TRANSCRIPT
Manulife US REIT's FY 2023 Results Media Briefing
Venue & Date: Manulife Tower, 8 February 2024, Thursday

On the Panel:
Mr Marc Feliciano, Chairman
Mr Tripp Gantt, Chief Executive Officer
Ms Caroline Fong, Deputy CEO, Chief Investor Relations and Sustainability Officer
Mr Robert Wong, Chief Financial Officer
Mr Patrick Browne, Chief Investment Officer
Mr Choong Chia Yee, Head of Finance

Mr Tripp Gantt: The big news in the second half of last year was obviously the Recapitalisation Plan. The restructuring that we negotiated with our lenders was approved by Unitholders in December. It allowed us to get a waiver of the breach of our loan covenants, extend our debt maturities and also temporarily relax the loan covenants to give us a little bit more space to be able to operate as we move forward.

The 2023 financials – gross revenue and net property income – were actually up year over year. The distributable income (DI) however, on a full-year basis, was down about 15.5% largely due to lower rental income, higher expenses both at the property level and higher borrowing costs, as well as the divestment of our Tanasbourne asset in April. The loss of that income had an impact on our DI as well. I think everybody's aware that we have temporarily halted distributions as a result of the restructuring with the lenders. We will be halting distributions until the end of December 2025, or until we are able to meet the Early Reinstatement Conditions. The Early Reinstatement Conditions are essentially if we get below the MAS gearing threshold of 45%, then we'll be able to resume distributions at that point. But until one of those milestones is hit, we will not be making distributions.

Looking at our net property income, it was up slightly at 2023, but if you notice, that was largely from termination fees that we received. It's the silver lining from some tenants who exercise their early termination options. We had US$9.0 million of these termination fees at Exchange and US$4.0 million at Plaza. Otherwise, without these termination fees, because of the lower rental income and higher property operating expenses, the NPI number would have been lower in 2023.

Our investment properties and total assets have declined somewhat, largely as a result of a combination of two things: the divestment of our Park Place asset to our sponsor for US$98.7 million and the 8% portfolio valuation decline at the end of the year. Our borrowings also went down as we used that US$98.7 million of proceeds to pay down our loans, in addition to a small ~US$9 million payment that we made in August, shortly after the breach of those loan covenants. The NAV has declined by about 17.5% from 40 US cents at the mid-year to 33 US cents.

All of our debt maturities have been pushed back by one year. We don't have any debt maturing until May 2025, which is when our first debt maturity will come due. The orange bar under 2024 (on slide 10) simply represents the last step of the first part of this recapitalisation process, which is the repayment of an additional US$50 million of debt from cash on our balance sheet by March 31 this year. The other thing to point out here is really the value of having those covenants relaxed. Our previous unencumbered gearing limit was 60%. As part of the Recapitalisation Plan, that gearing limit has been extended up to 80%, and the bank interest coverage ratio (ICR) has been lowered to 1.5x. So even with the property devaluation of 8% and the unencumbered gearing ratio going above 60%, we still have a good amount of buffer in our loan covenants. Now, the MAS aggregate leverage – keeping in mind that the bank's unencumbered gearing and the MAS gearing are calculated slightly differently – takes into account total assets in that denominator, whereas the bank's unencumbered gearing only takes into account the value of the property, so that's why there's a little difference. The MAS aggregate leverage went up to 58.3%, from 56.0% in 3Q 2023, largely as a result of the 8% decline in our valuations at the end of the year. Our MAS ICR remains at 2.4x. Since it's below 2.5x, our MAS gearing limit technically will be 45% going forward. The other thing to point out here is the fixed rate loans which went from 69.2% in 3Q2 023 to 91.3%. Essentially this is because as we paid down debt, our hedges remained in place so a larger proportion of our debt stack under those hedges has a fixed rate to it.

