‘Absolutely’ possible to save Manulife US REIT, says sponsor but time not on its side

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Can Manulife US REIT (MUST) BTOU -2.27% ▼

be saved? Marc Feliciano, Manulife Investment Management’s global head of real estate, private markets, believes it is “absolutely” possible. That sounds like good news to many MUST unitholders. However, it is a tall order for the manager and sponsor and will require a leap of faith.
As at Aug 16, MUST is trading at just 8.9 US cents (12.11 cents). Based on its 1.836 billion units in issue, this translates into a market capitalisation of just US$163.4 million. Although this is above the cash of US$133 million on its balance sheet, its current liabilities outweigh current assets by more than US$880 million as all MUST’s debt is deemed as current by its 12 lenders.

MUST’s latest 1HFY2023 ended June financial statement states that due to the reclassification of loans and borrowings into current liabilities as a result of a breach of a financial covenant, the manager is not in a position to declare any distribution for the half-year.

Analysts suggest that MUST should divest assets and raise equity to recapitalise. In July, Tripp Gantt, CEO of MUST’s manager, said MUST has three options to resolve its financial covenant breach. These were dispositions of assets, equity fundraising (EFR) or refinancing, which the sponsor is exploring.

At its current unit price, it does not make sense for MUST to raise equity through either a rights issue or a preferential equity fund raising exercise. Its market cap is just US$30 million more than the restricted cash on the balance sheet, which implies that the buildings are worth just US$30 million but this is not the case.

During MUST’s results briefing on Aug 14, Gantt said the divestment mandate would be packaged together in an EGM “with whatever form of sponsor support that we’ve discussed, whether it’s a transaction of Phipps or another method of sponsor support”.

Sale of Phipps ready for execution

On May 24, MUST’s manager announced the proposed sale of Phipps, a Class A office building in Atlanta, Georgia, to its sponsor at the average of two independent valuations commissioned by the manager and MUST’s trustee, and subject to unitholder approval in an EGM.

Phipps' valuation as at June 30 is US$178.15 million, down 15.2% from its valuation of US$210 million at December 31, 2022. In 2018, MUST acquired Phipps from the sponsor for US$205 million.

"In late May, there was an announcement that the sponsor would purchase Phipps and that remains on the table and ready to execute," says Feliciano.

"But I also want to add the caveat that there are two new important data points that I think any rational manager or sponsor would have to take into account," he adds.

"There has been a 15% drop in property valuation since then that has caused a breach of the unencumbered aggregate leverage."

Indeed, since the May 24 announcement, a couple of new challenges have emerged due to the drop in the valuation of MUST's portfolio. In addition to the breach in MUST's financial covenant, the drop in valuation will exacerbate MUST's debt problems.

According to MUST's debt expiry profile, a revolving credit facility (RCF) of US$39.7 million can be rolled over till August 2024, US$143 million matures in 2024 and a further US$285 million matures in 2025.

Since Phipps was revalued at US$178 million, its sponsor can only buy it back at not less than the lower of the two independent valuations since this would be an interested or related party transaction according to the code on collective investment schemes (CIS).

Thus, a sale of Phipps would only be a "band-aid" for MUST in 2024, leaving no extra money for capex or tenant incentives. This means MUST's manager would find it difficult to sign on new tenants.

"When you look at what the sponsor did earlier in the year, which was the purchase of Tanasbourne, that was not enough," Feliciano points out.

In April, MUST completed the sale of Tanasbourne to the sponsor for US$33.5 million. This was one of the three campus-like properties acquired in December 2021 that sent MUST over the proverbial tipping point.

However, its sale did not dent the scale of MUST's debt expiries and the sponsor feels that the sale of Phipps is not sufficient to solve MUST's problems too.

Sponsor should provide financing

"To be very comprehensive, the sponsor and management need to reflect on the debt maturities in 2024 and 2025," Feliciano explains. "What the sponsor did was take a step back without taking the Phipps purchase off the table and asked Is that enough given the current situation."

Indeed, MUST requires a plan that takes into account the debt maturities for the next two years. Feliciano explains: "What the sponsor would like to do with the lenders is to generate a financing alternative and maximise the runway with whatever gets the longest runway, whether it's Phipps or through a refinancing approach."

"The financing alternative is to maximise the runway for as long as possible so the S-REIT can clear debt maturities through to the first half of 2025," he emphasises.

