Manulife US Real Estate Inv

Version 3 | Bloomberg: MUST SP | Reuters: MANU.SI

DBS Group Research . Equity

8 Nov 2016

BUY

Last Traded Price (7 Nov 2016): US$0.84 (STI : 2,800.95)
Price Target 12-mth: US$0.93 (11% upside and 7.2% yield)

Potential Catalyst: Exceeding IPO forecasts, and acquisitions
Where we differ: na

Analyst
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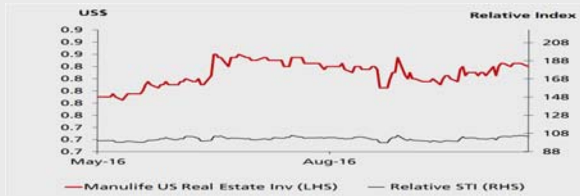
What's New

- **Maiden DPU of 2.01 UScts, 5.8% above IPO forecasts**
- 8.5% **rental reversions with prospect of higher rents on favourable demand and supply outlook**
- **Additional upside from increased NLA at Figueroa**

Price Relative



Forecasts and Valuation

FY Dec (US$m)	2015P*	2016F*	2017F	2018F
Gross Revenue	71.0	78.7	79.3	80.7
Net Property Inc	44.2	48.7	48.6	49.5
Total Return	26.0	27.2	30.8	33.9
Distribution Inc	34.3	35.4	38.4	38.8
EPU (US cts.)	4.15	4.32	4.84	5.29
EPU Gth (%)	nm	4	12	9
DPU (US cts.)	5.48	5.61	6.05	6.06
DPU Gth (%)	nm	2	8	0
NAV per shr (US cts.)	78.4	82.0	80.8	80.2
PE (X)	20.2	19.4	17.3	15.9
Distribution Yield (%)	6.5	6.7	7.2	7.2
P/NAV (x)	1.1	1.0	1.0	1.0
Aggregate Leverage (%)	36.6	36.2	37.1	37.6
ROAE (%)	10.6	5.4	6.0	6.6
Distn. Inc Chng (%):		-	-	-
Other Broker Recs:		B: 2	S: 0	H: 0

** FY15 numbers are on a proforma basis while FY16 are on an annualised basis*

Source of all data on this page: Company, DBS Bank, Bloomberg Finance L.P.

America's office is great

Play on exposure to an improving US office market. We maintain our BUY call and TP of US$0.93. We continue to like Manulife US REIT's (MUST) attractive prospective 7.2% yield, strong organic growth prospects and exposure to the favourable demand and supply fundamentals in the US office markets where MUST's properties are located. This translates to an 8% DPU growth in FY17, one of the highest among REITs in Singapore. The expected strength of the USD/SGD exchange rate could also result in inflows into the stock.

Increased confidence on the REIT's ability to deliver. Our recent visit to properties in the US and meetings with various property brokers as well as MUST's strong maiden results indicate that market fundamentals remain firm. We believe that MUST's properties in Midtown Atlanta and Downtown Los Angeles submarkets will continue to see steadily increasing rents, continued expansionary tenant demand, increased employment opportunities and also a lack of competitive new supply. Apart from upside when leases come due, 84.2% of leases (by NLA) have annual rental escalations of around 3%, and 15.0% have provisions for mid-term or period rent increases.

Acquisitions to be the next driver of growth. The manager has been disciplined towards acquisitions and with the recent decline in gearing to 34.6%, MUST is well placed to execute on DPU-accretive acquisitions. Apart from that, we expect any acquisition to diversify the REIT's geographic earnings base and tenant concentration. Markets that are of interest are core submarkets that enjoy demand from a diversified type of industries (i.e. manufacturing, financial, technology and law firms) which imply stability across market cycles. We have not priced in acquisitions in our forecasts.

Valuation:

TP is maintained at US$0.93 based on DCF. The stock offers attractive FY16-17F yields of 6.6-7.2%.

Key Risks to Our View:

Lower-than-expected rental income. The key risk to our view is lower-than-expected rental income, arising from the non-replacement/renewal of leases and/or slower-than-expected recovery of office rents in the US.