It was a relatively good year for us in leasing and we're encouraged by this. The ~740,000 square feet of leases that we signed in 2023 was almost double of what we signed in 2022. The leases have had relatively long terms, which has helped us increase our WALE to 5.0 years. And we saw some pretty healthy rental reversions too in the year at 8.2%. We're encouraged by the momentum that we're seeing in leasing. We executed several leases in the fourth quarter and that momentum kind of carried over through the first quarter of this year. Just in the first few weeks of 2024, we managed to sign up another 150,000 sq ft of leases. While we're going to try to keep that momentum going, I think we're encouraged by the amount of activity – what we call active tenant requirements. The number of tenants who are actually out in the market now looking at space, touring properties, has increased quite a bit. And it's usually about a two- to three-quarter lag between when we see that increase in leasing interest and activity at the property level to when those leases end up being signed. We're seeing some good signs of momentum in terms of leasing interest as tenants begin to get their mind around how much space they actually need and are beginning to feel more confident in making those decisions. Of the leases that we signed in the fourth quarter, more than two-thirds were new leases. But for the full year, roughly three-quarters of our leases signed were renewals of existing tenants.

While our lease expirations remain relatively well-spread, this year we have a lot of work. The reason for the two different colours on that 2024 chart is due to the way that we've reported leases that expire on 31 December. They are usually lumped into the following year. It skewed a little bit of how much work we have to do in 2024, so we broke it out differently. We actually had quite a few leases expire on 31 December 2023, the biggest of which was TCW which is one of our largest tenants vacating ~188,000 sq ft at our Figueroa property in Los Angeles. Overall, we still have our work cut out for us in terms of the amount of leases that we need to renew in 2024, which makes up 18.5% of our net lettable area. We've been making good progress on this. We've also seen some good momentum. Over the next two years, we're really focusing on getting these tenants to renew and we're being very active in that area.

In our top 10 tenants, we were pleased that we were able to get four of them either renewed or extended, and we're actively engaged with two more right now that expire in 2025. US

Treasury and Amazon have leases that expire in 2025. We're actually actively engaged with them at the moment to try to get those renewals executed. The William Carter Company at our Phipps property in Atlanta renewed until 2035, while Kilpatrick Townsend also renewed at our Peachtree building in Atlanta through 2030 on a quite a healthy rental reversion. The Children's Place at our Plaza property in Secaucus, New Jersey, recently renewed. They'll be in the building until 2037. They did downsize significantly from 190,000 sq ft to about 120,000 sq ft. On the other side of that though, Hyundai Capital at Michelson in Irvine actually came back to us again for more expansion space and their lease runs through 2030. We're really happy that they've been pleased with the building and are doubling down on their space, so that's a good sign as well.

Looking at the valuations, our valuations at year end were down by 8%. The Tranche 1 assets contributed to about 50% of that valuation decline. As part of our Recapitalisation Plan, our assets were classified by quality into Tranches 1, 2 and 3. The Tranche 1 assets are the ones that we, along with the lenders, felt that had the highest occupancy risk, and might have the hardest time being competitive for demand over a longer period of time. They have high capex requirements and a relatively low total return potential as we move forward. The Tranche 2 assets, on the other hand, are assets that we feel can be more competitive, have relatively less capex requirements and have more return potential in terms of the investments we make in those properties. The two Tranche 3 assets, Michelson and Phipps, are our newest buildings. They're the highest physical quality buildings in our portfolio and the ones that we feel have the most inherent competitive advantages in their submarkets. As values begin to recover in the U.S. office market, we feel that these assets will be on the leading edge of seeing those valuation increases. The valuation of Tranche 1 assets were down on average about 14%, which is more than double of the valuation decline of the Tranche 2 and 3 assets. It shows that what went into these valuations were the same things that we've seen in the past such as higher discount rates, higher terminal cap rates, but also assumptions in the underwriting about higher vacancy levels and the cost that's going to take to keep these buildings leased. This really had an impact on the Tranche 1 assets. Our portfolio valuation decline was also roughly in line with the indices that we look at across the U.S. The NCREIF Office suboffice, which is an index that we feel closely reflects the portfolio we have, was down 11.7% over the second half of 2023 compared to our 8% drop.

