4 October 2023

Property | REITS

REITS

Neutral (Maintained)

Awaiting New Catalysts

Stocks Covered	7
Rating (Buy/Neutral/Sell):	5 / 2 / 0
Last 12m Earnings Revision Trend:	Positive

- **Top Picks: Axis REIT and IGB REIT.** We maintain our NEUTRAL call on the sector as rerating catalysts remain limited amid the structural oversupply in the retail and office sectors, high interest rates globally, and gradual return of tourists to Malaysia. M-REITs offer a steady defensive play with minimal downside risks to earnings in the short term, and the sector's dividend yield spread vs the 10-year Malaysia Government Securities (MGS10) yield is close to +1SD from the historical mean.
- **Retail segment remains strong.** Retail REITs continue to be stable, backed by a strong domestic economy. According to the Department of Statistics Malaysia, retail trade was up by 5.5% YoY in July (0.5% MoM). Occupancy rates for malls under our coverage have also remained robust, underpinning the various management teams' guidance of mid-single digit rental reversions for FY23. As such, the retail REITs under our coverage are well positioned to capitalise on the seasonally stronger 4Q due to the year-end festivities.
- **Headwinds for retail.** We are cautious on the incoming supply of new malls, which could compress long-term rental reversions, especially as the new malls offer many of the same anchor tenants as existing malls. In this regard, we think that REITs' track record in refreshing offerings from hosting events and updating tenant mix can keep their malls competitive. We also keep an eye out on policy risks that could impact consumer's spending power such as the introduction of a luxury tax, subsidy rationalisation, and/or the reintroduction of the Goods and Services Tax (GST).
- **Office occupancy stabilising.** Office occupancy in Kuala Lumpur has increased slightly YoY to 73.5% in 1H23 (1H22: 71.6%), possibly due to more employees returning to office since the economic reopening. That said, the flight to quality trend remains, especially as the supply of green certified office buildings come into the market over the medium term.
- **Industrial segment still attractive.** The pace of industrial acquisitions has slowed down following the sharp rise in valuations during the pandemic as asset owners placed a premium on their properties, compressing the property yield. That said, because of the favourable supply-demand dynamics for landlords, we remain positive on industrial assets, which should record healthy rental reversions each year with minimal risk of non-renewals.
- **Top Picks:** Axis REIT is our new Top Pick for the industrial segment. We expect its occupancy level to increase following the signing of new tenancies and the commencement of its lease with SPX Xpress at the newly redeveloped Bukit Raja Distribution Centre 2. We like IGB REIT in the retail segment because of its fully occupied properties and high proportion of turnover rent, which could benefit from a pick-up in retail sales

Top Picks	Target Price
Axis REIT (AXRB MK) – BUY	MYR2.08
IGB REIT (IGBREIT MK) – BUY	MYR1.91

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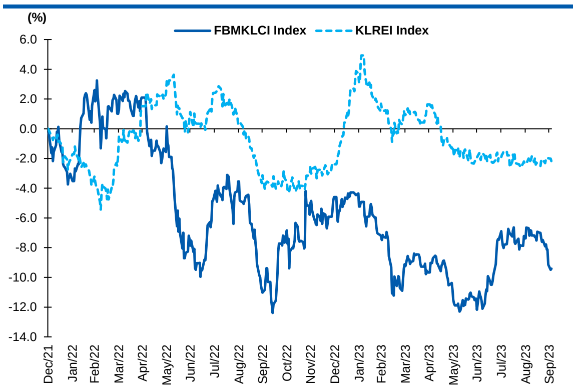
FBM KLCI vs KLREI Index



Source: Company data, RHB

Company Name	Rating	Target (MYR)	% Upside (Downside)	P/E (x) Dec-24F	P/B (x) Dec-24F	ROAE (%) Dec-24F	Yield (%) Dec-24F
AME REIT	Buy	1.40	10.0	18.8	1.3	6.6	5.8
Axis REIT	Buy	2.08	13.9	17.8	1.2	6.9	5.6
CLMT	Neutral	0.57	3.6	13.4	0.6	4.2	7.3
IGB REIT	Buy	1.91	13.8	16.3	1.6	9.7	6.4
KLCCP Stapled	Buy	7.57	11.8	15.7	0.9	6.9	6.0
Pavilion REIT	Buy	1.46	19.7	13.9	0.9	6.9	7.4
Sentral REIT	Neutral	0.89	7.2	12.0	0.7	5.7	8.1

