Singapore Company Update

Manulife US Real Estate Inv

Bloomberg: MUST SP | Reuters: MANU.SI

Refer to important disclosures at the end of this report

DBS Group Research . Equity

8 Feb 2023

BUY

Last Traded Price (7 Feb 2023): US$0.325 (**STI :** 3,380.84)
Price Target 12-mth: US$0.48 (48% upside)

Analysts
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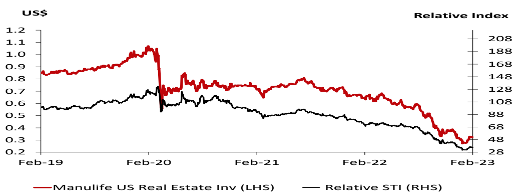
What's New

- MUST's portfolio valuation decline has caused a spike in gearing, resulting in limited buffer of only 15% in NPI, or 104bps increase in cost of debt, vs. 3Q22
- Manager taking proactive steps to recapitalise balance sheet, but more steps needed
- Sponsor's support to acquire some asset(s) will be the best-case scenario amidst all potential options in our view, including a takeover scenario (MUST currently trading at P/B of c.0.6x)
- Maintain BUY; TP of US$0.48

Price Relative



Forecasts and Valuation

FY Dec (US$m)	2021A	2022F	2023F	2024F
Gross Revenue	185	203	204	205
Net Property Inc	110	129	128	129
Total Return	39.4	78.2	73.7	74.1
Distribution Inc	85.6	87.6	82.7	83.3
EPU (US cts.)	2.23	4.41	4.13	4.12
EPU Gth (%)	nm	98	(6)	0
DPU (US cts.)	5.33	4.94	4.63	4.63
DPU Gth (%)	(5)	(7)	(6)	0
NAV per shr (US cts.)	67.3	67.0	66.5	66.0
PE (X)	14.5	7.4	7.9	7.9
Distribution Yield (%)	16.4	15.2	14.2	14.2
P/NAV (x)	0.5	0.5	0.5	0.5
Aggregate Leverage (%)	42.7	43.6	44.1	44.5
ROAE (%)	3.4	6.6	6.2	6.2

Distn. Inc Chng (%):		0	0	0
Consensus DPU (US		5.50	4.60	4.60
Other Broker Recs:		B: 7	S: 0	H: 0

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

Someday, my knight will come

Investment Thesis

Rides on "flight to quality" trends in US office market. Manulife US REIT's (MUST) portfolio comprises trophy/class A office buildings located in key cities in the US that ride on the "flight to quality" trends as US corporates rationalise their office space.

Sponsor's support to acquire MUST's asset(s) could be a win-win approach for both. MUST's portfolio valuation decline has caused gearing to spike up, resulting in a limited buffer for MUST in terms of regulatory limits. We believe if the sponsor were to step in to acquire some of MUST's asset(s), it could be the best-case scenario for MUST.

Headwinds largely priced in and resolution to MUST's gearing position should lift share price overhang, as we believe markets have priced in a "rights issue" at current price. Given our worst-case scenario (potential rights issue), MUST's current share price could still offer an c.8% yield, above its historical mean. We believe that the headwinds are largely priced in, and the share price is close to the bottom. Any potential resolution to MUST's current situation will lift the overhang on the share price and help in re-rating.

Maintain BUY; TP of US$0.48. We maintain our BUY rating and TP of US$0.48. Our DCF-based TP is based on a beta of 0.95x and risk-free rate of 4.2%.

Key Risks to Our View:

Slower-than-expected economic recovery and potential recession in the US. This situation would impact businesses, and that may cause a rising risk of vacancy.

Non-renewal of leases. MUST's financials, operations, and capital growth may be adversely affected by bankruptcy, insolvency, or downturns in the businesses of its tenants, which may lead to the non-renewal of their leases.

At A Glance

Issued Capital (m shrs)	1,777
Mkt. Cap (US$m/US$m)	577 / 577
Major Shareholders (%)	
Manulife Financial C	5.5
Free Float (%)	94.5
3m Avg. Daily Val (US$m)	1.3

GIC Industry : Real Estate / Equity Real Estate Investment (REITs)

DBS Insights Direct [Watchlist the stock on Insights Direct to receive prompt updates]

ed: BM/ sa: SS, PY, CS

WHAT'S NEW

Limited headroom to manoeuvre, analysing potential scenarios

On 30 Dec 2022, Manulife US REIT (MUST) announced that its portfolio valuation as at Dec 2022 will see a decline of 10.9% or US$237.4m to US$1,947m, vs. US$2,184.4m as at Dec 21.

