Singapore Industry Focus

US Office SREITs

Refer to important disclosures at the end of this report

DBS Group Research . Equity

27 Mar 2023

Rewards for the brave

- US office market remains in a state of uncertainty, but headwinds are largely known and priced in
- Some bright spots amidst a gloomy outlook, but will take time to play out and stabilise the market
- Valuations at 0.5x P/B are close to the bottom in our view, with imminent end of rate hike cycle a catalyst
- Preferred pick KORE – shown more resilient operations compared to peers

Headwinds are largely known. The US office market remains in a state of uncertainty, impacted by both a structural shift (higher adoption of flexible working) coupled with cyclical factors (impacted by the hawkish Fed) at play concurrently. Leasing momentum has also quietened down with landlords offering higher incentives to attract/retain tenants, impacting cash flow growth. While sector headwinds abound, we believe that these negatives are largely known and priced in at FY23 yields of 15% and an average valuation of 0.5x P/BV, below the COVID low in 2020 and -2 standard deviation (SD) levels.

Silver lining amidst a gloomy outlook. Despite the gloomy outlook on the US office market, we see bright spots emerging. While we may be making an early call, we see some optimism due to i) lower competition from declining new supply; ii) more landlords undertaking repositioning exercises and converting into other asset classes to reduce available supply; and iii) the imminent maturing phase of the current rate hike cycle. These factors will likely need time to play out before the US office market can stabilise. However, we remain constructive on the medium-term outlook.

Valuations close to the bottom; waiting for a re-rating catalyst. The US-listed office REITs are currently trading at 0.75x P/BV, close to the GFC low. While the US office SREITs do not have sufficient trading history stretching back to the last crisis, i.e., GFC, we believe that at 0.5x P/B, it is close to the bottom and awaiting a catalyst. We believe the re-rating catalyst lies in whether the Fed moderates or pauses the interest rate hikes, which will drive a share price turnaround and re-rating. Our preferred pick is KORE, which has shown more resilient operations compared to its peers. On the other hand, MUST has de-rated the most and would probably see the overhang lifted once it resolves its capital management issues.

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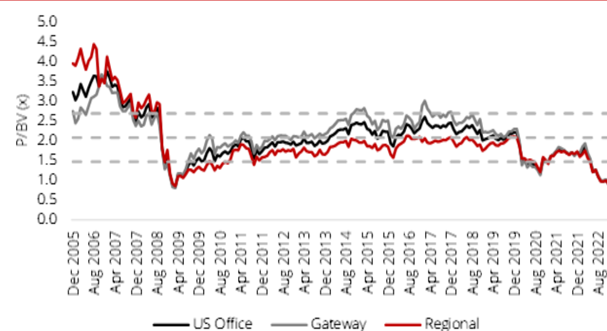
STOCKS

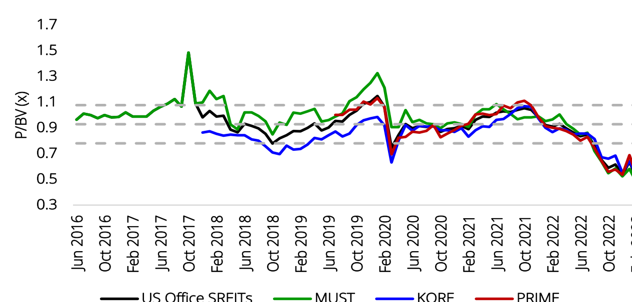
	Price US$	Mkt Cap US$m	12-mth Target Price US$	Performance (%) 3 mth	Performance (%) 12 mth	Rating
Manulife US Real Estate Inv	0.25	450	0.45	(19.4)	(60.6)	BUY
Prime US REIT	0.335	396	0.63	(18.3)	(55.6)	BUY
Keppel Pacific Oak US REIT	0.405	423	0.65	(6.9)	(43.4)	BUY

Source: DBS Bank, Bloomberg Finance L.P.
Closing price as of 24 Mar 2023

US office REITs trading at GFC low, at 0.75x P/BV



US office SREITs trading at 0.5x P/BV



Source: DBS Bank

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ed: BM/ sa: HPH, PY, CS

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Macro uncertainty remains an overhang but largely priced in

US office market still in a state of flux. The US office market remains in a state of uncertainty, impacted by both the structural shift to hybrid work coupled with cyclical factors at play concurrently – a twofold setback. That said, while the uncertainties operationally weigh on sentiment on the sector, we believe that these factors are well flagged by the market and largely priced in, with the SG-listed US office REITs trading at forward yields of c.15% and an average of 0.5x P/BV and, below the COVID low in 2020 and -2 standard deviation (SD) levels.

Contrary to the post-COVID recovery experience in most cities in Asia, where we note a general return to office for most employees, the US office market is observing a slower pace of return-to-office, with a higher adoption of flexible work arrangements. As such, office occupiers are re-evaluating their space needs and utilisation in a new working environment. As corporations review and "right-size" their office requirements, we also note that tenants are seeking newer buildings with high-end amenities to attract employees. In addition, tenants are seeking both shorter lease terms and office space design flexibility for easier adoption of change or collaboration work in the office.

Rate hikes weigh on expansionary plans. Macroeconomic challenges heightened by the Fed's hawkish rate hikes in 2022 continue to worsen for the already shaky US office market. In 2022, the Fed raised policy rates by 425 basis points, which raised concerns of a slowing economy. Unfortunately, the CPI staying stubbornly high is extending the high interest rate environment for longer. Consequently, corporations turned even more cautious and held back on any expansionary plans, thus impacting demand for office space. We are seeing "cracks" in the economy that have started to appear, with the first bank failure (Silicon Valley Bank) since the GFC causing fears of a potential contagion effect.