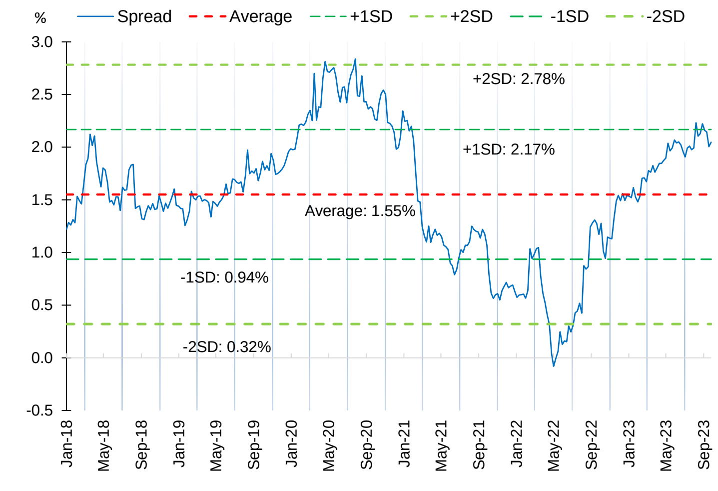
Source: Company data, RHB

Yield spread at c.205bps

The current dividend yield spread between the M-REIT Index and MGS10 is c.205bps, or close to +1SD from the historical mean. This should support valuation in the near term as we expect limited downside risks to REITs' earnings. Occupancy levels have remained stable, and the fourth quarter is typically a seasonally strong quarter for retail REITs due to an increase in festive spending. Moving into 2024, we expect a more normalised growth as this year's positive rental reversion was partly due to the lower base from the pandemic. As such, we continue to monitor changes in expectations for interest rate – a potential cut could be re-rating catalyst for the sector as this could further widen the yield spread and make REITs a more attractive yield play.

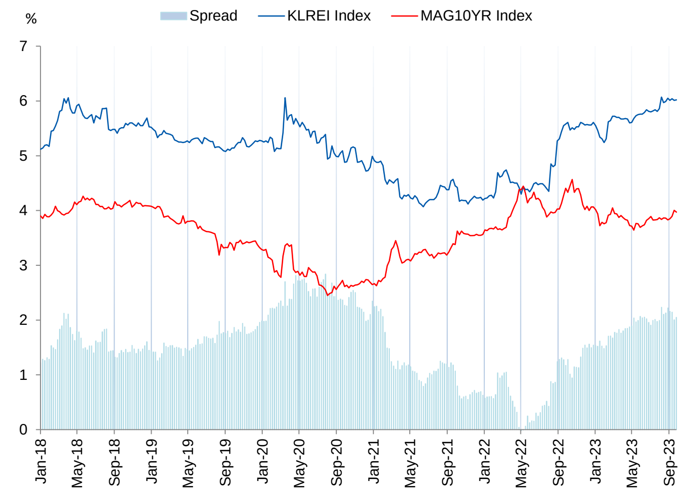
While the US Federal Reserve (US Fed) has slowed down the pace of its interest rate hikes from +75bps in Nov 2022 to +50bps in Dec 2022 to +25bps rate hikes (four times so far) in 2023, the US Fed has signalled higher-for-longer rates, meaning fewer rate cuts in 2024 than previously anticipated. Currently, RHB Economics team expects one more +25bps rate hike in 2023, followed by a 50-75bps rate cut to the Federal Funds Rate in 2024. However, it is not expecting any cuts to the overnight policy rate (OPR) by Bank Negara Malaysia (BNM) next year (maintained at 3%).

Figure 1: Yield spread between KLREI and the Malaysian Government 10-year bond



Source: Bloomberg, RHB

Figure 2: Yield spread currently at c.205bps



Source: Bloomberg, RHB

Retail – relatively more exciting

Retail REITs continue to be stable, backed by a strong domestic economy. According to the Department of Statistics Malaysia, retail trade was up by 5.5% YoY in July (0.5% MoM). Occupancy rates for malls under our coverage have also remained robust, underpinning the various management teams' guidance of mid-single digit rental reversions for FY23, and we expect the growth to be at 2-3% for FY24. Over the near term, the retail REITs under our coverage are well positioned to capitalise on the seasonally stronger 4Q due to the end-year festivities.

We are also positive on the potential recovery in tourists – especially from China – in 4Q23. From our recent Transportation sector strategy report, while China's outbound tourism has been gradual since the country reopened its borders, the encouraging recovery trend from 0.4m outbound travellers in January to 3.4m in July suggests that it will continue to improve going into 4Q23. As of June, the incoming China tourist arrivals in Malaysia was at 40% of the arrivals in Jun 2019. The pickup in tourist arrivals should boost retail spending, especially for malls in the Kuala Lumpur city centre, and this is further supported by the weaker MYR.

