Manulife US REIT halts distributions as manager mulls options

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Unitholders and even the manager of Manulife US REIT (MUST) BTOU -2.27%

are eager for a reprieve from the US office S-REIT's list of sorrows, which began almost immediately after an ill-timed acquisition in December 2021.
Then, the manager undertook debt financing and launched a US$100 million ($135.7 million) private placement to acquire Park Place and Diablo Technology Park in Arizona and Tanasbourne in Oregon for a total of US$201.6 million.

MUST raised equity in 2017, 2018, and 2019 to swiftly expand its IPO portfolio from three to 12 assets by end-2021. Six properties, including Figueroa, Michelson, and Peachtree, originated from the sponsor; while Exchange was acquired in 2017, and Penn and Phipps were acquired in 2018.

In March 2022, *The Edge Singapore* reported MUST's declining distribution per unit (DPU), which had fallen from 5.96 US cents in FY2019 ended December to 5.64 and 5.33 US cents in the two subsequent years.

MUST's FY2022 DPU fell further to 4.75 US cents following a US$3.8 million capital retention in 2HFY2022.

The manager also reported that its portfolio valuation fell 10.9% y-o-y to US$1.95 billion as at end-2022.

On Aug 14, MUST's manager paused distributions for 1HFY2023 due to a financial covenant breach. This led to loans being reclassified as current liabilities for the REIT.

For 1HFY2023, MUST posted a net loss of US$247.6 million, down from earnings of US$62.8 million last year. Distributable income, now halted, fell 17.4% y-o-y to US$37.9 million.

Ahead of the results, the manager had called for a briefing on July 18 to announce a further 14.6% fall in portfolio valuation to US$1.63 billion as at June 30.

The latest valuation excludes the recent purchase of Tanasbourne, which MUST divested to a wholly owned subsidiary of its sponsor for US$33.5 million — at a US$350,000 loss — on April 12.

As at June 30, MUST's gearing stands at 56.7%. According to the Monetary Authority of Singapore's (MAS) regulations, this is not considered a breach as it had occurred due to a decline in portfolio valuation, "which is beyond the manager's control".

However, MUST's loan covenants with banks are calculated differently. MUST has breached a 60% limit on the ratio of consolidated total unencumbered debt to consolidated total unencumbered assets, but a "good faith" payment made in August brought this down to 59.7% from 60.2% previously.

Negotiations are ongoing, and Tripp Gantt, CEO of the REIT manager, hopes to resolve the issue before the year ends. "To be candid, the lenders do have a lot of leverage at the moment."

Gantt says there is a "range of different outcomes", but waiving the breaches would be the "best outcome" to put MUST "back into normal operating territory".

He adds: "Everybody is focused on this. This is the top priority right now. We have to get clarity on this before we can have clarity on anything else strategically."

MUST's ability to resume paying DPU in 2HFY2023 is "predicated on a successful discussion or negotiation with the lenders" and ensuring the manager has ample liquidity to address current obligations, says Robert Wong, CFO of the manager. "We want to resolve this as soon as possible to return to normality."

How committed is Manulife?

Following a strategic review late last year, MUST's manager found a potential acquirer in South Korea's Mirae Asset Global Investments. The exclusivity period with Mirae lapsed in May.

The manager now says it is in discussions with US and Asia-Pacific groups and Singapore-listed real estate and financial institutions to explore "asset sales, capital injection [and] strategic transactions around the REIT platform".

MUST's namesake sponsor, Manulife, remains a light at the end of a long tunnel. In May, the manager announced that it had entered into a letter of intent with its sponsor on the proposed sale of Phipps, a 19-storey building in Atlanta.

That proposed transaction has since stalled, with the ball in the sponsor's court. Gantt says the manager has "done most of the work in the Phipps transaction already". "The sponsor has completed their due diligence [and] we have all the internal approvals… The next step would be to sign a sale and purchase agreement with the sponsor. Once we have that, we put that to the unitholders for a vote at an EGM."

A representative from the sponsor had been scheduled to speak in person at the release of MUST'S 1HFY2023 results but withdrew the prior evening. This led to a question on the sponsor's commitment level.

"I can't comment on why a sponsor's representative is not here in the briefing today; I apologise that I can't comment on that," says Gantt, who maintains that the sponsor is working closely with the manager on a solution.