This is the first of the SREITs in this period to see a sizable decline in valuation, that has consequently resulted in a rise in gearing, to 49%, close to the MAS gearing limit of 50%. The projected interest coverage ratio as at Dec 22 is c.3.1x. Although it is still below the 2.5x MAS limit, MUST, based on our estimates, may come close to the 2.5x level, given the sharp increase in interest rates, particularly in the US.

While this is considered a soft breach, as the increase in gearing was led by a valuation decline, the gearing level is too close for comfort, in our view. In addition, if its interest coverage ratio (ICR) was to dip below 2.5x, the MAS gearing limit would be 45% instead of 50%, meaning that MUST will have to take active steps to lower gearing. In the announcement, MUST highlighted that the financial covenants are not expected to be breached, despite the decline in valuation.

Terminal cap rates expanded 50bps to 100bps while discount rate widened 150bps. We understand that a few factors have led to the decline in valuation.

- Portfolio cap rates have moved by c.50bps. However, four properties that saw the largest decline in valuation saw cap rates expand by 100bps.
- Discount rate widened by 150bps.
- Figueroa had the largest decline (-33.1%), which makes up 44% of the portfolio valuation decline. Aside from the cap rates and discount rate expansion, Figueroa's valuation was impacted by the lower occupancy following the departure of TCW Group and downsizing of Quinn Emmanuel (estimated to be c.77% occupancy).

Just to give some perspective, if we exclude Figueroa, the portfolio valuation reduces by c.7% and if we exclude the four properties that saw a 100bps cap rate expansion, portfolio valuation would decline by c.5%.

Where does MUST stand?

Limited NPI and interest rate buffers, based on our ballpark estimates. While the 4Q22 financial details have yet to be released (expected on 9 Feb 2023), our ballpark estimates show that MUST has an NPI buffer of c.15% for an ICR ratio of 2.5x. This assumes the average cost of debt increasing to 3.8% from 3.3% as at 3Q22 (+44bps), i) taking into account some impact on the portion of unhedged interest rates (c.19% as at 3Q22), and ii) adjustment of higher refinanced interest rates of S$105m debt (c.11% of total debt) as the interest rate swap matures.

Assuming a stable NPI/EBITDA, MUST has an estimated average cost of debt buffer of c.104bps (4.4% from 3.3% as at 3Q22) for an ICR ratio of 2.5x.

Given the potential vacancy in the portfolio and higher interest rates, which are yet to be fully effective, MUST if left with very little room to ensure its sustainability.

Sensitivity of MUST's buffer for ICR to reach 2.5x

	3Q2022	Cost of debt breakeven	NPI breakeven
Weighted average cost of debt	3.34%	4.38%	3.78%
ICR	3.40	2.50	2.50
Gearing	42.5%	49.0%	49.0%
EBITDA (estimated annualised)	111.7	111.7	96.4
Interest cost (estimated annualised)	32.9	44.7	38.6
NPI (estimated)	99.3	99.3	84.0
Increase in cost of debt (bps)		104	44
EBITDA decline			-14%
NPI decline			-15%

Source: DBS Bank, Company

What can MUST do?

Every penny counts. In the short term, we believe MUST has some small 'levers' to pull to ensure that its gearing situation does not worsen from here. Albeit small, every penny counts.

- **Reduce dividend payout to 90%.** We believe that one of the immediate 'tools' to conserve cash will likely come from the reduction of dividend payout to 90% from 100% currently. Based on 1H22's annualised DI of c.US$92m, MUST could save approximately US$9m of cash per annum, which would be sufficient for some capex and working capital needs to ensure debt does not creep up further.
- **Dividend reinvestment plan.** MUST could likely utilise a dividend reinvestment plan to also conserve some cash payout for dividends. Although its interest in taking up a dividend reinvestment plan may be uncertain, another 10% take-up could result in another US$9m.

While these measures may be able to buy MUST some time, it may not be sufficient to bring gearing down to the more sustainable level of the 45% limit should its ICR ratio breach the 2.5x level.

On a more sustainable basis, MUST highlighted various options it could explore, including asset divestment and equity fundraising.

Asset divestment is a convenient way out but is not without challenges. Asset divestment is probably the easiest and most convenient way out for MUST. It is estimated that only c.US$170m in asset divestments would be required to bring gearing to slightly below 45%. This is achievable if it sells one large property or two small ones. If an asset divestment is successful, its ICR ratio could potentially improve to 2.8x.