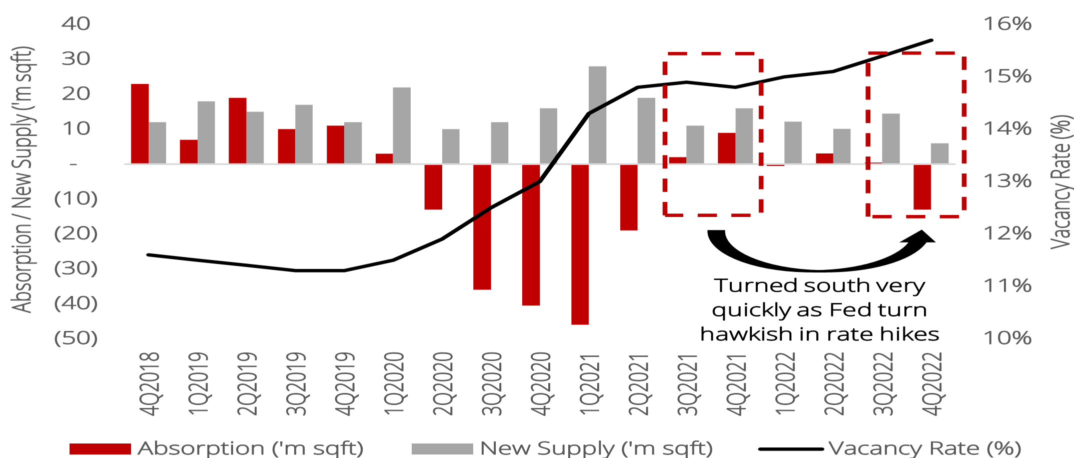
We list below some of the US office market data that has turned against the sector and may likely see a more volatile 2023.

Absorption turned south as soon as Fed turned hawkish in rate hikes

In 2H21, US office net absorption was on a recovery trend, reversing from negative absorption during the pandemic in 2020 and 1H21. 3Q21 recorded its first positive absorption while 4Q21 saw a significant growth in absorption.

Unfortunately, the recovery trend was thwarted in less than a year, when the Fed started to hike interest rates, and fell into negative territory again very quickly, after the Fed's hawkish stance in 3Q22. 4Q22 saw absorption fall to negative 11m sqft vs. a slightly positive value in 3Q22.

Recovery trend at the end of 2021 thwarted as absorption turned negative in 4Q22 when Fed turned hawkish



Source: Colliers, DBS Bank

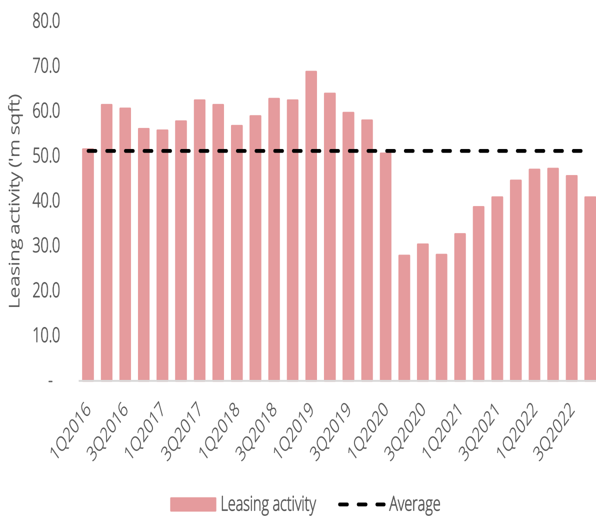
Leasing activity peaked in 2Q22 and saw an accelerated decline in 4Q22

Leasing activity bottomed out in 4Q20 during COVID and peaked in 2Q22 at 47m sqft, 75% below that of the pre-pandemic average in 2019. The decline accelerated in 4Q22, where leasing activity fell c.10% q-o-q to 41m sqft. According to JLL, the slowdown in activity was most notably felt among large-scale leases with just 42 transactions pertaining to space of more than 100k sqft being signed in 4Q22, the lowest total since 1Q21 and more than 50% below the pre-pandemic quarterly average. More than three quarters of the large leases executed were in Trophy or Class A buildings. Interestingly, the signing of the largest lease in 2022 occurred in 4Q22, but it was renewed with a 33% downsize. The US Patent and Trademark Office renewed 1.6m sqft of its previous total lease of 2.4m sqft in Northern Virginia.

Sublease space spiked to all-time high

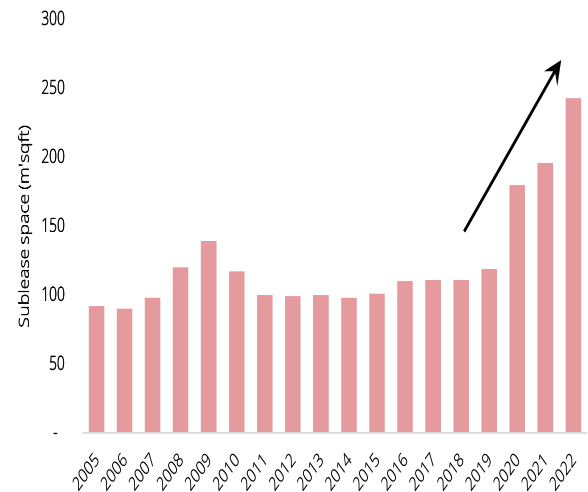
Sublease space has been rising since the pandemic and spiked to an all-time high in 4Q22. During the GFC, sublease space peaked at levels that were 40% lower than the current levels, according to Colliers. Direct Class A asking rents are, on average, 30% more than that of Class A sublease space in the CBDs of the top 10 markets. Some markets such as Houston are commanding a 50% sublease discount while Dallas is asking for just 16%. According to Colliers, there's a greater share of quality sublease options now compared to the prior downcycle, implying higher competition for space.

Accelerated decline in leasing activity in 4Q22



Source: JLL, DBS Bank Bank

Sublease spiked to an all-time high



Source: Colliers, DBS Bank

Rents have held relatively stable, but offset by higher tenant improvement (TI) allowance and free rents.