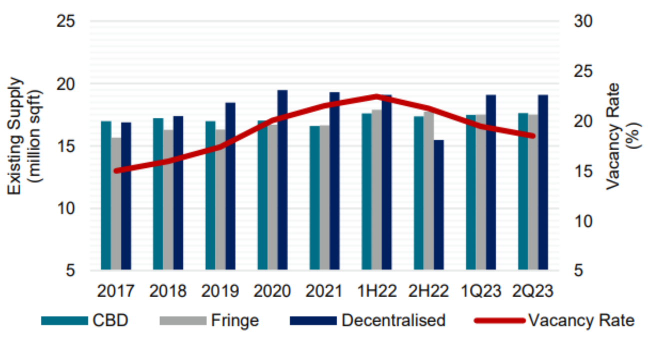
The retail vacancy rate Greater KL has come down to 18.5% in 2Q23 (1Q23: 19.5%, 4Q22: 21.2%), which is consistent with the malls under our coverage which have recorded improved occupancy following the full reopening of the economy. However, according to Cushman & Wakefield, in 2Q23, the rental for prime shopping centre has only increased by 1.8% YoY.

In terms of downside risks, we are cautious on the incoming supply of new malls, which could compress long-term rental reversions, especially as the new malls offer many of the same anchor tenants as existing malls. Klang Valley will see the addition of 3.4m sqf of NLA in 2023, exceeding the 2.7m sqf in 2022. The two biggest malls will be The Exchange Mall

@ TRX (1.3m sqf) and KSL Esplanade Mall (650k sqf). 2024 will see the addition of Warisan Merdeka Mall @ 118 with 900 sqf of NLA. While new malls will take time to be fully occupied and attract footfall, in the longer term, there may be some downward pressure on occupancy and rental rates. In this regard, we think that REITs' track record in refreshing offerings from hosting events and updating tenant mix can keep their malls competitive.

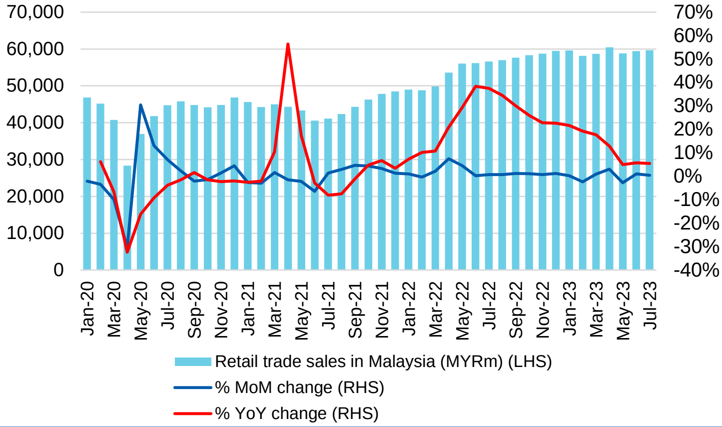
We also keep an eye out on policy risks that could impact retail sales. Fiscal reforms such as the introduction of a luxury tax (mentioned in Budget 2023 – no details yet), subsidy rationalisation, and/or the reintroduction of GST could reduce customers' spending power. On luxury tax – we are of the view that if is implemented on fashion items, it would more negatively impact malls in the Kuala Lumpur city centre such as Suria KLCC and Pavilion Kuala Lumpur as they have a higher proportion of fashion tenants.

Figure 3: Greater KL's existing supply and vacancy rate



Source: Cushman & Wakefield

Figure 4: Retail trade sales in Malaysia (MYRm)