Scenario analysis of MUST's various options

	2Q22 (annualised)	Assume NPI -5%	Assume 90% payout	Divestment of US$170m
NPI	115.2	109.5	109.5	100.1
Gearing	49.0%	49.0%	49.0%	44.5%
Average cost of debt	2.97%	3.78%	3.78%	3.78%
ICR	3.4	2.5	2.5	2.7
Distributable Income	92.1	82.1	73.9	67.5
No. of shares	1,777	1,777	1,777	1,777
DPU	5.18	4.62	4.16	3.80
NAV	0.55	0.55	0.55	0.55
DPU decline fr 2Q22 (annualised)		-10.8%	-19.7%	-26.6%
Share price	0.33	0.33	0.33	0.33
NPI yield	5.5%	5.3%	5.3%	5.2%
DPU Yield	15.7%	14.0%	12.6%	11.5%
P/NAV	0.60	0.60	0.60	0.60
Implied yield	7.6%	7.2%	7.2%	7.5%

Source: DBS Bank, Company

- **Divesting to a third party/open market takes time and may see some challenges**

The biggest challenge for asset divestment is the timeline to complete an asset transaction especially if it is divested to third party. Given the macroeconomic uncertainties, the transaction market has been almost completely quiet and both buyers and vendors await more clarity. MUST has been guiding for asset dispositions for a while now. However, it has been unsuccessful in 2022, given that the cost of funding has seen a sharp increase due to the Fed rate hikes in 2022.

The adjustments in valuations, taking into account the higher funding cost coupled with the tapering of Fed rate hikes, could spur buying interest and facilitate potential asset transactions. However, striking a price between the buyer and seller to ensure the closure of a potential deal may still require more time (especially when the economic outlook remains murky), something MUST does not have much of.

In addition, there has been news of redemption requests for property funds as the cost of funding rises and liquidity tightens. Massive redemption may eventually cause more potential assets to be offered on the market and this may lead to more pressure on asset prices.

Equity fundraising. In the past, SREITs that encountered the same situation have had to resort to equity fundraising to address the gearing issue. We have seen SREITs that have undertaken a rights issue experiencing a major impact on its share prices, as the rights issue would have been done at a deep discount to the prevailing trading price. In addition, MUST has a single ownership cap of 9.8%, which may pose some challenges in executing a rights issue.

Instead of a rights issue, we understand that MUST may choose to do a placement, as the amount required is not huge. While the impact to the share price may not be as dire compared to a rights issue, we may still see a c.44% decline in DPU, assuming a placement was made at a 5% discount to the prevailing share price.

Nevertheless, we hope that this would be the last resort for MUST.

Scenario analysis of potential EFR or rights issue

	2Q22 (annualised)	Placement of US$170m @ 5% discount to current price of US$0.33	Rights issue of US$170m @ 40% discount to current price of US$0.33
NPI	115.2	100.1	100.1
Gearing	49.0%	44.5%	44.5%
Average cost of debt	2.97%	3.78%	3.78%
ICR	3.4	2.7	2.7
Distributable Income	92.1	67.5	67.5
No. of shares	1,777	2,319	2,635
DPU	5.18	2.91	2.56
NAV	0.55	0.42	0.37
DPU decline fr 2Q22 (annualised)		-43.8%	-50.5%
Share price	0.33	0.33	0.33
NPI yield	5.5%	5.2%	5.2%
DPU Yield	15.7%	8.8%	7.8%
P/NAV	0.60	0.79	0.90
Implied yield	7.6%	7.5%	7.5%

Source: DBS Bank, Company

MUST is now an attractive takeover target.
While the FY2022 financial statements have yet to be released, we estimate, from the decline in its asset valuation, that MUST could be trading at c.0.6x P/Book with an estimated implied yield of more than 7%, vs. estimated new asset cap rates ranging from 6.5% to 8%. At these valuation levels, MUST is looking more attractive than ever as a takeover target. MUST is currently undergoing a strategic review.

Sponsor to the rescue?
In this situation, we believe a helping hand from its sponsor would save MUST from a 'crash landing'. With less than US$200m, the sponsor may be able to quicken MUST's asset divestment by acquiring directly from MUST. If this can be done, we believe this is the best-case scenario for MUST.