Asking rents have held up since the pandemic, despite rising vacancies and moderating absorption. However, this was offset by higher tenant improvement (TI) allowance and free rents, putting pressure on the net rental income of office landlords.

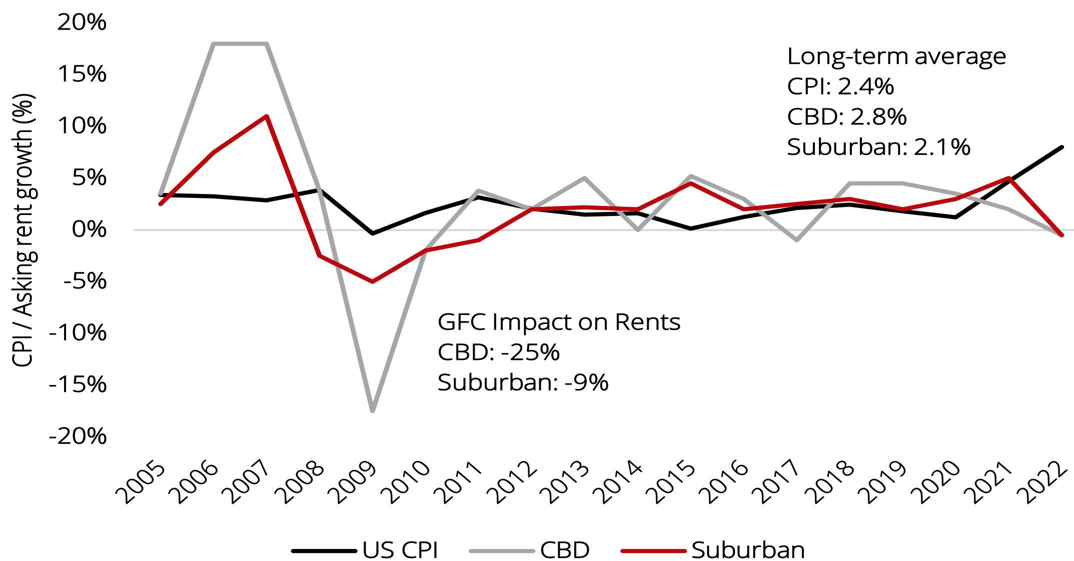
Suburban rents have held up much better than the CBD rents throughout the pandemic, but both have ended with flat growth at the end of 2022.

TI allowance continues to rise since the pandemic, with 4Q22 TI coming in c.18% higher than the pre-COVID level, partly to compensate for higher renovation costs. Free rents have also spiked to c.9 months vs. below 7 months in 4Q19.

Layoffs have begun, albeit still low

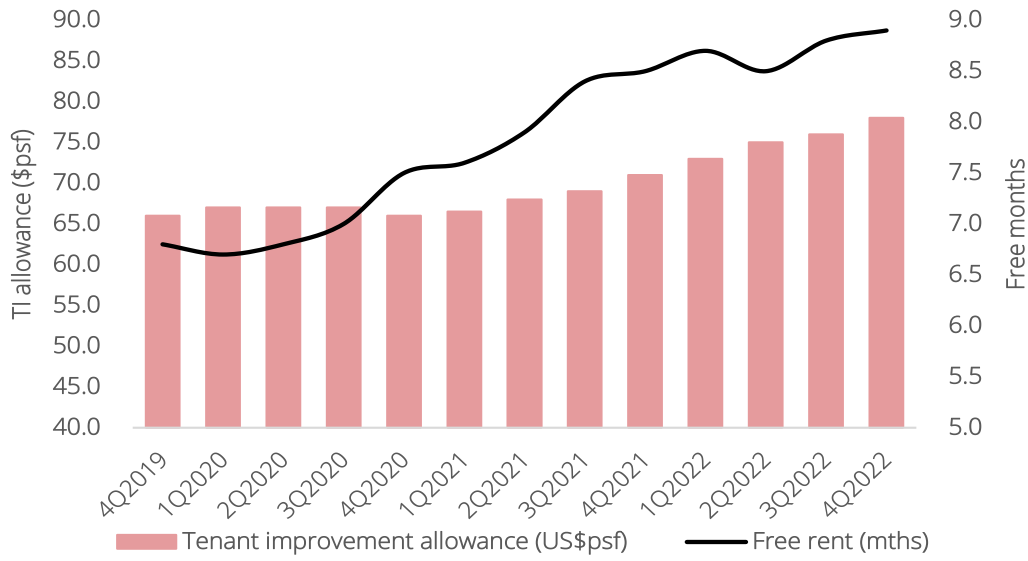
As the economic outlook turns grim, corporations have started to announce layoffs and hiring freezes since the end of 2022. The layoffs have been largely led by tech companies and followed by financial institutions in most recent times, with more to potentially come when the economy slows. According to media, announced layoffs amounted to c.52k in Nov 22 and another 48k layoffs from major tech companies were announced in Jan 23. While the numbers may seem daunting, the layoffs account for 5% to 30% of the respective organisation's workforce and, in most large firms, its global workforce. We believe this is still low in the perspective of the aggressive hiring that took place over the past few years, but layoffs may continue if economic growth continues to worsen.

Class A asking rent growth vs. inflation



Source: Colliers, DBS Bank

TI allowance and free rents continue to rise



Source: JLL, DBS Bank

Silver lining amidst gloomy outlook

Despite the gloomy US office market outlook, there is some silver lining or pockets of bright spots that could imply we are closer to a potential stabilisation. However, it may take a while for these to play out before the US office market could stabilise.

Lower new supply pipeline

With the volatile US office market and moderating demand over the past few years, the development pipeline has been on a declining trend due to construction delays. In addition, rising construction cost and cost of funding have also moderated development projects. According to JLL, volume under construction declined 7.5% q-o-q in 4Q22 to 3.9m sqft. In addition, more than half (c.58%) of the c.100m sqft of projects currently under construction are already preleased. The slowdown in new supply will help stabilise supply in the market, especially with the rising sublease space. However, the market needs some time to find an equilibrium again.