Source: Department of Statistics Malaysia, RHB

Figure 5: Occupancy rates of M-REIT buildings under our coverage

Name	2017	2018	2019	2020	2021	2022	1H23
Petronas Twin Towers	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Menara 3	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Menara Exxon Mobile	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Menara Dayabumi	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Menara Maxis	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Suria KLCC	97.0	98.0	99.0	97.0	93.0	92.0	96.0
Mid Valley Mall	99.0	99.0	99.0	99.7	97.8	99.9	99.9
The Gardens Mall	98.0	97.0	99.0	91.8	90.7	99.9	100.0
Pavilion Kuala Lumpur	98.9	98.7	98.0	96.5	90.2	91.6	93.9
Intermark Mall	90.0	94.4	97.1	85.7	83.6	86.9	86.9
DA MEN Mall	86.3	74.4	71.7	68.9	62.3	64.5	72.2
Elite Pavilion Mall	-	96.7	95.0	83.2	86.4	92.3	93.6
Pavilion Bukit Jalil	-	-	-	-	-	-	83.6
Pavilion Tower	98.5	94.0	85.8	85.8	79.1	73.0	66.0
Axis REIT*	91.0	94.0	92.0	91.0	96.0	95.0	89.0
Sentral REIT*	96.3	93.0	90.0	90.0	90.0	77.0	77.0
Gurney Plaza	99.4	99.9	99.8	98.6	96.3	98.2	98.1
East Coast Mall	98.9	99.0	99.5	97.4	97.5	98.2	98.7
Sungei Wang Plaza	90.1	75.3	82.0	64.2	66.4	75.6	75.1
3 Damansara Property	91.6	92.3	92.8	77.0	68.5	64.5	64.1
The Mines	94.4	89.1	90.5	85.2	76.2	79.0	78.6
Queensbay Mall	-	-	-	-	-	-	96.9

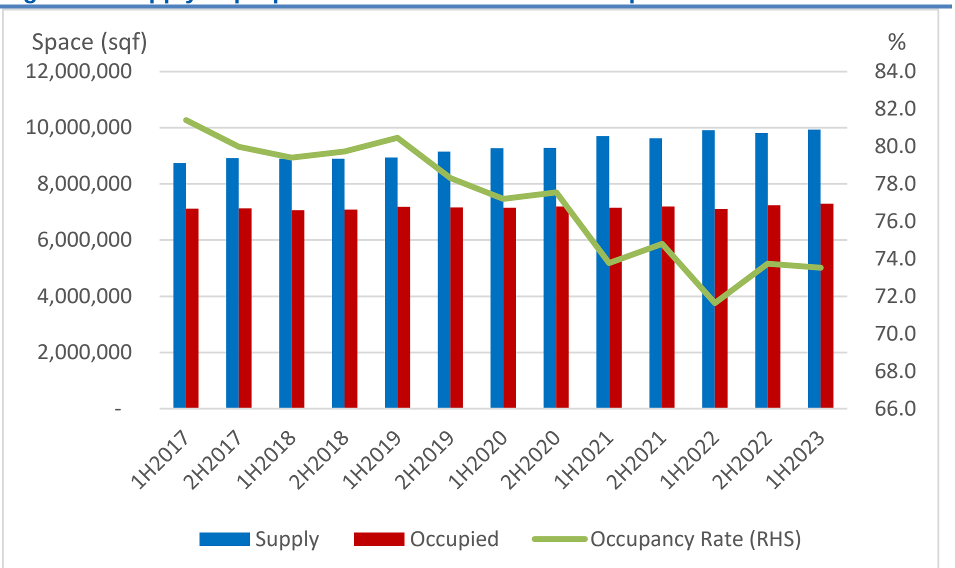
*Note: * blended portfolio occupancy*
Source: Company data, RHB

Quality offices should fare better

According to the National Property Information Centre or NAPIC, office occupancy in Kuala Lumpur has increased slightly YoY to 73.5% in 1H23 (1H22: 71.6%), possibly due to more employees returning to office since the economic reopening. That said, the flight to quality trend remains, especially as the supply of green certified office buildings come into the market. This situation is exemplified by Sentral REIT, which has two older buildings (Quill Building 2 and Wisma TechnipFMC) aged 19 and 29 years that have been left vacant since 2Q22 after one of its tenants moved to The Exchange 106, and the other scaled down its physical operations.

On the other hand, its premium office buildings like Menara Shell and Platinum Sentral are almost at full occupancy and recorded positive rental reversion. The REIT is also acquiring Menara CelcomDiGi, which is a 5-year old office building with a 15-year lease agreement, with an automatic extension of two further terms of three years expiring in Dec 2040.

