18 July 2019

Property | REITS

Keppel-KBS US REIT (KORE SP)

Buy (Maintained)

Key Takeaways From Investor Meeting

Target Price (Return)	USD0.88 (+7%)
Price:	USD0.82
Market Cap:	USD674m
Avg Daily Turnover (SGD/USD)	1.6m/1.2m

- **Maintain BUY with USD0.88 TP, 7% upside with 7.5% FY19F yield.** Yesterday, we hosted a meeting between Keppel-KBS US REIT's (KORE) management and institutional investors post-2Q19 results. Key questions were on sustainability of occupancy and rental rate growth, market outlook, tenant retention strategies, potential acquisitions/funding structure and taxes. In summary, management expects strong rental rate growth to continue, with key markets of Seattle, Austin and Denver still in a sweet spot (demand far exceeding supply).
- **High single-digit rental reversions expected until 2020.** Rental growth remains strong, with Seattle assets registering double-digit rental reversions in 1H. Houston is the only market still seeing flattish-to-slightly negative rental growth. While overall rental reversion came in slightly lower QoQ, this was largely on the nature and timing of lease renewals. Note that rental reversions are on top of rental escalations of ~3% pa.
- **With most of the incoming supply in its core markets already pre-committed, this rental growth trend is expected to continue in the near term.** Portfolio average rentals are still 10-20% below asking rates, so management remains confident of achieving high single-digit rental rate growth until 2020. The majority (60%) of leases due for renewal in 2020 (14% of total leases) are from Seattle assets. While one of its key tenants, Blucora (The Plaza Buildings, Seattle), is expected to leave upon its lease expiry in 2020, two of the building's tenants have already expressed interest in taking up that vacant space.
- **Acquisitions and fund-raising.** Management sees potential for ~USD100m in acquisitions later this year in sub-markets of key growth cities like Austin, Denver, Salt Lake City, Charlotte and North Carolina – where office capitalisation rates (~6-7%) are still attractive. Besides the sponsor's portfolio, it's also looking at third-party assets for acquisition. Funding is likely to be via a combination of debt and equity. Potential equity raising will likely be in the form of placement/preferential offerings, and management does not see a need for any rights issue in the near term. Gearing is at 38%, implying limited debt headroom of ~USD80m (assuming 40% as a comfortable level).
- **Potential upside from rollback in tax structure.** KORE is currently awaiting the finalisation of proposed US tax regulations (Dec 2018) that are expected to be announced by year-end. Based on the proposed regulations, the REIT should be able to roll back to its IPO tax structure – avoiding the need for a Barbados entity – that is likely to result in additional tax savings of ~2% (which is the tax paid at the Barbados entity). Management noted that such tax structure changes will incur minimal one-off costs (<USD1m) and can be completed within 1-2 months.

Forecasts and Valuation	Dec-18*	Dec-19F	Dec-20F	Dec-21F
Total turnover (USDm)	106	120	125	128
Net property income (USDm)	64	74	76	78
Reported net profit (USDm)	53	55	57	59
Distributable income (USDm)	44	50	52	54
DPS (USD - cents)	6.2	6.1	6.3	6.5
DPS growth (%)	-	(1.8)	3.8	2.7
P/BV (x)	1.0	1.0	1.0	1.0
Dividend Yield (%)	7.6	7.5	7.7	7.9
Return on average equity (%)	9.6	10.1	10.3	10.4
Return on average assets (%)	5.9	5.9	6.0	6.0
Interest coverage (x)	4.3	3.5	3.5	3.5
Total Debt to assets (%)	34	38	38	38

*Source: Company data, RHB; Note: *Since listing in Nov 2017 to Dec 2018*

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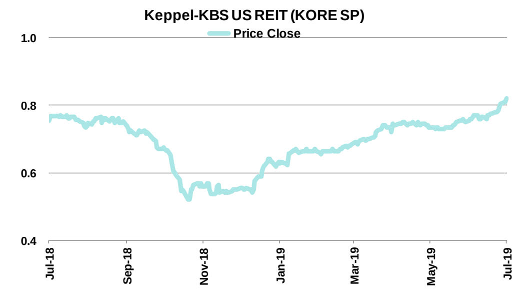
Share Performance (%)

	YTD	1m	3m	6m	12m
Absolute	34.4	8.6	10.1	26.2	0.3
Relative	24.8	3.7	9.6	21.5	(3.5)
52-wk Price low/high (USD)					0.53 - 0.83



Source: Bloomberg

Houston market is stabilising, healthy demand for spec suites. Management addressed investor concerns on Houston's office market, which has been showing recovery signs over the last two years after being impacted by the fallout in the oil & gas sector. The slow recovery has been mainly due to the large availability of shadow space in the market, which are now mostly taken up. There has been strong demand for spec suites (2,000-5,000 sqf) from tenants in the market looking to immediately occupy the space.

