19 March 2019

Property | REITs

MREITs

Overweight (Maintained)

Pick The Best, Leave The Rest

Stocks Covered	6
Ratings (Buy/Neutral/Sell):	3 / 2 / 1
Last 12m Earnings	Positive

- **Keep OVERWEIGHT on MREITs.** Top Picks are IGB REIT and Pavilion REIT. Given volatility in the Malaysian equity market as a result of the US-China trade war and slower GDP growth, we believe MREITs are still suitable for investors seeking defensive exposure. With an average sector dividend yield of c.6%, we advise investors to be selective among sub-sectors. We like IGB REIT and Pavilion REIT, given the quality and strategic locations of their retail assets.
- **4Q18 results roundup.** For the quarter under review, most REITs under our coverage reported earnings that were in line with our and Street expectations. Having said that, Capitaland Malaysia Mall Trust (CMMT) and MRCB-Quill REIT's (MQREIT) results missed Street estimates, mainly on weaker performances from their Klang Valley retail and office assets. We downgraded CMMT to SELL from Neutral, in view of its prolonged negative rental reversion at all of its Klang Valley shopping malls.
- **RHB economists expect Bank Negara Malaysia (BNM) to keep the overnight policy rate (OPR) at 3.25% for 2019.** Global growth has started to decelerate, while a protracted trade war between the US and China is likely to have an adverse impact on global trade. The 10-year US bond yield has fallen by over 40-50bps from its peak in 2018 – this will be positive for REITs as rising interest rates are generally unfavourable for them, given narrowing yield spreads. Moreover, we believe there is some room for policy easing in Malaysia amidst subdued inflation and a slower growth environment.
- **Average yield spread now at c.180-190bps** from the Malaysian 10-year Government Bond, which is trading at a c.4% yield. The yield spread is now close to +1SD from the 5-year average of 157bps. As such we believe there is potential upside for the REITs. In addition, we expect REITs under our coverage to record 4.2% average EPS growth in 2019, above the expected FBM KLCI EPS growth of just 0.7%. Having said that, the P/BV for MREITs of 1.2x is slightly above its 5-year historical average P/BV of 1x, but still cheaper than the 1.7x P/BV for FBM KLCI.
- **We prefer large-cap retail REIT players.** With an oversupply of retail space, anchor malls such as Suria KLCC, Pavilion Kuala Lumpur and Mid-Valley Megamall should fare better. We expect these malls to continue maintaining low single-digit rental reversions. The key risks/challenges for MREITs include slower economic growth, a looming oversupply threat in the retail and office segments, new competition from e-commerce/digital platforms for retail and hospitality businesses, as well as equity fund-raising to finance inorganic growth.

Company Name	Rating	TP (MYR)	% Upside (Downside)	P/E (x) Dec-19F	P/BV (x) Dec-19F	Yield (%) Dec-19F
IGB REIT	Buy	1.95	7%	21.0	1.8	5.5
Pavilion REIT	Buy	1.92	9%	18.9	1.3	5.0
Axis REIT	Buy	1.94	11%	17.6	1.3	5.7
KLCCP Stapled	Neutral	8.30	6%	18.7	1.0	4.7
MRCB-Quill REIT	Neutral	1.05	-3%	14.8	0.8	7.4
CMMT	Sell	0.95	-14%	17.0	0.8	6.7

Source: Company data, RHB

Top Picks	Target Price
IGB REIT (IGBREIT MK) – BUY	MYR1.95
Pavilion REIT (PREIT MK) – BUY	MYR1.92

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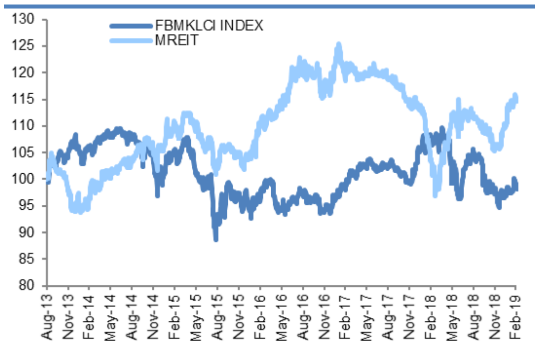
MREIT vs FBM KLCI Index



Source: BNM

Office sector. According to *NTL Research & Consulting,* Kuala Lumpur's office supply now stands at 82.89m sqf, with total completion of 2.5m sqf of new office space in 2018. With the continued oversupply of office space, the occupancy rate in Kuala Lumpur has dropped to 78% in 2018 from 89% in 2017.