Conversion and repurposing of office buildings into other asset classes

In addition to the declining development pipeline, there has been an increased appetite for the conversion of obsolete office assets for other uses or into other asset classes. Some of these buildings have been repurposed into residential or multi-family assets. According to JLL data, in 2022, 11.5m sqft of office was demolished or converted. This amount has increased c.14% y-o-y. The growing momentum for conversion will likely lead to less office supply in the market. However, these conversions could take time to execute.

Interest rate hikes close to the end

The market has varying views on interest rates moving forward. While the elevated US CPI may keep interest rates higher for longer, after a 425-basis point hike, the interest rate hike cycle is close to the end. In addition, the recent Silicon Valley Bank run could be a sign that the economy's cracks are starting to show, which may eventually lead to the Fed moderating interest rate hikes.

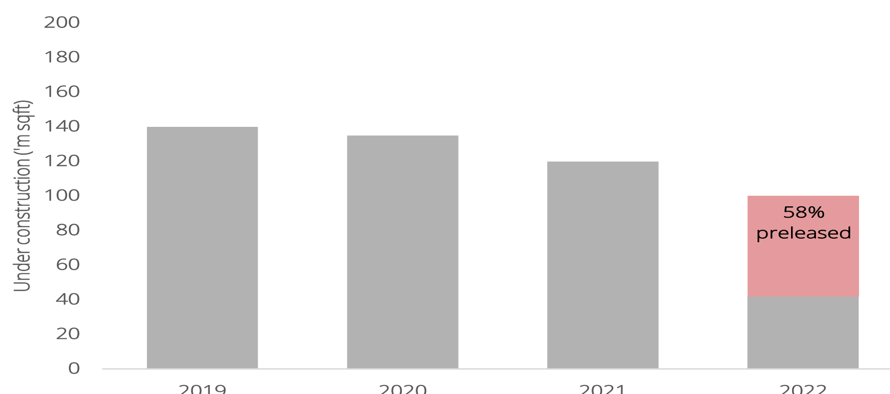
A stabilisation of interest rates could also stabilise the US office market, as businesses and projects would be able to now proceed with some visibility. The capital markets could likely return to spur some transaction activity.

Passed one round of asset repricing

At the end of 2022, we observed that the US office market went through its first round of valuation adjustments, which led to some decline in valuations to factor in higher discount rates (due to higher interest rates) and terminal value, and lower occupancy. The US office SREITs have seen changes in asset valuations in the range of 0% to 11%.

That said, we believe that the asset repricing trend is yet to be over and we see more downside if interest rates were to remain high for longer. The first level of repricing gives us a more realistic sense of the "fair value" of the asset values in the new higher interest rate environment.

Office pipeline under construction



Source: JLL, DBS Bank

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US office SREITs track the industry trend

In line with the industry trend and outlook, the US office SREITs are not spared. Operational metrics have seen some moderation but have not declined significantly enough to warrant the steep drop in share prices. The outlook of US office SREITs' submarkets has also seen declining optimism, which we do not see as a surprise, given the weaker economic outlook.

Among the US office SREITs, our preferred pick Keppel Pacific Oak US REIT (KORE)'s performance has held up relatively better compared to its peers, followed by PRIME US REIT (PRIME) and Manulife US REIT (MUST). Unfortunately, MUST has been adversely impacted by a decline in asset valuation causing a spike in gearing. Please refer to our previous report on the various options for MUST (*Someday, my knight will come*).

US office SREITs' submarkets have seen a decline in optimistic outlook, in line with industry

Similar to the broader industry trend, the US office SREITs' submarkets' optimism has declined, especially towards the end of 2022, reversing the strong start at the beginning of that year.

Based on JLL's 4Q22 US office market insights, the US Office SREITs submarkets with a positive/improvement outlook contributes 21% to 60% of NPI / CRI vs 35% to 82% in 1Q22 and 49% to 74% as at end 2021.

KORE continues to lead its SREIT peers with positive submarkets contributing the majority of its NPI/CRI, c.60%, mainly from the Seattle market, which comprises 42% of KORE's NPI. This is followed by PRIME, with positive submarkets contributing c.35%, mainly from Atlanta. Lastly, MUST's positive submarkets fell to only 21% from 35% in 1Q22, as Washington and Virginia are no longer positive submarkets.

US office SREITs' submarkets showed declining optimistic outlook

Contribution to NPI (%)	MUST			PRIME			KORE		
	2022	1Q22	2021	2022	1Q22	2021	2022	1Q22	2021
Positive	21%	19%	19%	35%	33%	38%	52%	56%	62%
Improving	0%	16%	30%	0%	11%	6%	8%	25%	12%
Neutral	12%	53%	23%	14%	37%	36%	15%	2%	9%
Negative	67%	12%	28%	52%	19%	19%	26%	17%	17%
Positive/improving submarkets	21%	35%	49%	35%	44%	45%	60%	82%	74%
Positive net absorption in 4Q22	35%	31%	42%	29%	58%	47%	67%	74%	57%
Vacancy < 20%	14%	23%	38%	42%	32%	49%	74%	71%	82%

Source: JLL, DBS Bank

KORE's average occupancy in key submarkets is more resilient compared to its peers