However, unitholders may comment that the sponsor might 'cherry pick' the best asset(s) in MUST's portfolio that may disadvantage the unitholders. MUST may consider proposing a partial stake sale to the sponsor with possibly an option to repurchase after a period of time.

A potential win-win for sponsor.
We believe the sponsor might stand to benefit from asset acquisition, mainly due to the following:

- Sponsor is acquiring at a marked-down valuation. Based on the latest asset valuation, it is 17% below the asset valuation as at Dec 2019 (excluding the latest three asset acquisitions in end-2021). With the potential repurchase option, the sponsor may be able to resell the asset(s) to MUST/a third party when the asset valuation has improved.
- It would be a strong statement by the sponsor if it extends support to its REIT, with less than US$200m. This will add to investors' confidence in MUST. SREITs with strong sponsors are well received by investors and could typically trade at a premium compared to peers lacking a strong sponsor. Moreover, the strong reputation of a SREIT together with its sponsor that has gone through the trials and survived, will build goodwill for the sponsor's future potential for another SREIT.
- Offer at 20% premium to current price (30% discount to book value) vs. a small acquisition, at 17% discount to book. With the share price currently trading at 0.6x P/Book, MUST is seen to be an attractive takeover target. If an offer is made at a 20% premium (assumption) to the current price, the offer implies 0.7x P/Book (c.30% discount). In comparison with a small asset acquisition with a c.17% discount, we believe the sponsor could potentially gain more in the long term.

Maintain BUY; TP of US$0.48. We maintain our BUY rating and TP of US$0.48. Despite the negative news that caused a further decline in MUST's share price, we believe it has largely priced in all the negatives. Given our worst-case scenario (potential rights issue), MUST's current share price could still offer an c.8% yield, which implies the share price is close to the bottom.

In addition, three out of the four options (except EFR option) for MUST would possibly lead to an uplift in the share price that has been weighed down by high gearing and a low ICR ratio. As such, we believe the share price is closer to the bottom and we continue to keep an eye out for the key rerating catalysts.

Decline in MUST's portfolio valuation since Dec 2019

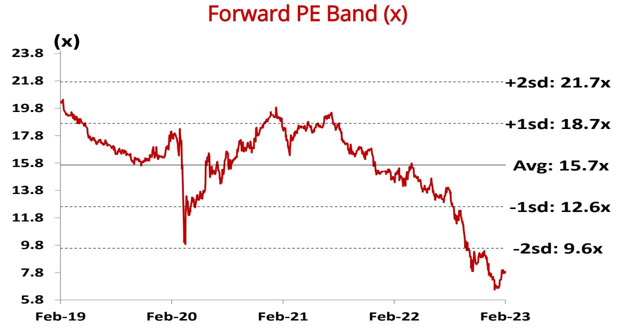
	Dec-19	Dec-20	Dec-21	Dec-22	Decline from Dec 2019
Portfolio valuation	2,095	2,035	2,184	1,947	-7.1%
y-o-y change		-2.9%	7.4%	-10.9%	
Like-for-like valuation	2,095	2,035	1,978	1,747	-16.6%
y-o-y change		-2.9%	-2.8%	-11.7%	

Source: DBS Bank, Company

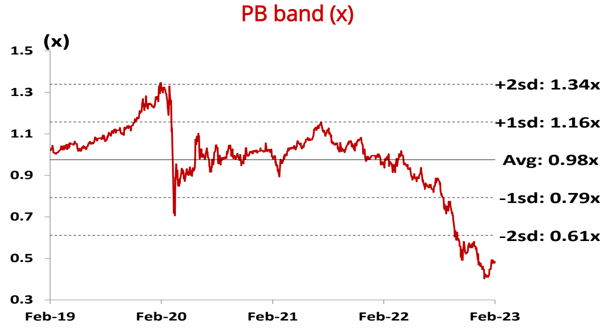
Company Background

Manulife US REIT (MUST) is the first pure-play US office REIT listed in Asia. Its portfolio consists of eight freehold, class A, or trophy-quality office properties in Atlanta, Los Angeles, New Jersey, Washington DC, Virginia, and Orange County.

