TRANSCRIPT
Manulife US REIT's 1H 2024 Results Media & Analyst Briefing
Venue & Date: Manulife Tower, 5 August 2024, Monday

On the Panel:
Mr John Casasante, Chief Executive Officer and Chief Investment Officer
Mr Mushtaque Ali, Chief Financial Officer
Mr Choong Chia Yee, Head of Finance

Mr John Casasante: Good morning, everyone. I would like to welcome everyone to the first half financial results for Manulife US REIT. Very excited to be here and I'm looking forward to our future. As a reminder, there are three phases to our plan: stabilisation, recovery and growth. We are currently in the stabilisation phase and our high-level strategies consist of the following: risk management, capital markets, asset level strategy and portfolio construction which includes hold-sell analysis. These strategies have not changed and will be consistent throughout all phases, allowing us to be innovative to create a path to maximise unitholder value. It has been a relatively short period of time since Mushtaque and I have joined and I think we have made good progress on these plans.

Some of our key highlights and priorities are dispositions. Our disposition plan is on track with three assets currently on the market which will be elaborated on as we go through this deck. Occupancy rate has been stable quarter over quarter (QoQ) and we have a WALE which lengthened to 4.7 years. We continue to have prudent capital and liquidity management in a highly constrained environment. Our portfolio is currently at 78.4% occupancy and we've executed 428,000 square feet of leases. I will now hand it over to Mushtaque to go over the financials.

Mr Mushtaque Ali: Thanks, John. The gross revenue of the REIT on same-store properties was US$86.7 million, 8.1% lower than the same period last year. This is primarily due to the drop in occupancy compared to the first half of 2023. Although our portfolio occupancy remained stable QoQ, when we compare this to the first half of 2023, we recorded a drop of 6.7%. Of that, 3.7% drop is attributable to one large lease, TCW Group, that vacated 189,000 sq ft of space at the start of this year. This was also highlighted in the past few meetings.

The other 3% reduction came from the downsizing of The Children's Place at 500 Plaza and a financial institution tenant that vacated 73,000 square feet at the Exchange. Aside from these vacancies, the remaining portfolio remained quite resilient with a very insignificant volume of negative net absorption on a year over year (YoY) basis. During the first 6 months, the REIT has earned adjusted income available for distribution (adjusted DI) of 1.29 cents per unit. This is 27% lower, primarily due to 16.7% reduction in same-store net property income (NPI), disposition of two assets (Tanasbourne and Park Place in Financial Year 2023) and an increase in interest expenses. However, as part of our Recapitalisation Plan, the REIT has halted its distribution to unitholders until 31 December 2025, or unless early restatement conditions are achieved.

The table provides a breakdown of the REIT's NPI and further categorises it by Tranche 1, 2 and 3 assets. It is important to highlight that Tranche 1 assets reported the largest drop in NPI by 33%, followed by Tranche 2 assets, by 14%, whereas Tranche 3 assets remained stable, reporting a slight growth of 1% in the first half of 2024. The NPI performance of these assets and tranches provides further reassurance about our classification of these assets into the respective categories. As we dispose of our assets, this reassurance gives us comfort on our strategy.

The fair value of our portfolio was US$1.43 billion, which remained consistent with 31 December valuations. We have reviewed the assumptions that went into the 31 December 2023 valuations and those remain broadly consistent. There has been no significant changes in the valuation, apart from regular capitalisation of cost on the carrying value of our investment properties. The REIT carries healthy cash balance of US$95 million after repayment of US$50 million of debt, in accordance with the Master Restructuring Agreement (MRA). The cash balance also includes US$18.2 million held in interest reserve account, which covers 6 months of interest payments held as security. Excluding this reserve account, we have US$77 million of cash available for use, which is sufficient for our existing capital commitments, as well as our 2024 budgeted leasing capital and operating requirements.

As part of our stabilisation efforts, we have adopted a disciplined approach on capital spending to improve liquidity. This allows strategic deployment of capital on specific leasing activities to improve occupancy in our Tranche 2 and 3 assets, as well as to use any excess cash to repay debts and delever our balance sheet as we look forward to moving to the recovery and growth phases. The REIT has US$131 million of debt maturing in 2025. The successful completion of our asset disposition milestones would allow us to repay our debt obligations on or before the scheduled maturity. In the current stabilisation phase of our strategy, we will remain focused to delever our balance sheet and reach a portfolio that sets the stage for recovery and the growth phase of our strategy. During the 6 months, the REIT remained fully compliant with bank facility covenants, with an ample buffer to withstand any potential adverse impact of valuation decline or decline in Earnings Before Interest, Taxes, Depreciation, and Amortisation (EBITDA) or increase in interest expenses.