Key Office Markets	Contribution	Portfolio Occupancy				
	to NPI (%)	2022	2021	2020	2019	y-o-y
MUST						
Atlanta	19%	90%	93%	95%	98%	-3.1 ppt
Jersey City	15%	86%	98%	95%	96%	-11.5 ppt
Orange County	11%	91%	87%	84%	90%	3.5 ppt
Los Angeles	11%	76%	89%	93%	94%	-12.3 ppt
Sacramento	10%	85%	88%	93%	94%	-2.9 ppt
Total / Average	66%	86%	91%	92%	94%	-5.3 ppt
					vs 2019	-8.6 ppt
PRIME						
Salt Lake City	11%	96%	92%	95%	96%	4.1 ppt
Atlanta	11%	95%	93%	86%	97%	2.1 ppt
Washington	11%	64%	90%	97%	99%	-26.1 ppt
Sacramento	10%	86%	88%	93%	na	-2.2 ppt
Denver	9%	84%	82%	83%	99%	1.9 ppt
San Diego	8%	97%	100%	na	96%	-2.7 ppt
St Louis	8%	96%	97%	98%	96%	-0.7 ppt
Total / Average	68%	88%	92%	92%	97%	-3.4 ppt
					vs 2019	-8.3 ppt
KORE						
Seattle (Bellevue / Redmond)	44%	96%	94%	95%	96%	1.3 ppt
Denver	13%	99%	99%	97%	97%	-0.2 ppt
Houston	10%	88%	89%	84%	82%	-1.5 ppt
Dallas	10%	92%	91%	95%	96%	1.1 ppt
Total / Average	76%	93%	93%	93%	93%	0.2 ppt
					vs 2019	0.8 ppt

Source: JLL, DBS Bank

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Portfolio occupancy declined marginally to below 90%, except for KORE

Portfolio occupancy has seen a progressive decline throughout FY22 to end the year at just a little below 90%. This is apart from KORE, which saw occupancy rise to 92.6% from 91.9% as at end-2021, partly due to the disposal of Powers Ferry and Northridge Centre.

Gearing crossed 40%, except for KORE

Following the asset valuation decline in 4Q22, both MUST and PRIME saw gearing cross 40%. MUST's gearing spiked to 49%, given a higher valuation decline of c.11%, while PRIME's gearing increased to 42% (from 37.9% in 4Q21), with still some buffer. On the other hand, KORE has kept its gearing below 40%, at 38.2%, mainly due to minimal asset valuation decline and the disposal of some smaller assets.

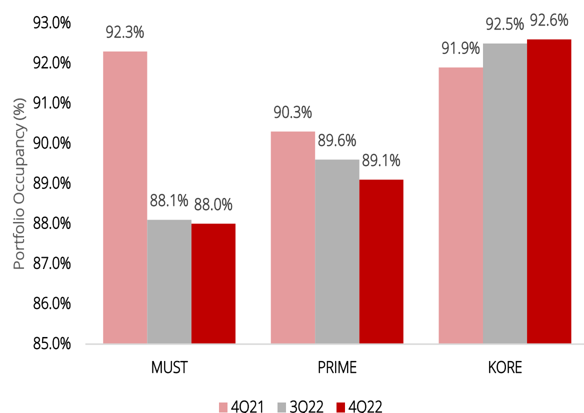
DPU declined by 1% to 7% y-o-y

Headline FY22 DPU fell by 3% to 11% y-o-y, in line with the decline in vacancies and the increase in interest costs.

However, we note that KORE has converted its management fees in units to be paid out in cash instead, while MUST has announced a 9% retention in distributions.

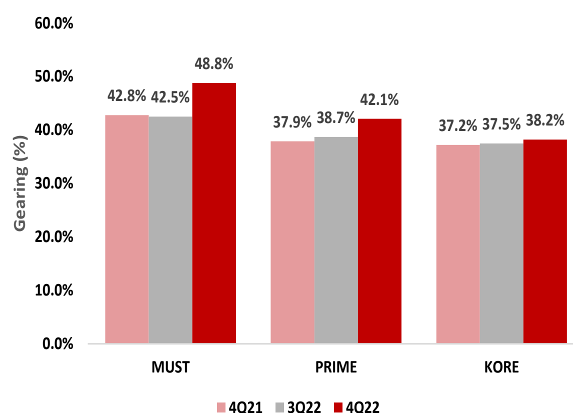
Excluding these adjustments, we note that FY22 DPU fell by 1% to 7% y-o-y, with the lowest decline from KORE, followed by PRIME and then MUST.

US office SREITs: Portfolio occupancy (%)