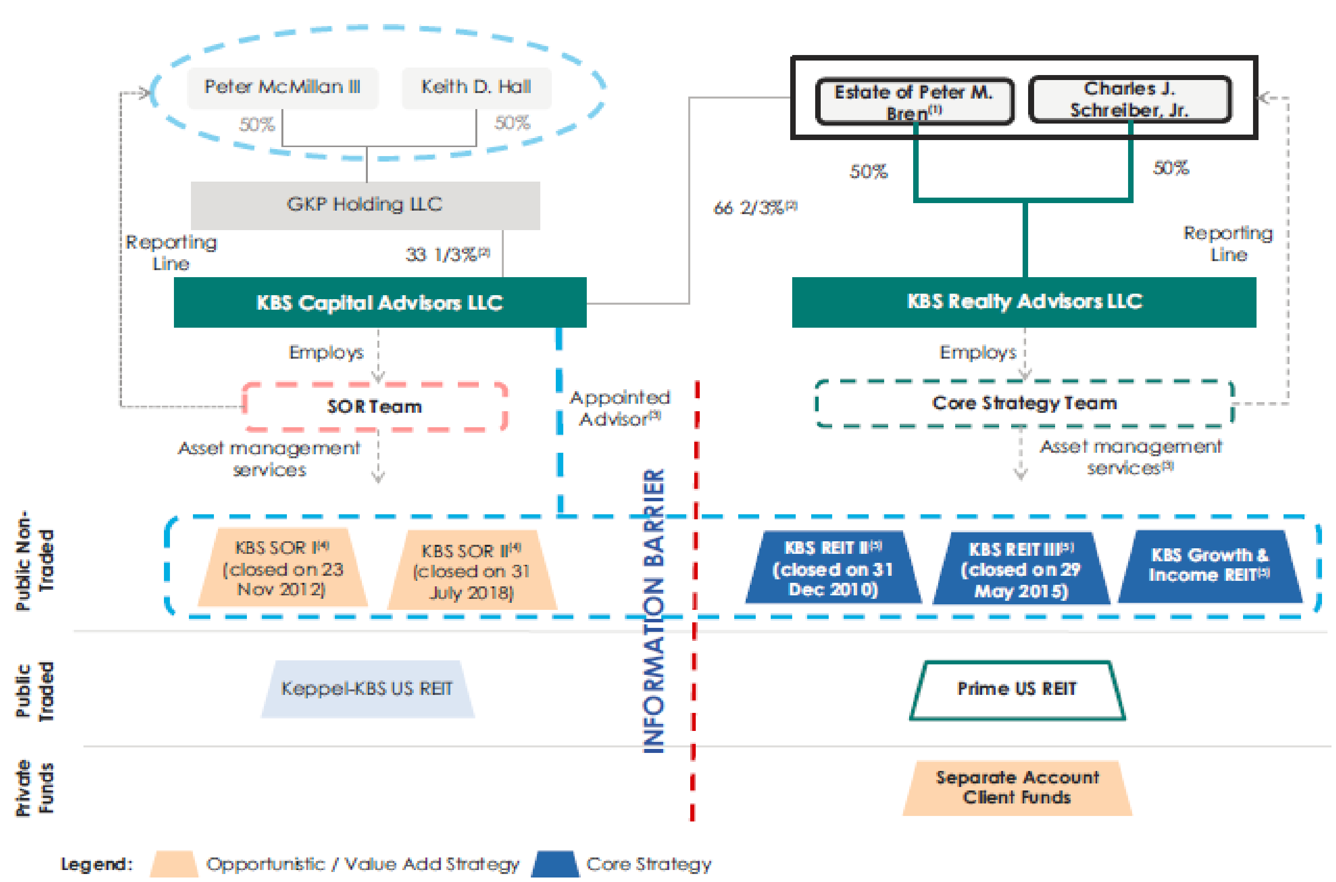
In 1800 West Loop South, management has carved out nine such spec suites – of which four has already been taken up, with strong leasing enquiries fielded for the rest. The building occupancy rate is expected to drop by about 5% in July, with a temporary tenant leaving the premise – but KORE is in talks with various prospective tenants and expects to backfill the space by year-end. Additionally, asset enhancement works are also currently in progress with the addition of a new cafeteria, tenant lounges and a gym to increase the attractiveness of the asset.

Reasons for listing in Singapore. Management noted that the REIT's relatively small portfolio size and diverse secondary market presence are different compared to US office REITs, which typically have a large portfolio and are focused mainly on gateway cities. When compared to other REIT markets worldwide, Singapore offers a favourable tax structure, transparent policy framework, and has a good international investor base – which was the key reason for choosing to list its assets here.

Potential conflicts of interest with Prime US REIT. The initial assets injected in KORE came from KBS Strategic Opportunity II fund which focuses on assets with a value-add strategy, while Prime US REIT assets are from KBS REIT III fund, which is based on a core strategy (focused on income, growth and capital preservation). The two funds are operated by two distinct teams with separate reporting lines, and is headed by different independent owners. While there is still a possibility of these two teams competing for the same asset, each team will make their own final independent decisions based on how it fits into their portfolio. As such, overall, it doesn't see any adverse impact to its current portfolio and acquisition opportunities from the listing of Prime US REIT.