At A Glance

Issued Capital (m shrs)	626
Mkt. Cap (US$m/US$m)	525 / 525
Major Shareholders (%)	
Manulife International	7.5
Free Float (%)	92.5
3m Avg. Daily Val (US$m)	0.51
ICB Industry : Financials / Real Estate Investment Trusts	

WHAT'S NEW

Strong maiden results

Boost from lower interest expenses

- MUST delivered its maiden DPU of 2.01 UScts (for the period of 20 May to 30 September), 5.8% above its IPO forecasts and tracking in line with our annualised FY16F DPU of 5.61 UScts.
- The DPU exceeded IPO forecasts mainly due to a lower-than-expected interest rate of 2.46% versus initial projections of 2.8%. In addition, NPI of US$17.6m exceeded IPO forecasts by 1.5% despite revenue of 1.1% below IPO forecasts due to lower recoveries/property expenses.

Healthy portfolio occupancy and strong rental reversions

- Overall portfolio occupancy was healthy at 97% up from proforma FY15 occupancy of 96.5%, though slightly below the projected occupancy at end-December 2016 of 97.7%.
- From 1 January to 30 September 2016, MUST also reported strong rental reversions of 8.5% on a portfolio basis. On a per property basis, this consists of a 9.7% increase at Figueroa, 9.9% at Michelson and 4.8% at Peachtree.
- Meanwhile, average gross passing rents as at end-September were on average 3.8% higher than at end-December 2015. Passing rents at Figueroa, Michelson and Peachtree now stand at US$35.10 psf per year (+4.3%), US$47.50 (+3%) and US$30.00 (3%) respectively.

Minimal lease expiries with lengthening WALE

- On the back of renewals year to date and forward renewals, there are no longer any leases that are due for renewal for the remainder of FY16 (5.7% of cash rental income at the start of the year) and for FY17, the amount of leases due to expire has fallen from 11.6% to 5.1%.
- In addition, the forward renewal of a major tenancy at Michelson which was due to expire in FY17, extended the overall portfolio weighted average lease expiry (WALE) from 5.7 to 6.1 years.

Increase in portfolio values with gearing dropping to 34.7%

- On the back of increased investment demand and favourable leasing activities, the portfolio cap rate compressed from 5.7% to 5.3%, resulting in MUST's portfolio increasing in value to US$777.5m, 4.6% higher than the initial acquisition costs at IPO. Valuations at Figueroa, Michelson and Peachtree rose 6.3%, 3.4% and 4.1% respectively.
- As a consequence of the higher valuations, NAV per unit rose 7.7% from IPO to US$0.84.
- Gearing also fell from 36.8% as at end-December 2015 to 34.7%, which provides additional debt headroom of c.US$75m should MUST gear up to 40%, the top of its gearing range. The increased debt headroom should assist MUST in its plans to potentially acquire one asset per year worth between US$100-150m.

No refinancing until 2019 and immune to near-term rise in interest rates

- MUST currently faces no refinancing risk until 2019, with US$108m, US$67m and US$121m due in 2019, 2020 and 2021 respectively.
- Moreover, MUST's earnings are immune to an increase in short-term increases in interest rates as 100% of its debt is fixed until 2019.

Visible growth ahead, with healthy underlying market fundamentals

- Moving into 2017, we expect MUST to deliver an 8% growth in DPU. This is underpinned by the fact that 99.2% of leases having rental escalations of which 84.2% have an annual escalation of around 3%, with another 15% subject to mid-term or periodic rental increases.
- In addition, we expect MUST to continue to deliver healthy rental reversions as it renews its upcoming leases. 5.1% of leases by cash rental income are due to expire in 2017 with another 1.7% up for renewal in 2018.
- This is supported by healthy market fundamentals at Greater Downtown Los Angeles, where Figueroa is located. Current demand exceeds supply which resulted in Class A rents rising by 2% in 3Q16 versus 2Q16 or 4.9% on a y-o-y basis.
- At Michelson, the Irvine, Orange County market faces limited new supply which resulted in a 12-month rental growth of 8.4% and vacancy dropping to 10.6% from 11.2% in the previous quarter.
- Meanwhile at Midtown Atlanta, Peachtree enjoys the fact that rent growth over the last 12 months has increased by 12.5%, with positive net absorption.