The aggregate average of the REIT, under the current Monetary Authority of Singapore (MAS) guidelines, remained at 56.3% which has slightly improved from 58.3% at the beginning of the year. As announced, MAS has proposed new guidelines for consultation with stakeholders to revise the aggregate leverage to a maximum limit of 50%, with a minimum interest coverage ratio (ICR) of 1.5 times. We believe that when MAS enacts these new guidelines, it will be beneficial for Manulife US REIT and will help accelerate our transition from stabilisation, to recovery and future growth. The weighted average interest rate, as at 30 June 2024 was 4.58%. This is 61 basis points higher compared to 3.97% at the start of the quarter. This increase is primarily due to US$143 million of expired interest rate swaps in the first half of 2024 that lowered our fixed ratio from 96.5% to 80.2%.

The income available for distribution remains sensitive to Secured Overnight Financing Rate (SOFR) and we have estimated that a 50 bps change in the floating rate would increase or decrease the adjusted DI by US$0.9 million. At the moment, 20% of the REITs' floating rate debt is unhedged, which will benefit as the SOFR goes down from the expected reduction in interest rates. This will contribute positively to the financial performance of the REIT. We have also adopted a new policy to manage our fixed and hedged portion of our debt, to keep it within a band of 50% on the lower side and 80% on the higher side of the range. As part of our strategy, with interest rates expected to go down and the REIT pursuing its disposition program, we will target to remain on the lower end of the hedged ratio.

With this, I'll pass it back to John.

Mr John Casasante: Thanks, Mushtaque. Moving on to the positive leasing momentum, we've had a very strong first half of the year, with 428,000 square feet of leasing with a long WALE for those leases at 7.3 years. I would like to emphasize on the strategic nature on how we are approaching these leases. Each of these submarkets is different. Valuations on the buildings and buyer pools in those markets are different as well. Therefore, we are being disciplined in how we are deploying leasing capital. There's lots of deals that we have in negotiations that we could make and we could definitely move up our occupancy, but we may not get paid for those deals. Putting money into an asset and then not being able to get your money back when you dispose the asset, will be a waste of money. In a lot of these markets, there is no significant change in the asset valuation for that amount of occupancy, so we've decided to be very strategic. As some of the CMBS markets have opened up, we have also looked at potential options from other angles. It's about positioning the assets in the best-case scenario for the best outcome for that asset.

Part of that process is going to be to make some hard decisions on not executing on some leases. While the leasing market is continually improving, there are still ten-year deals where you will not get paid back until the ninth year. There are also buyers that are not valuing those leases or that occupancy in those markets. Hence, we're looking at each asset on an individual basis.

Our rent reversion for the first half of 2024 is negative 10.6% and I would like to point out that 11 out of the 17 leases were signed above market. It is important to distinguish that in the reversion metric, it doesn't always align with market. Depending on the timing of when the lease was executed and the growers (escalations) that came with it, there is a high probability that that the lease could have outgrown market rent at the point of expiration. If one happens to be in a softer market, which is where we are now, you're going to be re-leasing that space or renewing that tenant at a lower rate. Additionally, being prudent with our capital is also contributing a little to that. In the U.S., the more tenant improvements (TIs) you give, the higher the rent is. From our standpoint, we would rather have cash in hand than amortise that extra cash over a longer lease and taking 5 to 10 years to get repaid for that capital that we have now. We think we have a much more strategic deployment with the capital in hand than that slight difference in the rent.

We've had one of our top five tenants renew. Lease term was 3+ years with modest tenant concessions. These are modest tenant concessions conserving our capital while maintaining the occupancy. We also have a very diversified rent roll with strong credit tenants and an annual rent escalation on average of 2.3% per annum.

On to leasing cycle activity, we have almost a million and a half square feet of leases in some sort of negotiation. We're negotiating on deals where we have more activity than we have vacancy in some of these buildings. It's putting us in a good position to be able to align that leasing activity with what's best for that asset while trying to achieve the lowest cost of capital in completing that lease. In some situations, some of that leasing activity lines up with sale candidates where we can deliver a potential sale opportunity with a lease or two in hand, and let the next buyer make the decision if they want to pay for it or not, without us coming out of pocket for that capital.

Under lease expirations, Tranche 1 assets account for roughly 66% of expiries in the balance of this year and 2025. Based on this, if one or two of those assets were disposed, occupancy would jump up dramatically. We can achieve higher occupancy without having to spend large capital expenditures on TIs. That's the reason why we have presented the expiries this way so that everyone can see it on a property-by-property basis.