The refinancing approach is to provide MUST with sufficient credit to cover the expiries up to June 30, 2025. That is likely to work out to be US$330 million to US$350 million for the sponsor (inclusive of Phipps). This would take care of the US$39.7 million RCF, and US$143 million expiries in 2024, and expiries of between US$150 million and US$170 million due in the first half of 2025.

"The S-REIT needs some of the Phipps proceeds for capex and tenant incentives (TI). The $178 million won't even deal with all the debt maturities in 2024," Feliciano says.

In the US, landlords have capex needs to keep their properties up-to-date with amenities, green features and additional areas for employees to relax in.

"TI allowance is the money that you give to a tenant to fit out their space," Gantt said during the media and analysts briefing on Aug 14.

As an example, Patrick Browne, chief investment officer of MUST's manager, reveals that the manager is in negotiations with a large tenant who is thinking about occupying a space at 500 Plaza in Secaucus which is larger than what former anchor tenant The Children's Place had occupied. Such a tenant would ask for TI.

This means whatever plan MUST's manager and its sponsor agree on would require funds over and above that generated by the sale of Phipps.

Both plans have merit

Still, Feliciano insists the sponsor is "willing to move forward with a purchase of Phipps in conjunction with an agreement with lenders on a plan that deals with maturities in 2024 and 2025 and a longer-term agreement regarding potential breaches due to property valuations".

Ideally, the best would be a combination of the two plans, an analyst *The Edge* spoke to says.

"Phipps takes care of the short-term and could put a floor to the behaviour of the unit price," adds the analyst who declined to be named.

Feliciano points out: "Realistically, the market might react better if we purchase Phipps," he says.

While credit financing could get MUST past the expiries, it may not do much to reduce its high gearing level. However, if the cost of the credit is at market value, the interest coverage ratio (ICR) which stands at 2.6x would suffer.

On the other hand, a sale of Phipps alleviates the immediate gearing issue but not sufficiently. A combination would raise sufficient cash to keep the REIT's best properties in good shape and get the REIT past the debt expiries, the analyst adds.

Feliciano agrees, "The management team needs to put out a capital strategy, cashflow strategy and portfolio strategy. It means selectively picking which assets to spend your capital based on cash flow strategy, where you should reinvest through capex to maximise asset value, and which assets you feel you shouldn't spend that capital on, and sell those assets."

Office sector to trough in 2025

Indeed, the post-pandemic office property cycle has been brutal for MUST and there are little signs of the situation abating.

Various US office benchmarks like the NCREIT Office subindex continue to deteriorate in 2Q2023, declining 18.4% y-o-y. The NCREIT Office subindex is appraisal-based and does not take into account transactions.

During the global financial crisis, the NCREIT index's peak was in 2Q2008 and its bottom in 2Q2010 with a 31% decline for office, compared to –18.4% currently. Feliciano believes that the office cycle decline started in 1Q2022. However, instead of a two-year decline, the decline could persist for three years as workers continue to work from home. As such, the trough could be sometime in 2025.

"What provides the greatest certainty? Refinancing that clears all the debt maturities through the first half of 2025 or sell Phipps to the sponsor, which only deals with the 2024 maturities?" Feliciano wonders.

Adds Feliciano: "Which option we go with will be conditional on what we can reach with the lenders. I want to create the longest runway and we're indifferent to whether it is Phipps or alternative financial debt." Or a combination of both.

In a recent discussion on the outlook on the US office sector, a JLL consultant said "REITs with a majority of investments in East Coast gateway markets are seeing leasing volume grow".

Of the groups with a majority of holdings in East Coast gateway, JLL says "SL Green, Vornado, COPT, Brandywine, Empire State, Paramount saw 77% q-o-q growth in leasing volume".

Interestingly, rents at Hudson Yards are reportedly higher than pre-Covid levels and MUST's Exchange, a 30-storey Class A office building located along the Hudson River in Jersey City, is just a Path stop away from Hudson Yards.

Finding the best solution

Feliciano says: "Whether it's Phipps or the financing approach that clears off the debt maturities and provides the right amount of capital for capex reinvestment into the right properties, that's what we need the management team to put together."

However, time is of the essence as a solution is needed before the end of the year.

"We would like to get some resolutions with lenders in the next couple of months and before the year-end, the management will put it to the unitholders. We would like to have a resolution in an EGM and unitholders will decide," says Feliciano.

"The sponsor is committed to helping the manager to steer through the current challenges. It's never wavered from its commitment. Before you can create unitholder value, you have to stabilise unitholder value and deal with the lenders first. They have all the control because of debt covenants," he adds.