Incremental earnings from additional NLA at Figueroa

- Due to the implementation of new Building Owner and Managers Association (BOMA) 2010 code, which prescribes the measurement of net lettable area (NLA), for buildings in the US, Figueroa's NLA will increase from c.695k sqft to 732k sqft.
- However, the ability to maximise the additional NLA will only occur when existing leases come up for renewal and MUST charges for the additional space. For example, in the latest results, NLA increased by 7.1% on c.72k sqft of new leases renewed.

Maintain BUY, TP of US$0.93

- With a strong maiden set of results, we maintain our BUY call with TP of US$0.93. We continue to like MUST for its exposure to the growing US office market and attractive 7.2% FY17F yield.

Quarterly / Interim Income Statement (US$m)*

FY Dec	3Q2016
Gross revenue	28.2
Property expenses	(10.6)
Net Property Income	17.6
Other Operating expenses	(1.7)
Other Non Opg (Exp)/Inc	0.0
Net Interest (Exp)/Inc	(3.1)
Exceptional Gain/(Loss)	0.0
Net Income	12.8
Tax	(12.0)
Minority Interest	0.0
Net Income after Tax	0.85
Non-tax deductible Items	(21.1)
Net Inc available for Dist.	12.6
Ratio (%)	
Net Prop Inc Margin	62.4
Dist. Payout Ratio	100.0

** 3Q16 relates to results between 20 May to 30 September 2016 and are MUST's maiden results. Thus there is no valid y-o-y or q-o-q comparison.*
Source of all data: Company, DBS Bank

CRITICAL DATA POINTS TO WATCH

Earnings Drivers:

Exposure to the recovery of US real estate market. According to Colliers International (Colliers), the office market outlook for Downtown Los Angeles, Orange County and Atlanta are attractive given (i) rising demand due to projected falling unemployment rates on the back of a pick-up in business activities, and (ii) a deep pool of local talents and skilled workers which attract companies to set up and maintain their presence there.

The sub-markets where Manulife US REIT's properties are located are also characterised by a lack of new competitive supply due to limited land availability and high construction costs. Given supportive market dynamics, Colliers expects Class A rents in the respective markets to improve by 1.5-23.0% per annum over 2015-2017. Through the initial portfolio and potential acquisitions in the future, we believe that MUST offers a cyclical recovery story, with rents and capital values at or close to an upswing, underpinned by improved business activity in the US and real estate values that are off previous highs.

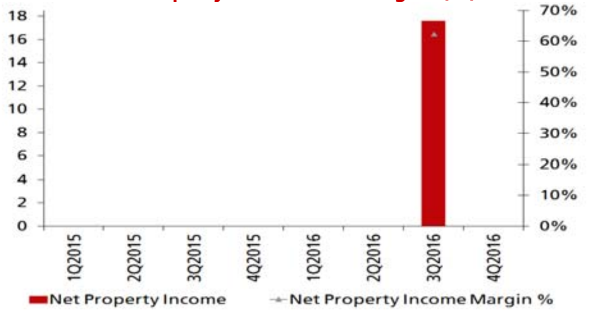
Inbuilt organic growth. MUST's properties are well positioned to experience strong organic growth delivered through built-in rental escalations embedded into their lease contracts. As at 30 September 2016, (1) approximately 84.2% of leases (by NLA) for the initial portfolio had built-in annual rental escalations, mostly between 2.5% and 3.5%, and (2) 15% of leases (by NLA) had mid-term or period rent increases, thus providing a visible and growing rental income stream.

Long WALE of 6.1 years offers strong income visibility. With leases typically signed on a 3- to 10-year lease and some in excess of 10 years, the initial portfolio enjoyed a long WALE of 6.1 years (by NLA) as at 30 September 2016. As such, the initial portfolio has minimal expiries in the following years - only 5.1% and 1.7% of its leases (by cash rental income) are expiring in 2017 and 2018 respectively, and we are expecting these leases to revert positively when leases are due for renewal.