Given weaker economic growth expected this year, we expect to see some tenants continuing to downsize their spaces. Recently, Technip Geoproduction (M) reduced its occupancy to 74% (from 100%) in Wisma Technip, while SBM, Amgeneral and Pemandu have downsized their office space in Platinum Sentral. Overall, Platinum Sentral's occupancy rate has now dropped to 87% from 98% in Dec 2017.

Having said that, despite the supply glut, we believe KLCCP Stapled will remain resilient compared to other REITs as three out of four of its office buildings – Petronas Twin Towers, Menara 3 Petronas and Menara Dayabumi – are on triple net leases with Petronas.

Retail sector. Existing retail space in Klang Valley currently stands at 62.7m sqf, with an average occupancy rate of 88%. An additional 15.5m sqf of retail space is expected to enter the Klang Valley by 2020. Mid-sized malls, in particular, should continue to struggle, as these malls tend to have lower footfall. As such, mall operators have to be more creative in advertising and event activities, as well as implementing value-added asset enhancement initiatives (AEIs) to keep up with the market.

Neighbourhood/mid-sized shopping malls in these areas have already been affected by the oversupply of retail space – The Mines, Sungei Wang Plaza, 3 Damansara Mall (formerly Tropicana City Mall), Da Men, and Sunway Putra Mall all recorded negative growth. The Mines is our main concern, as it saw rental reversions falling 16.9%. We believe this was mainly due to competition from a newer mall – IOI City Mall Putrajaya – in its vicinity. Meanwhile, Sungei Wang Plaza's rental reversion remained negative at 13.3%.

Parkson, one of the biggest department store operators in Malaysia, has closed its outlets at Sungei Wang Plaza and Maju Junction, and will soon close its outlet in Suria KLCC. Parkson's lease at KLCC is expiring at the end of Mar 2019. We understand that the area will be transformed into a space for a diversified mix of tenants in the new fashion, cosmetics and food & beverage (F&B) segments.

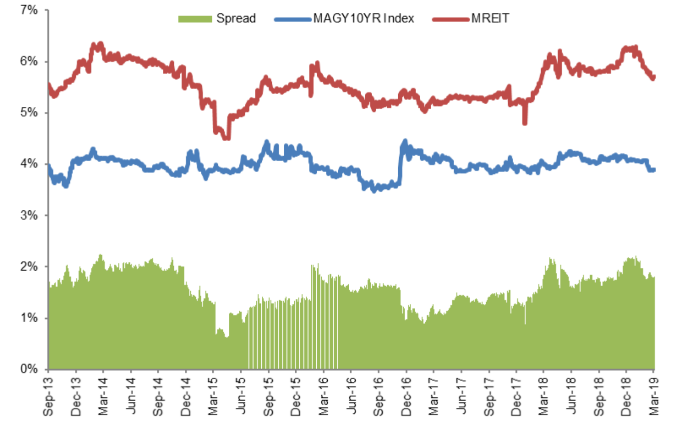
Hospitality sector. With slowing economic growth, we do not see any significant increase in demand for hotel rooms. A large supply of hotels, coupled with the mushrooming of alternative accommodation options amidst dwindling tourism activities, have posed challenges to the hotel segment. In the Klang Valley, hotel supply stood at 57,881 rooms over 202 hotels as at 3Q18. During the year, new supply totalling 5,003 rooms were added into the market. In 2019, it is estimated that another 11 hotels – offering 3,154 rooms – will be completed in the Klang Valley. With the oversupply, occupancy has been very challenging. During the quarter, Mandarin Oriental's occupancy rate remained weak at 55%, while Sunway Resort Hotel & Spa, Sunway Pyramid Hotel, and Sunway Putra Hotel's occupancy rates also fell below 70%.

Asset injections in the pipeline. On inorganic growth, we are only expecting Menara Celcom to be injected into MQREIT this year. Having said that, we understand that negotiations between the asset sponsor and the REIT have yet to commence. Other new malls such as Sunway Velocity Mall and Southkey Mid Valley Megamall may take at least one full rental cycle (3-4 years) to stabilise before they can be injected into REITs, in our view.