Management fees. Management expects to continue receiving the management fees fully in units in the near-term, until the REIT achieves optimum portfolio growth.

Figure 1: Organisational structure of KBS



Source: Prime US REIT IPO Prospectus

Figure 2: DDM valuation

-	FY19F	FY20F	FY21F	FY22F	FY23F	Terminal Value
DPU (US cents)	6.1	6.3	6.5	6.7	6.9	97.2
Target price (USD)	**0.88**					
Current Price (USD)	0.82					
Price Upside (%)	7.3%					
Distribution Yield FY18F (%)	7.5%					
Assumptions						
Risk-free rate (%)	3.0					
Beta	0.9					
Cost of equity (%)	9.2					
Terminal growth (%)	2.0					

Source: Company data, RHB

Figure 3: Rental rate growth outlook across portfolio sub-markets

Submarket *Property*	Submarket Vacancy Rate (%)	Last 12M Deliveries (sf'000)	Last 12M absorption (sf'000)	Average Submarket Rent (US$ p.a.)	Last 12M Rental Growth (%)	Projected Rental Growth (%)
Seattle, Bellevue CBD *The Plaza Buildings*	4.2%	-	137.0	51.3	9.4%	7.8%
Seattle, Eastside *Bellevue Technology Center*	4.9%	-	32.1	34.8	5.8%	4.3%
Seattle, Redmond *Westpark Portfolio*	4.6%	10.0	(160.0)	32.9(1)	6.9%	5.6%
Sacramento, Folsom *Iron Point*	5.6%	-	21.9	26.8	5.6%	5.3%
Denver, Northwest *Westmoor Center*	8.5%	134.0	178.0	21.7	3.1%	3.6%
Austin, Northwest *Great Hills & Westech 360*	8.9%	0.4	(23.3)	36.0	5.6%	4.9%
Houston, Galleria/Uptown *1800 West Loop*	15.3%	-	283.0	31.9	(0.5%)	(0.2%)
Houston, Galleria/Bellaire *West Loop I & II*	16.2%	-	2.5	25.2	2.7%	1.8%
Atlanta, Cumberland/I-75 *Powers Ferry*	14.2%	4.9	397.0	24.9	3.9%	3.4%
Atlanta, Central Perimeter *Northridge I & II*	14.2%	4.9	(292.0)	28.5	3.0%	3.4%
Orlando, Maitland *Maitland Promenade I & II*	9.2%	-	(74.7)	22.8	4.3%	2.9%

Source: Costar Office Report (Jun 2019), Company data

Figure 4: Asset summary

Portfolio Overview

Property	City	Location	NLA (sf)	Committed occupancy (by NLA)	WALE (in years)	Carrying Value (US$m)
The Plaza Buildings	Seattle	Bellevue CBD, one of the most active leasing submarket in Seattle	490,994	96.5%	3.5	258.8
Bellevue Technology Center	Seattle	Bellevue, one of the most active leasing submarket in Seattle	330,508	98.5%	3.4	137.7
The Westpark Portfolio	Seattle	Redmond submarket, one of the best performing office markets in the Seattle region	782,185	97.8%	3.7	180.3
Iron Point	Sacramento	Carmichael / Fair Oaks / Citrus Heights; Expected to outperform the overall Sacramento market	211,944	95.8%	2.8	37.4
Westmoor Center	Denver	Northwest Denver; Well-positioned to capture tenants that outgrow nearby Boulder, and has better quality real estate	612,890	91.2%	5.2	128.6
Great Hills Plaza	Austin	Northwest submarket, a popular office locale along the Capital of Texas Highway corridor	139,252	98.1%	5.3	37.9
Westech 360	Austin	Northwest submarket, a popular office locale along the Capital of Texas Highway corridor	177,615	96.4%	2.7	47.2
1800 West Loop South	Houston	West Loop, which is amenity-rich and highly sought after	400,101	81.9%	4.2	79.4
West Loop I & II	Houston	Bellaire, one of Houston's most desirable and affluent neighbourhoods	313,873	89.5%	4.4	43.6
Powers Ferry	Atlanta	Cumberland / I-75: Have been outperforming greater Atlanta market in terms of occupancy rate	149,324	98.0%	3.0	19.8
Northridge Center I & II	Atlanta	North Central / I-285 / GA 400: Home to numerous Fortune 500 companies, which solidifies the positive attributes of the location	188,944	85.1%	2.8	21.1
Maitland Promenade I	Orlando	Maitland Center, which is dominated by finance, insurance, tech and strong activity in the Class A market	230,366	97.9%	3.6	49.5
Maitland Promenade II	Orlando	Maitland Center, which is dominated by finance, insurance, tech and strong activity in the Class A market	230,371	99.7%	4.4	44.5
		Portfolio Information as at 30 June 2019	**4,258,367**	**94.0%**	**3.9(1)**	**1,085.8**

Source: Company

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