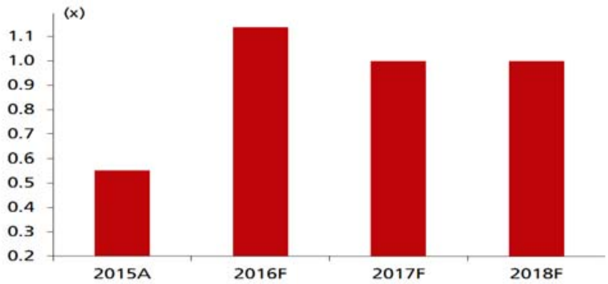
Growth through acquisitions by tapping into the expertise of its Sponsor. MUST's Sponsor is The Manufacturer's Life Insurance Company, which is part of Manulife Financial Group, a Canada-based financial services group. Through its subsidiary, Manulife Real Estate (MRE), the Sponsor has a strong acquisition capability and track record, demonstrated by the acquisition of 85 properties worth US$6.2bn since 2010. This has resulted in a CAGR of 17.5% per annum in the value of MRE's AUM. Therefore, we believe MUST will be able to tap on its Sponsor's real estate platform, to source deals, access local market expertise and gain assistance in securing financing to grow its portfolio through DPU-accretive acquisitions in the US.

Net Property Income and Margins (%)

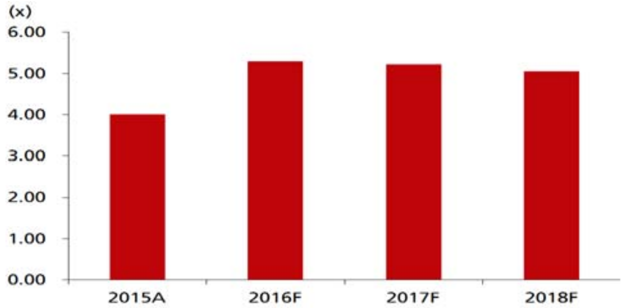
Net Property Income and Margins (%)



Distribution Paid / Net Operating CF



Interest Cover (x)



Source: Company, DBS Bank

Balance Sheet:

Stable gearing. Post recent portfolio revaluation gains, MUST's gearing has fallen to 34.7% from 36.8% as at end-December 2015. This provides for a debt headroom of c.US$75m should MUST increase its gearing back up to 40%.

Conservative interest rate profiles. To manage its interest rate risks, MUST has hedged 100% of its interest exposure at an average interest rate of 2.46% till 2019.

Share Price Drivers:

Establishing a track record. A key pushback from potential investors is the lack of familiarity with the US office market, which we believe after a few quarters of strong results, will allay most of investors' concerns. This may lead to a re-rating of the stock. Another key share price driver is the potential outperformance relative to MUST's IPO forecast. This could be driven by stronger-than-expected recovery of the US office market leading to higher rental reversions.

Key Risks:

Risk of non-renewal and non-replacement of leases. MUST's financials, results of operations, and capital growth may be adversely affected by bankruptcy, insolvency or downturn in the businesses of one or more of the tenants, as well as the decision by one or more of these tenants not to renew their lease/s at the end of a lease cycle.

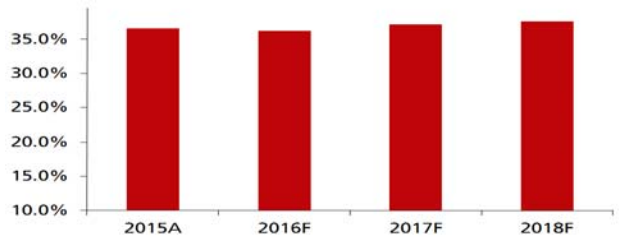
Foreign currency risks. All of the REIT's assets are located in the US and generate revenues in USD. Thus, investors who elect to receive distributions in SGD have exposure to volatility in the USD/SGD FX rate. This is mitigated should investors elect to receive distributions in USD.

Regulatory risks. MUST's tax efficiency relies in part on its Parent US REIT and Sub-US REITs being able to maintain their status as US REITs as well as qualifying for US portfolio interest exemption when repatriating cashflows back to Singapore as interest. Should there be any changes in tax or REIT regulations in either the US or Singapore which affects the current REIT structure or ability to repatriate cash in a tax-efficient manner, distributions paid to MUST's unitholders may be adversely impacted.