These charts (on slide 16) are proprietary research that JLL does for us in our submarkets, and this is not nationwide data. This is specifically for the submarkets where our properties are located. You can see that while leasing volumes are still relatively low, it is picking up a little bit. Anecdotally, the evidence that we're seeing on the ground gives us some encouragement that we're beginning to see some momentum built here. Concession packages are still relatively high. It is still a renters' market. The number of months of free rent has picked up, as have the tenant improvement (TI) allowances. Over the course of 2023, we saw those TI allowances beginning to moderate a bit, and we saw a slight uptick in the fourth quarter which appears to be in line with the inflation on construction costs in the U.S. The construction cost inflation in the U.S. has outpaced general inflation by quite a bit largely because of labour costs. The uptick in TI allowance is roughly in line with that inflationary increase. Where these concession packages meet the road is in the next chart which shows the difference between the base rents and net effective rents. We're pleased that the spread between those two lines are steady, and hopefully over the course of the coming quarters, we'll be able to see those lines come closer together. Lastly, the sublease space in our market is beginning to stabilise. We're at all-time highs in terms of sublease availability in the U.S. In our submarkets, the sublease space available has actually declined a little bit and it's showing a trend of moderating. Across the U.S., it has continued to increase though.

A couple of ESG highlights here. I'll point out that we've really tried to maintain engagement with our investors, analysts and media. It's been a year of tough news for us, but we've really tried to stay in front of you, and stay available and accountable to you. We'll continue to do that going forward. We're going to continue to do these kinds of events to maintain open communication and be available for everybody to answer questions.

As for the U.S. economic outlook, the GDP growth is slowing. Inflation is still a bit above the Fed's target rate of 2%. Unemployment remains healthy but what we're really focused on is the federal funds rate. A lot of the market has accepted that we are in a 'higher for longer' scenario. What we're looking for here is for the Fed to indicate to the market that 'We're done, we're stable now'. The market broadly expects that we would see some rate cuts early in the year. The Fed has signaled those rate cuts are probably not going to happen until later in the year. This instability and uncertainty remains the biggest obstacle to banks getting back into lending in the U.S. office space and U.S. commercial real estate in general. Until those banks are back in the market, and there's a functioning healthy stable debt market, no matter what that rate is, transactions are going to be slow to occur. Price discovery and the bid-ask spread that we have between sellers and buyers is going to remain. We're looking for stabilisation of interest rates and a normalisation of lending markets in the U.S. to give us the indication that we're on the road to recovery in the U.S. office market.

The Recapitalisation Plan was a very tough negotiation. We had 12 lenders plus our Sponsor-Lender. As you can imagine, aligning the interest of 12 different lenders over a short period of time was an incredibly difficult task to undertake. We were pleased that we were able to get through that and announce the Recapitalisation Plan in November, after a really wide-reaching roadshow to investors, analysts, and media. We were able to get support for all three of the resolutions at our EGM and we were very, very grateful to get all of the resolutions passed. These are the key pieces of that Recapitalisation Plan. The first one: we've completed the disposal of Park Place to our Sponsor for US$98.7 million. The second part was putting into place the Sponsor-Lender loan of US$137.0 million which was used to pay down existing lenders, but it does remain as debt on our balance sheet. In return, we received the waiver of the breach, the relaxation of covenants, and the extension of loan maturities.

What we're focused on now, the next step, would be to pay down that US$50 million in March 2024, which should reduce our pro forma gearing to 56.9%. What we're laser focused on at the moment and our top priority is asset dispositions and trying to maximise the proceeds, not only so we can pay down debt, but so that we have liquidity to be able to invest and optimise the rest of our portfolio. We have started the process and we are targeting asset disposals of about US$100 million by the second or third quarter of this year. Other than that, we're focused on maximising the operations and the income of our remaining assets, looking to be very prudent on our spending, limiting only to essential capex, and managing liquidity so that we can be in a position to address maturities and capture opportunities moving forward.