Figure 6: Supply of purpose-built offices in Kuala Lumpur



Source: Department of Statistics Malaysia, RHB

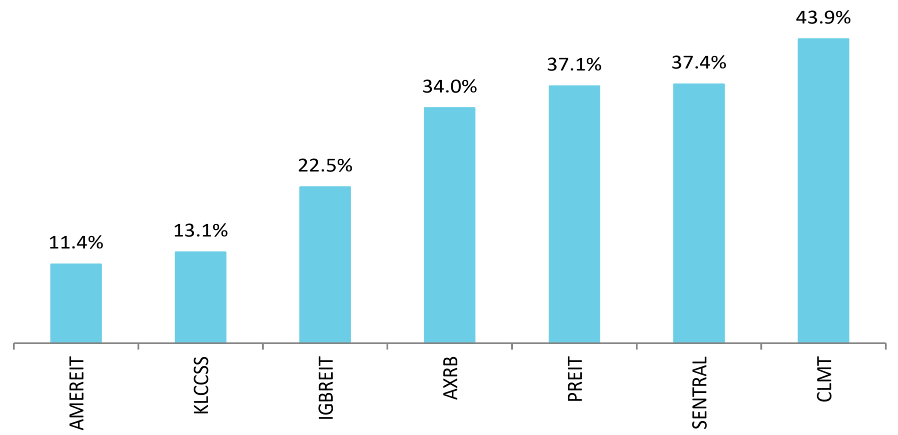
Industrial segment is still attractive

The pace of industrial acquisitions has slowed down following the sharp rise in valuations during the pandemic, as asset owners placed a premium on their properties, compressing the property yield. YTD-FY23, Axis REIT is acquiring a logistics property worth MYR92m. The REIT has a MYR170m acquisition target for 2H23, compared to MYR479m worth of acquisitions achieved in 2022 and MYR223m in 2021. That said, because of the favourable supply-demand dynamics for landlords, we remain positive on industrial assets, which should record healthy rental reversions each year with minimal risk of non-renewals.

In terms of inorganic growth for industrial REITs, we believe AME REIT has a distinct advantage because of the healthy pipeline of new assets from its sponsor, which should ensure a steady pace of acquisitions.

Varying gearing levels

Figure 7: M-REITs' gearing levels as at end-June



Source: Company data, RHB

The average gearing level of 28% as at June is well below the 50% gearing limit imposed by the Securities Commission. CLMT has the highest gearing ratio at 44% following the acquisition of Queensbay Mall in March, and assuming Sentral REITs proposed placement is fully subscribed, Sentral REIT's gearing level could be up to c.45% post acquisition (expected to be completed in 4Q23). At the time of writing, divestment opportunities for its two vacant buildings seem less likely, with management instead sharing positive responses to its leasing efforts.

AME REIT and KLCCP Stapled have the lowest gearing levels of the REITs under our coverage (11% and 13%). For AME REIT, it targets roughly MYR100m in acquisitions each year to bring its asset under management to the MYR1bn mark within five years. This will be supported by the pipeline of new assets from its sponsor. For KLCCP, management previously shared that it plans to expand its core business via an increase in property investments. While there is no guidance on timeline, type of property, or location, its large size and relatively low gearing suggest that the REIT has plenty of room to fund new acquisitions without needing to tap in the equity market.

Top Picks: Axis REIT is our new Top Pick for the industrial segment. We expect its occupancy level to increase following the signing of new tenancies on two of its buildings, as well as the commencement of its lease with SPX Xpress at the newly redeveloped Bukit Raja Distribution Centre 2 which will provide a significant earnings boost to the REIT. The tenant will lease the entire building for 15 years beginning 1 Aug 2023. We like IGB REIT in the retail segment for its fully occupied properties and high proportion of turnover rent, which could benefit from a pick-up in retail sales.

Figure 8: Valuations of M-REIT stocks

	FYE	Target (MYR/s)	Mkt Cap (MYRm)	P/E (x) FY23F	P/E (x) FY24F	EPS Growth (%) FY23F	EPS Growth (%) FY24F	P/BV (x) FY23F	DY (%) FY23F	Rec
KLCCP Stapled	Dec	7.57	12,276	15.8	15.7	3.8	0.6	0.9	5.9	Buy
IGB REIT	Dec	1.91	6,044	17.3	16.3	3.3	6.6	1.6	6.1	Buy
Pavilion REIT	Dec	1.46	4,456	13.7	13.9	10.5	(1.3)	0.9	7.5	Buy
Axis REIT	Dec	2.08	3,204	20.2	17.9	(5.4)	12.8	1.2	4.8	Buy
CLMT	Dec	0.57	1,503	13.5	13.4	1.7	1.1	0.5	7.2	Neutral
Sentral REIT	Dec	0.89	884	12.6	12.0	(4.5)	5.1	0.7	7.8	Neutral
AME REIT	Mar	1.40	664	19.4	18.7	5.7	3.6	1.3	5.6	Buy
Sector Avg				**16.2**	**15.6**	**3.4**	**3.1**	**1.1**	**6.2**	

Source: RHB

RHB Guide to Investment Ratings

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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
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