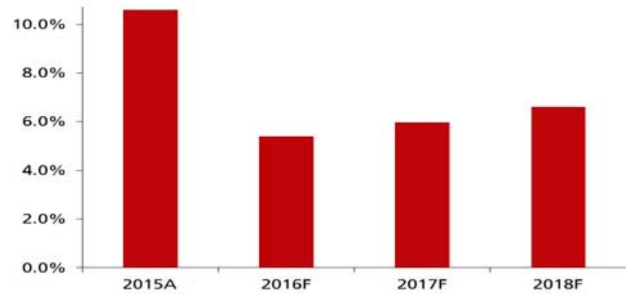
Company Background

Manulife US REIT (MUST) is the first pure-play US office REIT listed in Asia. Its portfolio consists of three freehold, Class A or Trophy quality office properties in Atlanta, Los Angeles, and Orange County with aggregate net lettable area (NLA) of c.1.8m sqft.

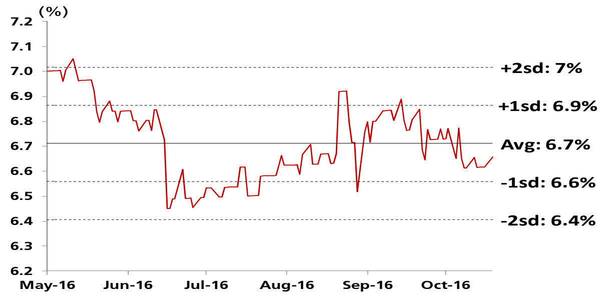
Aggregate Leverage (%)



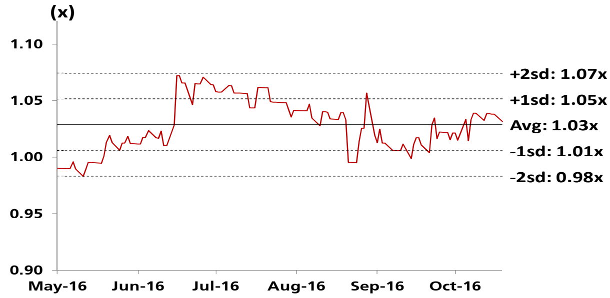
ROE (%)



Distribution Yield (%)



PB Band (x)



Source: Company, DBS Bank

Income Statement (US$m)

FY Dec	2016F	2017F	2018F
Gross revenue	78.7	79.3	80.7
Property expenses	(30.0)	(30.7)	(31.1)
Net Property Income	48.7	48.6	49.5
Other Operating expenses	(5.4)	(5.4)	(5.7)
Other Non Opg (Exp)/Inc	0.0	0.0	0.0
Net Interest (Exp)/Inc	(8.2)	(8.3)	(8.7)
Exceptional Gain/(Loss)	(6.6)	(2.9)	0.0
Net Income	28.6	32.1	35.2
Tax	(1.3)	(1.3)	(1.2)
Minority Interest	0.0	0.0	0.0
Preference Dividend	0.0	0.0	0.0
Net Income After Tax	27.2	30.8	33.9
Total Return	27.2	30.8	33.9
Non-tax deductible Items	8.14	7.65	4.91
Net Inc available for Dist.	35.4	38.4	38.8
Growth & Ratio			
Revenue Gth (%)	11.0	0.8	1.7
N Property Inc Gth (%)	10.4	(0.2)	1.9
Net Inc Gth (%)	4.9	13.1	10.2
Dist. Payout Ratio (%)	100.0	100.0	100.0
Net Prop Inc Margins (%)	61.9	61.3	61.4
Net Income Margins (%)	34.6	38.8	42.1
Dist to revenue (%)	44.9	48.4	48.2
Managers & Trustee's fees	6.9	6.8	7.0
ROAE (%)	5.4	6.0	6.6
ROA (%)	3.3	3.7	4.0
ROCE (%)	5.3	5.2	5.2
Int. Cover (x)	5.3	5.2	5.1

Source: Company, DBS Bank

Growth driven by recovery in the US office market

Quarterly / Interim Income Statement (US$m)

FY Dec	3Q2016
Gross revenue	28.2
Property expenses	(10.6)
Net Property Income	17.6
Other Operating expenses	(1.7)
Other Non Opg (Exp)/Inc	0.0
Net Interest (Exp)/Inc	(3.1)
Exceptional Gain/(Loss)	0.0
Net Income	**12.8**
Tax	(12.0)
Minority Interest	0.0
Net Income after Tax	**0.85**
Total Return	33.7
Non-tax deductible Items	(21.1)
Net Inc available for Dist.	12.6
Growth & Ratio	
Revenue Gth (%)	N/A
N Property Inc Gth (%)	nm
Net Inc Gth (%)	nm
Net Prop Inc Margin (%)	62.4
Dist. Payout Ratio (%)	100.0

