Thoughts on Manulife Reits (MUST) – Decline in Valuations Resulting in Breach of Financial Covenants

Manulife Reits announced an important announcement this afternoon which was important yet dreaded by all unitholders of the company.

Unfortunately, this announcement was somewhat expected to come at some stage given how the office market continues to decline at today's rate, so they just have to bite the bullet for it.

In any case, here are the summaries of the beef of the announcement along with the Q&A that I attended for easy reference:

- Mid-year Portfolio revaluation was done, and it **declined by 14.6%** to US$1,633.55 million, from US$1,913.5 million as of 31 Dec 2022. The large part of this is due to higher discount rates (as high as ~7%) and terminal cap rates (as much as 75 basis points) for certain properties, as well as continued weakening of occupancy performance (hence affecting discounted cashflow) across the U.S. office market.

- Based on this revaluation, the fair value of investment properties will be appropriately reflected in MUST's 1H 2023 financial statements. MUST's aggregate **leverage will float up to 57%**. The gearing is not considered to be breached according to the Property Funds Appendix, if it is due to circumstances beyond the Manager's control.

- However, Manulife US REIT has **breached a financial covenant** in some financing documents relating to the ratio of unencumbered debt to unencumbered assets of **60%**. Because of this, the Manager has commenced discussions with lenders to seek their waiver for the breach and discuss plans to address MUST's liquidity needs before they can advise if distributions for the first half will be announced.

- Discussions on the **proposed disposal of Phipps to the Sponsor are still ongoing**, and even if all the proceeds are used to repay loans, it will not bring the gearing below 50%. Therefore, the Manager and Sponsor are actively exploring a potential alternative method which may address MUST's mid- and long-term liquidity needs. At the moment, rights offering to unitholders are not in the pipeline.

I attended the management call and I really feel for the management braving and working on this situation hard over the past 24 months.

This isn't just a simplicity case of non-performing assets, execution competence, sponsor or structural issue. It is a mixture of all the situation added together and one brick after another falling onto their plate relentlessly over the last couple of months.

A lot of this situation is not having the ability to control over them with added time pressure running against them.

You try to look at the sponsor and they are bounded by the limitation of the 10% limit stake they can undertake in the Reit.

The Reit is working on asset divestment but as per their announcement, that is still ongoing and even if completed, it probably won't help them to reduce much of their gearing and financial covenants now that they've done this revaluation. As a result of the breach of the financial covenants, they now have to speak to the lenders and seek a waiver before they can announce any DPU distributions to unitholder, more uncertainty ahead.

The clock is also ticking because they are expecting further downward revaluation for year-end which could lead to another storm coming, and with DPU obligation not completed, they are in potential breach of having to incur additional tax penalty on their structure.

Management also mentioned that transactions in the US are down by about 70% year on year. Lenders were also reluctant to lend money to buyers for purchasing office assets. In fact, most buyers today were opportunistic unleveraged buyers.

There are no rights offering planned for the unitholders and we can also expect probably around similar revaluation downward for the other two office Reits.