Mushtaque already covered where the major vacancies occurred from YoY. They were in three deals which roughly accounted for about 300,000 square feet. One of them was a renewal and downsize, and two were move-outs. We have 171 tenants, which are diversified across 20 trades. Top 10 tenants have a long WALE of 6.8 years. Currently on our rent roll, we have no significant termination options under top 10 tenants within the next 5 years.

As for the markets, we have seen a lot of positive signs. There was approximately a 14% increase in overall leasing activity QoQ. We have also seen a slow positive absorption of sublease space. A lot has to do with sublease space getting down to a short enough term where a subtenant cannot sublease it at that point and a negotiation typically occurs between the landlord and the subtenant and then they will just buy out of the lease or the subtenant will find a tenant and then hand it over to the landlord to do a direct deal. Those are positive signs - there's less sublease space on the market and we're seeing an increase in demand. Rents are staying steady and concessions haven't really moved much. Generally, free rent has not been a huge issue.

The key of the concession standpoint is the cost of TIs, which are wildly different market to market. For example, in Downtown LA, it could be US$150 to US$200 psf. However in another market, it could be US$60 to US$100, depending on the term of the lease. Hence, we see a huge variance between markets. From a strategic standpoint, given our vacancy, if you put a number against increase in occupancy, the focus would be on the cheapest occupancy. Therefore, you can get 5% occupancy for a lot cheaper in, for example Atlanta, than 5% of occupancy in Downtown LA right now given the cost of TIs.

Some economic information are on this slide: GDP rose by 2.8%, CPI is at 3% and unemployment was at 4.1% but that has moved up slightly in the latest report. According to the latest job's report, unemployment has moved up, though it is still under the average of 5%. If we were to look at a silver lining in that information, as unemployment starts to increase, it will put more power into the employers' hand versus the employees' hand. This will hopefully get us back to a position where we're in a more normalised, back to office situation. Part of the struggle in the U.S. with getting people back in the office was because it was such a very tight job market, and employers were afraid of losing employees. Hence they were way more generous and allowing out of office. There might be an equilibrium here where we're going to see more people back in office. We have not seen any retractions across the leasing side other than what we normally see in the market but we are seeing some industries starting to look at expanding into more space. For them to pull the trigger (on expansions), I think they had to have some level of confidence that their employee base will actually be in the office. No one wants to make an executive decision to take on an extra half a floor or full floor, and then have no employees in it. As we move back to a better protocol for back in the office, we might see leasing activity pick up. This could possibly tie in with the presidential elections depending on who wins. We are moving in the right direction, as far as back to office is concerned.

Leasing volume is up QoQ by almost 15% and net absorption has improved from -20m sq ft to -9m sq ft. We aim to outpace the market for occupancy but currently we are at market level for our occupancy. Depending on a couple of strategic dispositions, our occupancy could shoot up pretty dramatically.

These are the phases that I referenced before: stabilisation, recovery and growth. This is going to be a consistent message that you see, as we get to our growth cycle. Currently, within the stabilisation phase, we are focused on asset dispositions while maximising sale proceeds but with the understanding that liquidity has a price and there's nothing we can do about that. However, the key is to find liquidity and see where the prices come in on that liquidity.

This was the design of having multiple tranches and differentiating the assets within those tranches. Liquidity comes at a price. We are very focused on asset dispositions and are viewing our dispositions from multiple angles. Currently, we have three properties on the market, another property being marketed off the market, and some off market tours of our assets. We have also had some conversation on some alternative transactions as it relates to the assets. We are not putting all our eggs into a basket. We are allowing ourselves to have some flexibility. As time goes on, this would also give us some optionality to pick and choose versus potentially being in a position where we have to go with what we have. Given that everything kind of comes together as we hope, it will put us in a position where we have some optionality to be a little more strategic in addition to what we're already doing in relation to our dispositions.

Portfolio management ties into the hold-sell analysis of an asset to make sure we're spending capital wisely and we're putting the asset in the best position possible for the strategy of that asset. We are going to do our best to maximise occupancy, with an alignment of the broader plan on the disposition side. As all these needs to come together, we will be reviewing these on a continual basis. In addition to that, we have very stringent capital controls, not only from the standpoint on leasing capital, but also on building capital. If we're doing any sort of repositioning or renovation, it needs to be very clear that there's going to be a payback in a relatively short period of time or upon an exit of an asset we would also get paid for that. For capital and risk management, we repaid US$50 million of debt in March of 2024. We are progressing on the milestones of our MRA and looking to delever and advanced to the recovery stage. We've also put in place a hedging policy within acceptable risk tolerance.