Historical PE and PB band



Source: Bloomberg Finance L.P., DBS Bank estimates



Source: Bloomberg Finance L.P., DBS Bank estimates

Income Statement (US$m)

FY Dec	2020A	2021A	2022F	2023F	2024F
Gross revenue	194	185	203	204	205
Property expenses	(78.5)	(75.6)	(74.3)	(75.9)	(75.5)
Net Property Income	116	110	129	128	129
Other Operating expenses	(11.8)	(11.3)	(11.5)	(11.0)	(11.0)
Other Non Opg (Exp)/Inc	0.0	0.0	0.0	0.0	0.0
Associates & JV Inc	0.0	0.0	0.0	0.0	0.0
Net Interest (Exp)/Inc	(29.6)	(29.1)	(38.6)	(42.8)	(43.5)
Exceptional Gain/(Loss)	(140)	(28.5)	0.0	0.0	0.0
Net Income	(66.0)	40.6	79.0	74.5	74.9
Tax	22.7	(1.1)	(0.8)	(0.7)	(0.7)
Minority Interest	0.0	0.0	0.0	0.0	0.0
Preference Dividend	0.0	0.0	0.0	0.0	0.0
Net Income After Tax	(43.3)	39.4	78.2	73.7	74.1
Total Return	(43.3)	39.4	78.2	73.7	74.1
Non-tax deductible Items	132	46.2	9.38	8.94	9.18
Net Inc available for Dist.	89.0	85.6	87.6	82.7	83.3
Growth & Ratio					
Revenue Gth (%)	9.3	(4.7)	9.8	0.4	0.4
N Property Inc Gth (%)	4.6	(5.4)	17.8	(0.6)	0.9
Net Inc Gth (%)	nm	nm	98.4	(5.7)	0.5
Dist. Payout Ratio (%)	100.0	100.0	100.0	100.0	100.0
Net Prop Inc Margins (%)	59.6	59.2	63.5	62.8	63.1
Net Income Margins (%)	(22.3)	21.3	38.5	36.1	36.2
Dist to revenue (%)	45.8	46.2	43.1	40.5	40.6
Managers & Trustee's fees	6.1	6.1	5.6	5.4	5.4
ROAE (%)	(3.6)	3.4	6.6	6.2	6.2
ROA (%)	(2.0)	1.8	3.4	3.2	3.2
ROCE (%)	5.3	4.8	5.5	5.4	5.4
Int. Cover (x)	3.5	3.4	3.0	2.7	2.7

Source: Company, DBS Bank

Interim Income Statement (US$m)

FY Dec	1H2020	2H2020	1H2021	2H2021	1H2022
Gross revenue	98.6	95.7	90.8	94.3	100
Property expenses	(36.5)	(42.0)	(34.7)	(40.8)	(42.8)
Net Property Income	62.2	53.7	56.1	53.5	57.6
Other Operating	(6.6)	(5.2)	(5.7)	(5.6)	(6.2)
Other Non Opg (Exp)/Inc	(14.1)	2.20	4.21	9.69	32.8
Associates & JV Inc	0.0	0.0	0.0	0.0	0.0
Net Interest (Exp)/Inc	(14.7)	(14.9)	(14.7)	(14.5)	(15.3)
Exceptional Gain/(Loss)	0.0	0.0	0.0	0.0	0.0
Net Income	26.8	35.8	39.9	43.1	68.9
Tax	15.0	7.74	4.13	(5.3)	(7.7)
Minority Interest	0.0	0.0	0.0	0.0	0.0
Net Income after Tax	41.7	43.5	44.0	37.8	61.2
Total Return	(35.6)	(7.7)	6.70	32.7	62.8
Non-tax deductible Items	6.25	(2.5)	(1.0)	9.90	(15.2)
Net Inc available for Dist.	48.0	41.0	43.0	42.6	46.0
Growth & Ratio					
Revenue Gth (%)	4	(3)	(5)	4	6
N Property Inc Gth (%)	6	(14)	4	(5)	8
Net Inc Gth (%)	41	4	1	(14)	62
Net Prop Inc Margin (%)	63.0	56.1	61.8	56.7	57.4
Dist. Payout Ratio (%)	100.0	100.0	100.0	100.0	100.0

Balance Sheet (US$m)