Pavilion REIT has announced that it will not proceed with the invitation to participate in the ownership of the ongoing development of Pavilion Bukit Jalil. We are mildly positive on the news as it has eased investors' concerns on potential fund-raising exercises. There is no earnings impact from this cancellation as we did not factor in any potential contributions from the development. Note that Malton (MALT MK) has announced that The Qatar Investment Authority (QIA) has obtained principal approval to participate in the ownership of the ongoing development. The mall is scheduled to open in 3Q20, and will have NLA of 1.8m sqf. We do not rule out the possibility that the mall will be injected into the REIT in the future (around 2021).

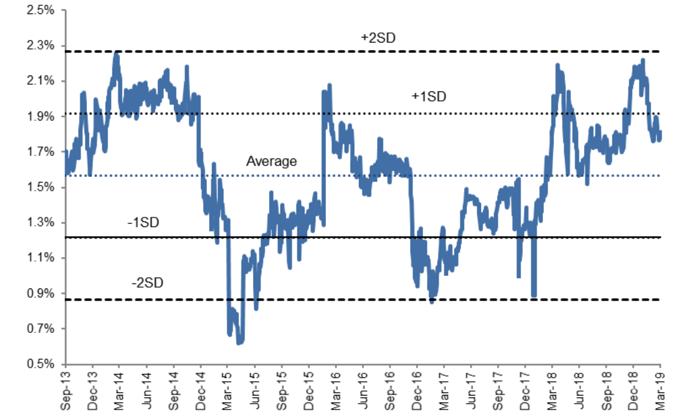
Government's REIT initiative. We note that the Government is actively looking for opportunities to inject government-related assets into REITs. In Budget 2018, the Government indicated its intention to set up the world's first airport REIT. Since then, however, we have yet to hear of any new developments on the project. Interestingly, Alpha REIT Managers SB chairman Dato' Stewart Labrooy, in his presentation at the 12th Malaysian Property Summit, mentioned that the idea of injecting government buildings has been considered by the Government, as well as setting up a trust for government hospitals. Overall, we are positive on the REIT's initiative, as this will likely bring more activities into the REIT market. Currently, the number of REITs that have a market cap of above MYR5bn is still very limited.