Balance Sheet (US$m)

FY Dec	2016F	2017F	2018F
Investment Properties	813	821	827
Other LT Assets	0.0	0.0	0.0
Cash & ST Invts	20.3	20.3	20.4
Inventory	0.0	0.0	0.0
Debtors	3.15	3.17	3.23
Other Current Assets	0.70	0.70	0.70
Total Assets	**837**	**845**	**851**
ST Debt	0.0	0.0	0.0
Creditor	7.87	7.93	8.07
Other Current Liab	4.34	4.34	4.34
LT Debt	303	314	320
Other LT Liabilities	5.10	5.10	5.10
Unit holders' funds	517	514	514
Minority Interests	0.0	0.0	0.0
Total Funds & Liabilities	**837**	**845**	**851**
Non-Cash Wkg. Capital	(8.4)	(8.4)	(8.5)
Net Cash/(Debt)	(283)	(294)	(299)
Ratio			
Current Ratio (x)	2.0	2.0	2.0
Quick Ratio (x)	2.0	2.0	2.0
Aggregate Leverage (%)	36.2	37.1	37.6

Source: Company, DBS Bank

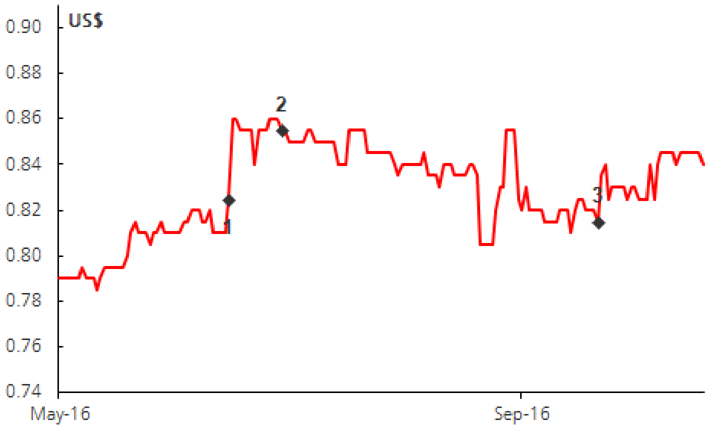
Cash Flow Statement (US$m)

FY Dec	2016F	2017F	2018F
Pre-Tax Income	35.1	35.0	35.2
Dep. & Amort.	0.0	0.0	0.0
Tax Paid	(1.3)	(1.3)	(1.2)
Associates &JV Inc/(Loss)	0.0	0.0	0.0
Chg in Wkg.Cap.	(4.3)	0.04	0.08
Other Operating CF	1.56	4.79	4.91
Net Operating CF	**31.1**	**38.5**	**38.9**
Net Invt in Properties	(0.6)	(2.1)	(0.8)
Other Invts (net)	0.0	0.0	0.0
Invts in Assoc. & JV	0.0	0.0	0.0
Div from Assoc. & JVs	0.0	0.0	0.0
Other Investing CF	(8.8)	(8.4)	(5.0)
Net Investing CF	**(9.4)**	**(10.6)**	**(5.8)**
Distribution Paid	(35.4)	(38.4)	(38.8)
Chg in Gross Debt	9.44	10.6	5.83
New units issued	0.0	0.0	0.0
Other Financing CF	0.0	0.0	0.0
Net Financing CF	**(25.9)**	**(27.9)**	**(33.0)**
Currency Adjustments	0.0	0.0	0.0
Chg in Cash	(4.3)	0.04	0.08
Operating CFPS (US cts.)	5.61	6.05	6.06
Free CFPS (US cts.)	4.84	5.72	5.95

Minimal capex due to recently refurbished buildings

Source: Company, DBS Bank

Target Price & Ratings History



S.No.	Date of Report	Closing Price	12-mth Target Price	Rating
1:	04 Jul 16	0.83	0.91	BUY
2:	18 Jul 16	0.86	0.93	BUY
3:	10 Oct 16	0.82	0.93	BUY

***Note**: Share price and Target price are adjusted for corporate actions.*

Source: DBS Bank

Analyst: Mervin SONG CFA, Derek TAN

DBS Bank recommendations are based an 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

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