FY Dec	2020A	2021A	2022F	2023F	2024F
Investment Properties	1,993	2,184	2,203	2,222	2,243
Other LT Assets	0.0	5.65	5.65	5.65	5.65
Cash & ST Invts	86.7	78.6	45.3	43.4	40.4
Inventory	0.0	0.0	0.0	0.0	0.0
Debtors	6.93	5.55	8.70	8.74	8.77
Other Current Assets	1.66	1.44	1.44	1.44	1.44
Total Assets	2,088	2,276	2,264	2,281	2,299
ST Debt	234	297	297	297	297
Creditor	18.1	58.8	30.7	30.8	31.0
Other Current Liab	6.88	8.25	8.25	8.25	8.25
LT Debt	619	675	691	708	726
Other LT Liabilities	52.9	49.6	49.6	49.6	49.6
Unit holders' funds	1,158	1,188	1,188	1,188	1,188
Minority Interests	0.0	0.0	0.0	0.0	0.0
Total Funds & Liabilities	2,088	2,276	2,264	2,281	2,299
Non-Cash Wkg. Capital	(16.4)	(60.0)	(28.8)	(28.9)	(29.0)
Net Cash/(Debt)	(766)	(893)	(943)	(962)	(982)
Ratio					
Current Ratio (x)	0.4	0.2	0.2	0.2	0.2
Quick Ratio (x)	0.4	0.2	0.2	0.2	0.2
Aggregate Leverage (%)	40.8	42.7	43.6	44.1	44.5
Z-Score (X)	1.0	1.0	1.0	1.0	1.0

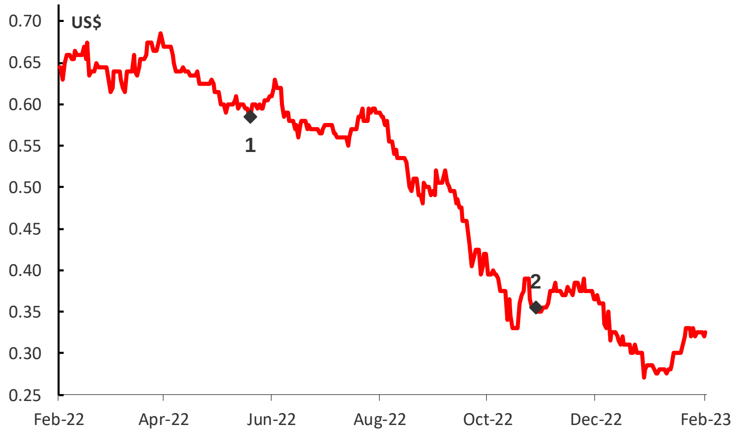
Source: Company, DBS Bank

Cash Flow Statement (US$m)

FY Dec	2020A	2021A	2022F	2023F	2024F
Pre-Tax Income	74.4	40.6	79.0	74.5	74.9
Dep. & Amort.	(0.7)	1.93	0.0	0.0	0.0
Tax Paid	(1.9)	(0.1)	(0.8)	(0.7)	(0.7)
Associates &JV Inc/(Loss)	0.0	0.0	0.0	0.0	0.0
Chg in Wkg.Cap.	19.0	(20.8)	(31.2)	0.09	0.09
Other Operating CF	(8.8)	69.1	9.38	8.94	9.18
Net Operating CF	82.0	90.6	56.3	82.8	83.4
Net Invt in Properties	(24.2)	(231)	(2.0)	(2.0)	(3.1)
Other Invts (net)	0.0	0.0	0.0	0.0	0.0
Invts in Assoc. & JV	0.0	0.0	0.0	0.0	0.0
Div from Assoc. & JVs	0.0	0.0	0.0	0.0	0.0
Other Investing CF	0.17	0.02	(16.7)	(17.1)	(17.4)
Net Investing CF	(24.0)	(231)	(18.7)	(19.2)	(20.5)
Distribution Paid	(70.7)	(84.0)	(87.6)	(82.7)	(83.3)
Chg in Gross Debt	38.6	215	16.7	17.1	17.4
New units issued	0.0	0.70	0.0	0.0	0.0
Other Financing CF	0.0	0.0	0.0	0.0	0.0
Net Financing CF	(32.2)	132	(70.9)	(65.6)	(65.9)
Currency Adjustments	0.05	0.0	0.0	0.0	0.0
Chg in Cash	25.9	(8.1)	(33.2)	(2.0)	(3.0)
Operating CFPS (US cts.)	3.98	6.32	4.94	4.63	4.63
Free CFPS (US cts.)	3.66	(8.0)	3.07	4.52	4.46

Source: Company, DBS Bank

Target Price & Ratings History



S.No.	Date of Report	Closing Price	12-mth Target Price	Rating
1:	26 May 22	0.59	0.70	BUY
2:	03 Nov 22	0.36	0.48	BUY

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

Source: DBS Bank

Analyst: Rachel TAN

Derek TAN

DBS Bank recommendations are based on 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 share price catalysts within this time frame)

**Share price appreciation + dividends*

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