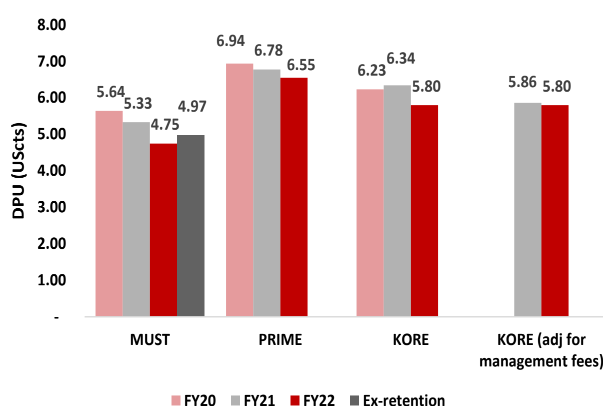
Source: Company, DBS Bank

US office SREITs: Gearing



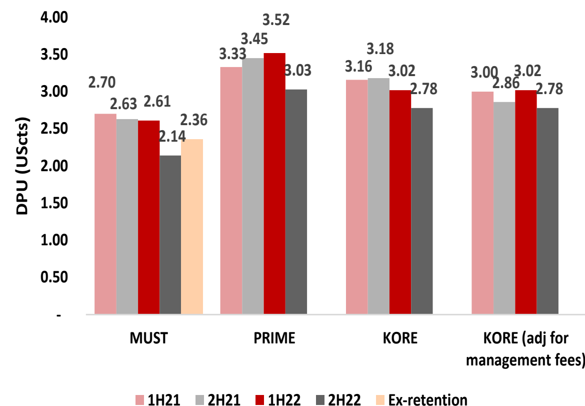
Source: Company, DBS Bank

US office SREITs: FY20-FY22 DPU



Source: Company, DBS Bank

US office SREITs: 1H21-2H22 DPU



Source: Company, DBS Bank

Snapshot of US office SREITs

As at Dec 2022	MUST	PRIME	KORE
AUM (US'm)	1,947	1,542	1,423
No of properties	12	14	13
NLA (sqft)	5,452,476	4,376,625	4,756,914
Committed occupancy	88.0%	89.1%	92.6%
WALE	4.7	4.1	3.4
Lease expiries - 2023	10.8%	15.4%	13.5%
Lease expiries - 2024	10.8%	13.2%	16.5%
Built-in average annual rental escalations	2.6%	n/a	2.4%
Rental reversions (4Q22 except MUST is FY22)	0.7%	20.2%	8.1%
Gearing	48.8%	42.1%	38.2%
All-in average Cost of Debt	3.7%	3.3%	3.2%
Average Term to maturity (years)	2.8	2.7	3.6
Interest coverage ratio	3.1	4.1	4.0
Hedging ratio	77.3%	82.0%	77.9%
% debt expiring in FY23 #	14.1%	-	1.8%
% debt expiring in FY24	13.9%	17.3%	12.9%
% debt expiring in FY25	17.5%	-	26.7%

 # debt expiry for MUST and KORE in FY23 includes revolvers
Source: Company, DBS Bank

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Valuations close to the bottom; waiting for a re-rating catalyst

US office REITs' and US office SREITs' share prices started a downward trend when Fed started to hike interest rates

The share prices of both the US office REITs and US office SREITs started to price in the interest rate hikes as soon as the Fed started to hike interest rates. US office REITs peaked in Apr 22 and have seen its share price halve since then. Similarly, the US office SREITs' share prices peaked in Mar 22, and to date, share prices have halved since the peak.

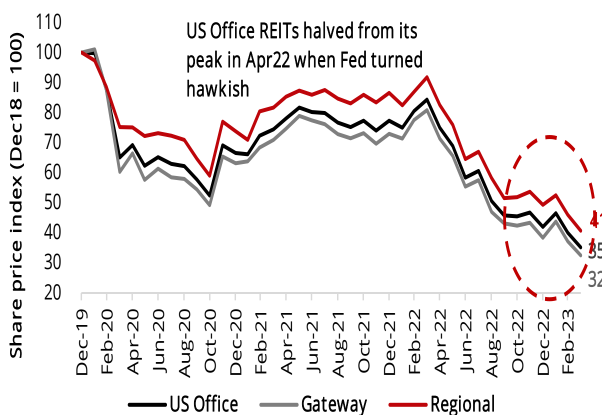
Share prices of both US office REITs and US office SREITs held above the COVID low in Mar/Oct 2020 until the Fed started to hike interest rates.

Share prices saw a short re-rate when Fed started to indicate potential moderation in rate hikes at the start of 2023

Despite the sharp declining trend of the share prices, we note that both US office REITs and US office SREITs saw share prices basing out and re-rating slightly when the Fed started to indicate a potential moderation in rate hikes at the start of 2023.

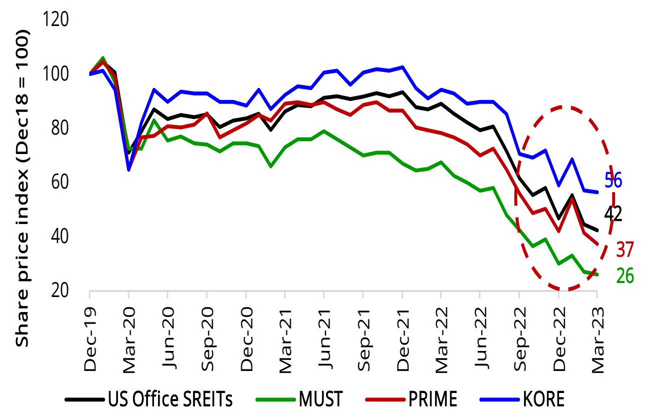
Consequently, we believe that share prices have priced in the bad news and headwinds and are awaiting a re-rating catalyst to demonstrate a turnaround. While a hawkish Fed for an extended time may continue to de-rate the share price, we believe that as soon as the Fed starts to moderate interest rate hikes or pause its interest rates, the overhang on both the sectors might get lifted and share prices might see a strong turnaround.

US office REITs' share prices halved since peak in Apr 22



Source: Refinitiv, DBS Bank

US office SREITs saw similar trends



Source: Refinitiv, DBS Bank

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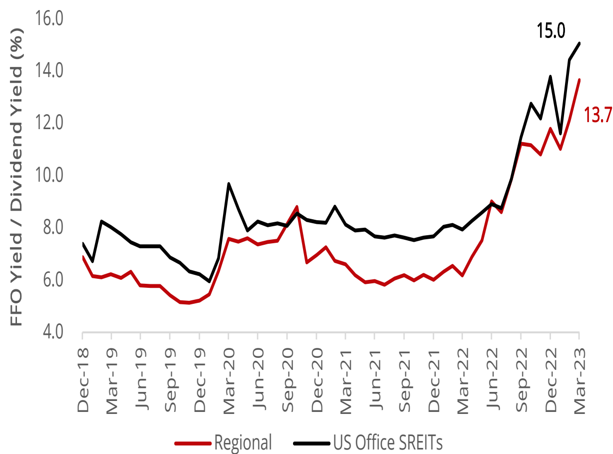
The spread between US office SREITs and US office regional peers has narrowed, closer to historical average of 1.3%

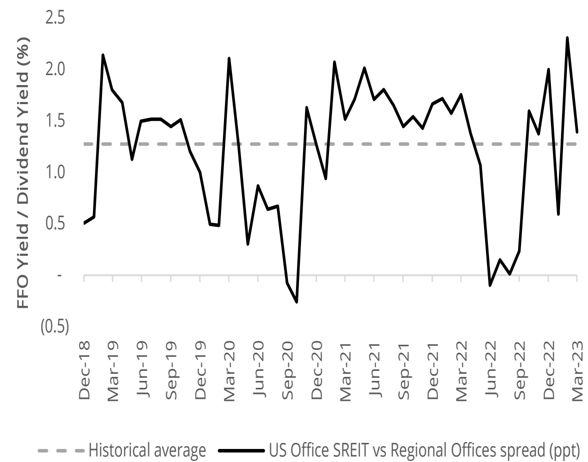
The yield spread between US office REITs and US office regional peers has narrowed with both the sectors offering more than 10% FFO/dividend yield. The yield spread is now closer to the historical average of 1.3%.