Figure 1: MREITs' yields vs Malaysia's 10-Year Government bond yields



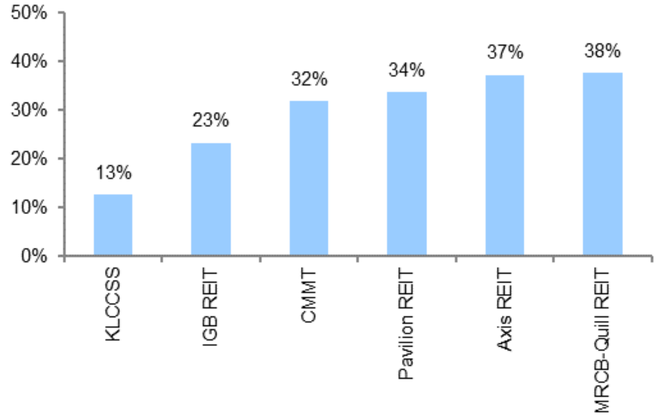
Source: RHB, Bloomberg

Figure 2: MREITs' yield spread and SD levels



Source: RHB, Bloomberg

Figure 3: MREITs' gearing levels



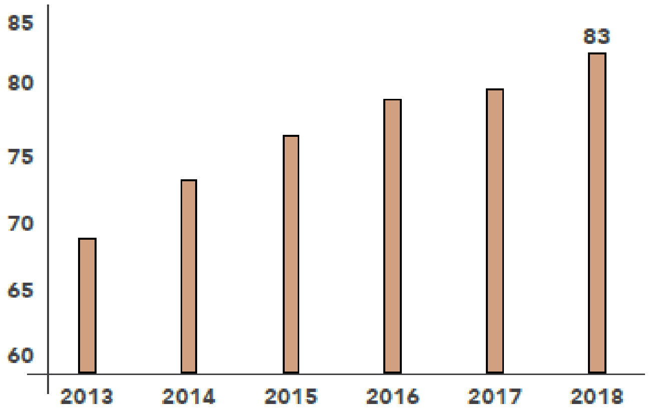
Source: RHB, Company data

Figure 4: New office development in Kuala Lumpur

Office buildings	Location	NLA (sqf)	Expected completion
Exchange 106	Tun Razak Exchange	2,650,000	2019
Prudential Tower	Tun Razak Exchange	392,000	2019
YTL Headquarter	Jalan Bukit Bintang	324,000	2019
Menara TCM	Jalan Tun Razak	403,000	2019
Menara Felcra	Jalan Semarak	1,121,000	2020
Menara Hap Seng 3	Jalan P Ramlee	240,000	2020
Sapura Tower	Jalan Kia Peng	1,180,000	2020
Cititower	Jalan Ampang	1,700,000	2020
Merdeka PNB 118	Jalan Hang Jebar	1,700,000	2020
Oxley Tower	Jalan Ampang	346,000	2020
The Stride, BBCC	Jalan Pudu	394,000	2020
HSBC Tower	Tun Razak Exchange	568,000	2020
Affin Bank Tower	Tun Razak Exchange	576,000	2020
The Met Corporate Towers	KL Metropolis	600,000	2021
KL Eco City	Jalan Bangsar	756,000	2021
Total		**12,950,000**	

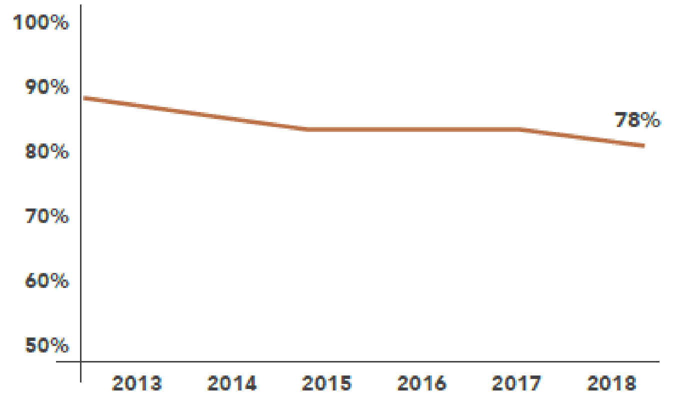
Source: NTL Research

Figure 5: Office supply in Kuala Lumpur (m sqf)



Source: NTL Research

Figure 6: Office occupancy rates in Kuala Lumpur



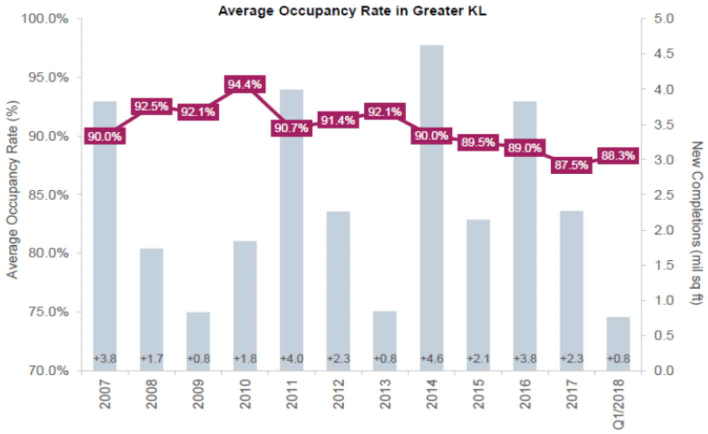
Source: NTL Research

Figure 7: New mall developments in Kuala Lumpur

Malls	Location	NLA (sqf)	Expected completion
Empire City	Damansara Perdana	2,500,000	2019
Pavilion 2	Bukit Jalil	1,800,000	2020
The Exchange Mall @ TRX	Jalan Tun Razak	1,330,000	2020
M101 Skywheel	Jalan Raja Muda Abd Aziz	200,000	2021
Merdeka @ 118	Jalan Hang Jebar	1,000,000	2021
Mitsui Shopping Park	Jalan Pudu (BBCC)	900,000	2021
Mall @ Maju	Sungai Besi	750,000	2021
Pavilion Damansara Heights	Damansara Heights	1,170,000	2021
Suria KLCC (expansion) Lot 1	KLCC	300,000	2021
Total		**9,950,000**	

