Office SREITs and PRIME for US Office SREITs. We maintain our positive stance on the office sector. We believe corporates and institutions will start to review their expansion plans as the economy recovers and hiring begins again. Our top picks for SG Office SREITs are KREIT and MCT, and PRIME for US Office SREITs as their best-in-class portfolios will likely emerge strong post pandemic.

Office metrics throughout pandemic

	Pre-COVID			Latest		
	Occupancy (office only)	Est rent reversions	Gearing	Occupancy (office only)	Est rent reversions	Gearing
SG Office						
KREIT	98.7%	14.4%	35.7%	96.5%	10.9%	35.2%
MCT	97.8%	8.7%	33.1%	93.1%	0.4%	33.9%
Suntec	99.2%	n/a	38.6%	96.7%	-0.9%	44.4%
OUECT	90.4%	15.3%	39.4%	91.7%	4.0%	40.4%
Average	96.5%	12.8%	36.7%	94.5%	3.6%	38.5%
US Office						
MUST	97.4%	12.1%	37.6%	92.0%	2.1%	41.3%
PRIME	95.8%	10.5%	33.7%	91.7%	8.5%	33.8%
KORE	92.1%	10.0%	38.1%	91.6%	5.7%	37.5%
Average	95.1%	10.9%	36.5%	91.8%	5.4%	37.5%

** Simple average for all metrics; estimated rental reversions will be a simple average on the range of rental reversions*
Source: Company, DBS Bank

Salient points from the DBS-SGX-REITAS Conference (US Office participants)

	Manulife US REIT	Prime US REIT	Keppel Pacific Oak US REIT
Navigating past COVID:	• Physical occupancy rates have improved to c.20% (May'21) but the manager is looking at possibly hitting physical occupancy of up to 80% by 4Q21. • A tenants' market currently and tenant improvements (Tis) undertaken to attract tenants. • More renewals now rather than new leases being signed but expect demand to pick up in 2H21.	• Tenants are returning to offices in phases and expect most to return by 4Q21. • Discussions around short term extensions have tapered off in the recent quarter. • Focus is to work with tenants to understand their needs and footprint, with an office design that is "future ready" as companies start planning for the longer term.	• Tech firms are leading the leasing demand and while physical occupancy rates remain in the 20% region, expect a strong run-up in 2H21. • Occupancy rates to bottom somewhat in 3Q21/4Q21 once companies finalise plans on their longer-term space needs (i.e. more flexible options etc). • Reversions should remain stable and positive.
Acquisitions	• Continues to target magnet cities with growing tech presence, healthcare supported by population growth and corporate in-migration with lower cost of living. • Targeting to acquire properties with cap rates of 6.5%-7.5%.	• Guided by deepening exposure within the tech, healthcare sectors and cities that support in-migration. • Cap rates are similar to pre-COVID levels and ample capital is chasing quality assets. • Conservative gearing profile at 33% with significant headroom to leverage on.	• Looking for cities/ in-migration destinations with attractive lifestyle, amenity-rich locations, and cities offering ample employment. • Seeing contraction in cap rates below pre-pandemic levels for quality assets. • Keen to grow its presence in the "Super Sun Belt" and "18-hr cities".

Salient points from the DBS-SGX-REITAS Conference (SG Office participants)

Highlights	OUE Commercial Trust	Keppel REIT
Navigating past COVID:	• Quality asset base and diversified tenant base anchors stable cashflows; positive rental reversions will likely continue in 2H21 with key anchors secured and expiries significantly "de-risked". • Leasing sentiment and momentum has been doused in the near-term, but the manager is seeing some relocation demand as tenants undertake "flight to quality" to offices with better specifications; OUE Bayfront and Downtown are enjoying some of this demand. • Some challenges for retail tenants located in the CBD and Orchard impacted by lack of workers and tourists respectively. Strategy is to sign on tenants on short term leases (existing and prospective) given the cloudy operational outlook. Manager to continue to provide financial aid to tenants to tide them over in the immediate term.	• Had started to see strong return of office employees prior to the recent "shut-down"; expect this trend to return in 2H21. • Office rents may turnaround sometime in 2H21; although the momentum has somewhat slowed with phase 2 (heightened alert); hope that we get out of this phase in the medium term. • While financial institutions occupy the bulk of its space, the manager is working to "back-fill" potential vacancy and lack of supply in the market is supporting them. • Tenants are looking for options with flexible expansion and return options. • Tough to grow the business with a largely remote working environment and expect companies will over time bring employees back to office.
Acquisitions:	• Commercial properties in gateway cities which are business hubs supported by strong demand fundamentals. • Looking at possibly expanding to Asia and Europe and deploy proceeds from the sale of its stake in OUE Bayfront.	• Looking to divest selected assets in Australia and remains keen to redeploy capital into Sydney and Melbourne. • Gearing expected to be a low at c.39%; have S$200m-S$300m debt headroom. • Unlikely to tap perpetuals; the manager may use a mix of debt and equity to fund any acquisitions if needed.

Source: Company, DBS Bank

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**Share price appreciation + dividends*

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DBS Regional Research Offices

HONG KONG
DBS (Hong Kong) Ltd
Contact: Carol Wu
13th Floor One Island East,
18 Westlands Road,
Quarry Bay, Hong Kong
Tel: 852 3668 4181
Fax: 852 2521 1812
e-mail: dbsvhk@dbs.com

MALAYSIA
AllianceDBS Research Sdn Bhd
Contact: Wong Ming Tek
19th Floor, Menara Multi-Purpose,
Capital Square,
8 Jalan Munshi Abdullah 50100
Kuala Lumpur, Malaysia.
Tel.: 603 2604 3333
Fax: 603 2604 3921
e-mail: general@alliancedbs.com
Co. Regn No. 198401015984
(128540-U)

SINGAPORE
DBS Bank Ltd
Contact: Janice Chua
12 Marina Boulevard,
Marina Bay Financial Centre Tower 3
Singapore 018982
Tel: 65 6878 8888
e-mail: groupresearch@dbs.com
Company Regn. No. 196800306E

THAILAND
DBS Vickers Securities (Thailand) Co Ltd
Contact: Chanpen Sirithanarattanakul
989 Siam Piwat Tower Building,
9th, 14th-15th Floor
Rama 1 Road, Pathumwan,
Bangkok Thailand 10330
Tel. 66 2 857 7831
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INDONESIA
PT DBS Vickers Sekuritas (Indonesia)
Contact: Maynard Priajaya Arif
DBS Bank Tower
Ciputra World 1, 32/F
Jl. Prof. Dr. Satrio Kav. 3-5
Jakarta 12940, Indonesia
Tel: 62 21 3003 4900
Fax: 6221 3003 4943
e-mail: indonesiaresearch@dbs.com