Yield spread between US office SREITs and US office regional peers has narrowed



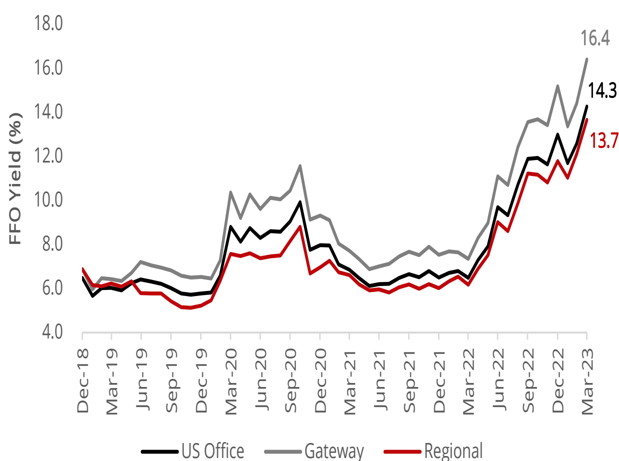
Source: Refinitiv, DBS Bank

Yield spread is now close to historical average of 1.3%



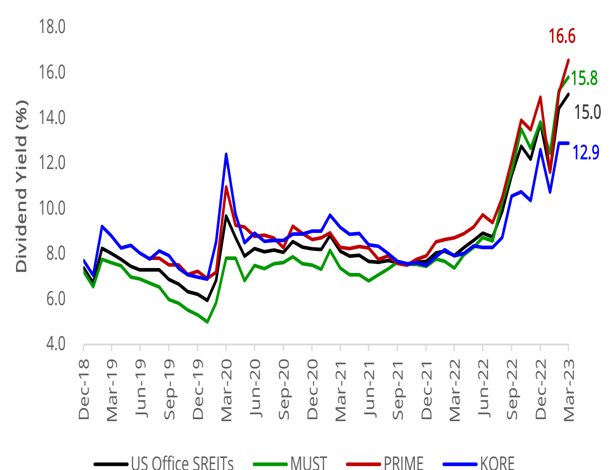
Source: Refinitiv, DBS Bank

US office REITs: FFO yield (%)



Source: Refinitiv, DBS Bank

US office SREITs: Dividend yield (%)



Source: Refinitiv, DBS Bank

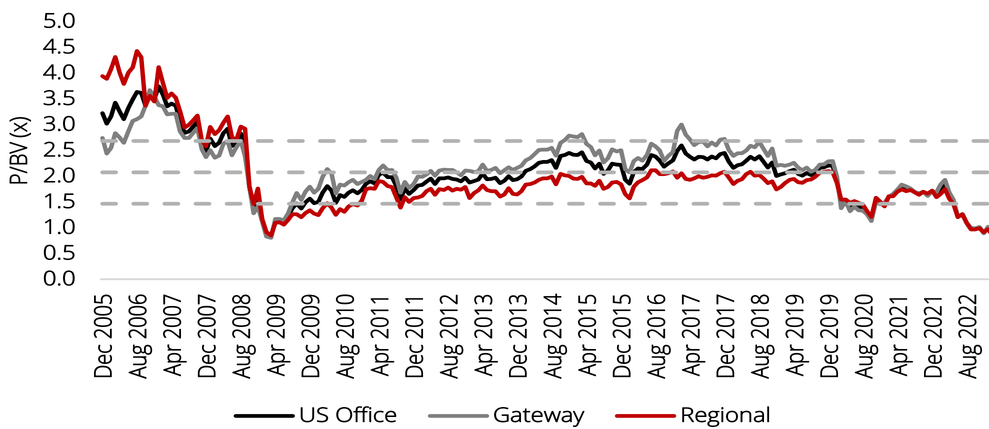
Valuation is close to the bottom – US office REITs are trading at GFC low P/B of 0.75x; while the US office SREITs are trading at 0.5x P/B

We believe the valuation is close to the bottom, as US office REITs are now trading at the GFC low P/B of 0.75x.

On the other hand, while the US office SREITs do not have sufficient trading history that stretches back to the last crisis, i.e., GFC, we believe that at 0.5x P/B, it is closer to the bottom.

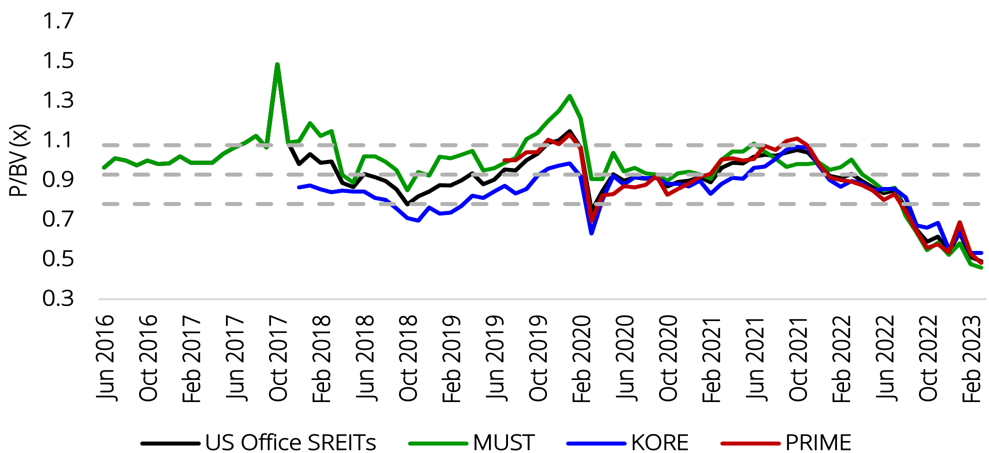
As such, based on valuations, we believe the US office SREITs are close to the bottom and are awaiting a positive catalyst for a sector re-rating. We believe the re-rating catalyst lies in the Fed moderating or pausing interest rate hikes, which will also drive a turnaround in the share price.