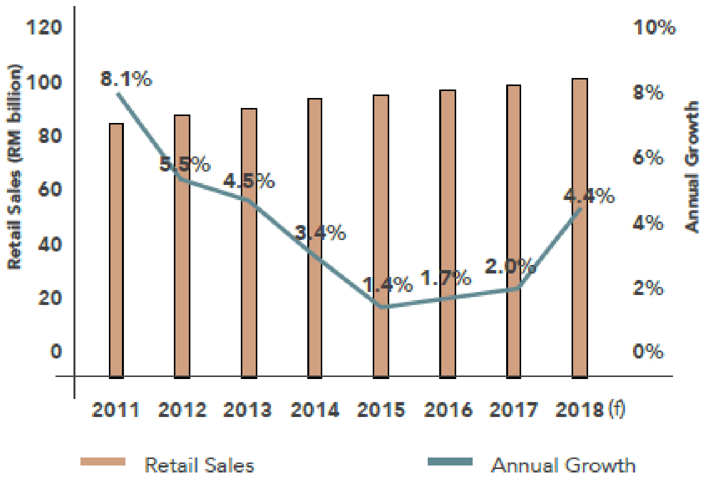
Source: RHB, Company data

Figure 8: Average occupancy rates of malls in Greater Kuala Lumpur



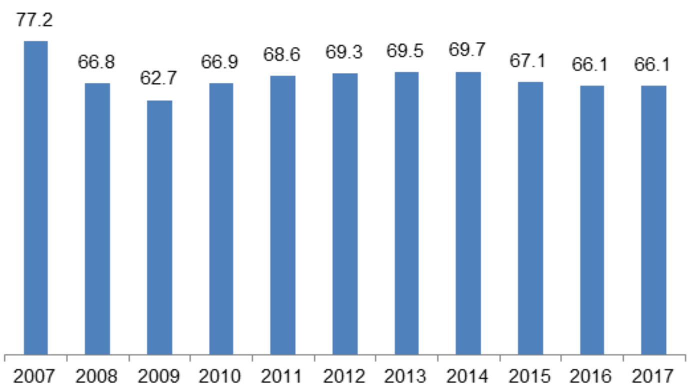
Source: Savills Research

Figure 9: Malaysia's annual retail sales



Source: NTL Research, Malaysian Institute of Economic Research

Figure 10: Occupancy rates of hotels in Kuala Lumpur (%)



Source: NTL Research

Figure 11: MREIT's valuation table

	FYE	Price	Target	Mkt Cap	P/E (x)		EPS Growth (%)		P/BV (x)	P/CF(x)	ROE (%)	DY (%)	Rec
		(MYR/s)	(MYR/s)	(MYRm)	FY19F	FY20F	FY19F	FY20F	FY19F	FY19F	FY19F	FY19F	
IGB REIT	Dec	1.83	1.95	6,442	21.0	20.7	0.8	1.4	1.8	16.8	8.3	5.5	Buy
Pavilion REIT	Dec	1.76	1.92	5,229	18.9	18.7	8.1	1.1	1.3	13.2	7.1	5.0	Buy
Axis REIT	Dec	1.74	1.94	2,132	17.6	16.9	7.1	4.1	1.3	8.7	7.3	5.7	Buy
KLCCP Stapled	Dec	7.84	8.30	13,497	18.7	17.8	3.2	5.1	1.0	14.4	5.5	4.7	Neutral
MRCB-Quill REIT	Dec	1.08	1.05	1,153	14.8	14.7	6.3	0.7	0.8	10.8	5.7	7.4	Neutral
CMMT	Dec	1.11	0.95	2,238	17.0	17.3	(2.2)	(2.3)	0.8	10.3	4.9	6.7	Sell
Sector Avg					**18.5**	**18.0**	**4.2**	**2.8**				**5.8**	

Source: RHB, Company data

19 March 2019

Property | REITs

Axis REIT (AXRB MK)

Buy (Maintained)

Inorganic Growth To Continue; Keep BUY

Target Price (Return)	MYR1.94 (+11%)
Price:	MYR1.74
Market Cap:	USD501m
Avg Daily Turnover (MYR/USD)	1.14m/0.28m