Equity fundraising has been mentioned sparingly as an alternative. The manager says it is considering this option but needs to know how much capital to raise, which is only possible after negotiating with lenders and confirming the sponsor's support.

The sponsor may be unable to underwrite a rights issue as its stake is capped at 9.8% due to US tax rules. "Changing the trust structure is a complex exercise that would require confirmation from tax advisors, Singapore regulators, the trustee, and unitholders' approval through an EGM, which would be time-consuming to complete," reads a briefing slide.

Further divestments

Given the sale of Tanasbourne in April, could MUST divest Diablo too? The two properties and Park Place were acquired in December 2021, just months before MUST's gearing became a concern and the manager's first CEO, Jill Smith, retired in May 2022.

Diablo, a five-building office campus, is the only Class B asset in MUST's portfolio following the divestment of Tanasbourne. Compared to end-2022, its weighted average lease expiry (WALE) and occupancy have both fallen, and it is currently MUST's smallest asset by valuation.

As at June 30, Diablo is valued at US$58.6 million, 5.1% down from the US$61.75 million MUST paid in December 2021.

Gantt says he is examining the portfolio's assets for "optimal candidates for disposition" but notes that Phoenix, Arizona — where Diablo and Park Place are located — has held up with around 3.8% rent growth over the past 12 months. "The submarket saw the lowest overall percentage declines in valuation. We're going to consider all those things when we're looking at which assets to dispose of, and Diablo will be included in that analysis."

Compared to the "CBD-type office space" that saturates Phoenix, Diablo is a "light industrial and office type flex product", says Patrick Browne, CIO of the manager. "We continue to see growth there. It's hitting a cyclical point where there has been

some softness in terms of subleasing activity; that has put a little bit of downward pressure on headline rent growth in the real top-end of the market. But for the type of product that we have, we think we'll ride that out."

'Hotelisation' and co-working

MUST has offered many solutions since Gantt took over a year ago, and among his earliest initiatives was "hotelisation".

MUST announced in November 2022 that Peachtree, a 27-storey building in Atlanta, will embark on a US$18 million asset enhancement initiative (AEI) from 1H2023 to introduce a grand entrance, lobby, conference centre, coffee bar and outdoor terrace.

Browne says the AEI amount has not been fully spent, but the project is underway. "Our timeline remains plus or minus Jan 1, 2025."

In September 2022, the manager partnered with Flex by JLL to introduce a flex office and coworking space at Plaza, an 11-storey building in New Jersey.

The plan hit an unexpected roadblock in June when the building's fifth-largest tenant exercised its early termination rights for its leases expiring May 31, 2029, opting to vacate the building on May 31, 2024.

Browne says the manager is now in talks with a "large tenant" that could surpass the vacant space at Plaza. "[It] would likely result in us reshuffling where we put Flex by JLL in Plaza." In the meantime, Flex by JLL has paused the partnership.

Have WeWork's financial pressures cast doubt on the viability of co-working spaces? Browne thinks the co-working operator faces "legacy problems" separate from the sector.

WeWork is MUST's largest co-working tenant, occupying some 47,000 sq ft in Capitol, a 29-storey building in California. Co-working spaces represent just 2% of MUST's total occupancy, with WeWork representing 1%.

WeWork's consolidated revenue for 1HFY2023 ended June was up 7% y-o-y. "That's a sign of tenant demand," says Browne. "[WeWork's problem is] a classic asset-liability mismatch that we've seen [repeatedly] in financial history."

Quarz's open letter a mystery

It was strange that Quarz Capital Asia published an open letter on the proposed Mirae transaction in April, given that the hedge fund presently does not hold any units in MUST.

This was confirmed by the deputy CEO of the manager, Caroline Fong, at the Aug 14 briefing.

Quarz is an activist hedge fund investor; it is a mystery to market watchers why it issued an open letter on MUST.

Unitholders breathed a sigh of relief when MUST's manager announced that the Mirae offer — which included a sale of the manager and a preferred placement that would dilute unitholders significantly — had lapsed.

MUST's issue has been "a valuation problem that has caused the gearing problem, that has caused a breach, where we are today", says Fong. "Being internalised or not will not solve our problem, [which] is right in front of us today."