US office REITs: P/BV trading at GFC low of 0.75x



Source: Refinitiv, DBS Bank

US office SREITs: P/BV trading below COVID low at 0.5x



Source: Refinitiv, DBS Bank

Revised estimates incorporating some vacancies and dividend retention (for MUST)

	Old Estimates				New estimates			
	12-mth Target Price	Rating	DPU - FY22F	DPU - FY23F	12-mth Target Price	Rating	DPU - FY22F	DPU - FY23F
MUST	0.70	BUY	4.63	4.63	0.45	BUY	4.13	4.13
Prime	0.88	BUY	6.30	6.30	0.63	BUY	6.00	6.00
KORE	0.86	BUY	5.56	5.72	0.65	BUY	5.56	5.72

Source: Company, DBS Bank

Peer valuation

	Price (S$)	Market Cap (S$'m)	12-mth Target Price (S$)	Rating	Yield FY22	Yield FY23F	Yield FY24F	P/NAV FY22	DPU growth (%) 2-yr CAGR
MUST	0.27	477	0.45	BUY	17.9%	15.6%	15.6%	0.46	-6.7%
Prime	0.36	426	0.63	BUY	18.2%	16.7%	16.7%	0.48	-4.3%
KORE	0.44	454	0.65	BUY	13.3%	12.8%	13.2%	0.56	-0.7%
Average					16.5%	15.0%	15.1%	0.50	-3.7%

Source: Thomson Reuters, Company, DBS Bank

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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 share price catalysts within this time frame)

Share price appreciation + dividends

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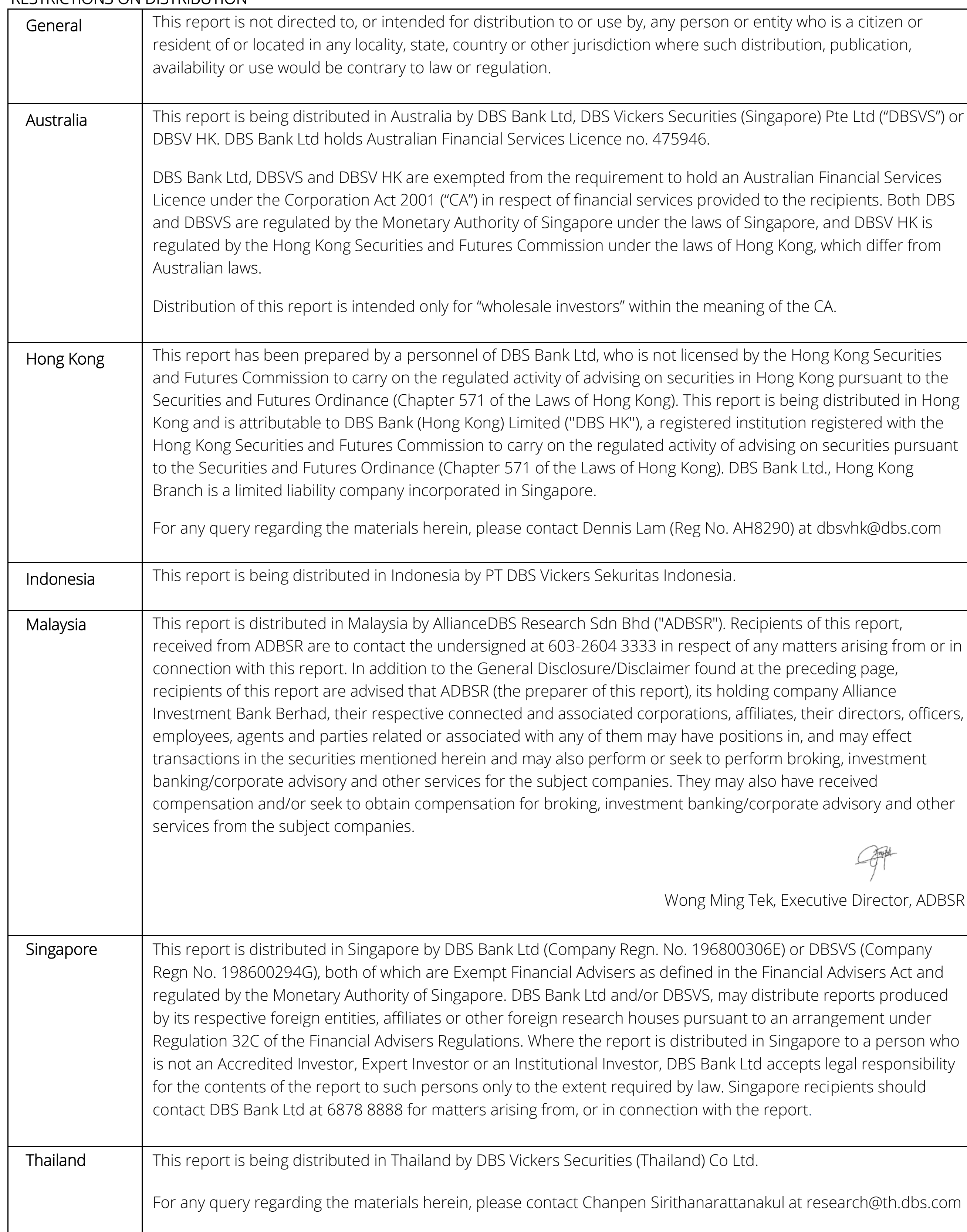

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