- **Reiterate BUY, new Street high-end TP of MYR1.94 from MYR1.82, 11% upside plus 5% 2019F yield.** We believe the below sector-average dividend yield is justifiable as Axis REIT is one of few *shariah*-compliant REITs. The REIT is expected to remain proactive in capital management to facilitate future acquisitions. We expect earnings to continue growing, driven by income from newly-acquired assets and new contributions from greenfield developments.
- **Occupancy rates remain stable.** As at Dec 2018, its portfolio's occupancy rate stood at 94% (Dec 2017: 91%), with a stable weighted average lease expiry period of 5.57 years based on rental. The REIT has 34 properties enjoying 100% occupancy, and only 11 properties with partial vacancies. Overall, rental reversion for FY18 remained healthy at 5%. The industrial sector is expected to remain positive, driven by demand for warehousing and manufacturing space. Meanwhile, the office sector remains challenging with an oversupply of office space, especially in the Klang Valley.
- **Inorganic growth.** Going into 2019, the REIT will have 45 assets under its umbrella. The latest include a property located at Senawang, Seremban, Negeri Sembilan from Gandour (Malaysia), and two industrial facilities at i-PARK Iskandar Malaysia. We expect the REIT to acquire 2-3 more assets this year. Having said that, we do not expect the acquisitions to be very sizeable as its gearing has already reached 37%.
- **Expecting lower non-renewal risk.** The REIT has c.21% of total NLA up for renewal this year, ie slightly higher than FY18's 18%. Having said that, we believe the non-renewal risk is lower, as 19% of renewals comprise industrial offices, warehouse logistics and manufacturing facilities. We believe the risk of non-renewal of its single-tenanted assets may be mitigated by the fact that there are fixed facilities in place.
- **Maintain BUY.** We leave our FY19F-21F estimates unchanged but raise our TP to MYR1.94 after updating for lower cost of equity assumptions. Although its expected dividend yield of 5% is lower than the REIT sector average, we believe it is fair – given its *shariah* REIT status and the quality of its assets. The downside risk to our call is an oversupply of office properties, which may affect its office properties' occupancy and rental rates.

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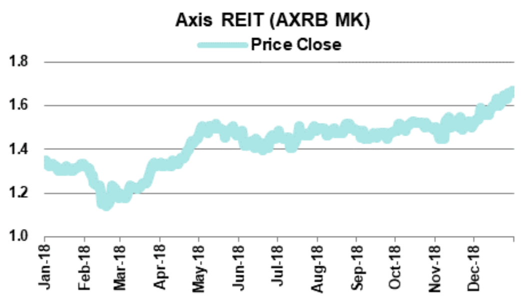
Share Performance (%)

	YTD	1m	3m	6m	12m
Absolute	7.1	11.3	10.6	12.1	19.3
Relative	6.8	9.8	12.7	15.4	26.6
52-wk Price low/high (MYR)					1.19 - 1.63



Source: Bloomberg

Forecasts and Valuations	Dec-17	Dec-18	Dec-19F	Dec-20F	Dec-21F
Total turnover (MYRm)	169	204	220	226	230
Net property income (MYRm)	146	183	194	199	202
Reported net profit (MYRm)	127	155	121	126	129
Total distributable income (MYRm)	92	113	121	126	129
DPS (MYR)	8.3	8.7	8.8	9.2	9.4
DPS growth (%)	0.1	5.8	1.1	4.0	2.3
P/BV (x)	1.36	1.30	1.31	1.31	1.31
Dividend Yield (%)	4.7	5.0	5.0	5.3	5.4
Return on average equity (%)	8.0	9.3	7.4	7.6	7.8
Return on average assets (%)	5.0	5.5	4.1	4.2	4.3
Interest coverage (x)	3.0	2.9	2.3	2.4	2.4

Source: Company data, RHB

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Trading Buy:	Share price may exceed 15% over the next 3 months, however longer-term outlook remains uncertain
Neutral:	Share price may fall within the range of +/- 10% over the next 12 months
Take Profit:	Target price has been attained. Look to accumulate at lower levels
Sell:	Share price may fall by more than 10% over the next 12 months
Not Rated:	Stock is not within regular research coverage

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