Sponsor pressed to step up support after Manulife US REIT breaches aggregate leverage ceiling

Manulife US REIT (MUST) is the first S-REIT with US assets that is testing the generally held view that sponsors are meant to support their REITs.

On July 18, MUST's manager announced that the valuation of the entire portfolio had declined by 14.6% from the valuation as at Dec 31, 2022. This caused MUST to breach the 50% aggregate leverage ceiling. The valuation decline was blamed on higher discount rates to compute net present value (NPV), higher capitalisation rates and weakening occupancies.

According to the July 18 announcement, the bulk of the US$280 million ($371 million) decline came from properties Figueroa, Michelson, Exchange, Penn in Washington DC and Phipps Tower in Atlanta.

Potential financial covenant breach

MUST's loans contain a financial covenant where its loan-to-value (LTV) of the total unencumbered debt to unencumbered assets is 60%. With its latest voluntary half-year valuation, MUST's financial covenant is at 60.2%. The problem with covenant breaches is the potential for cross-defaults.

Robert Wong, chief financial officer of MUST's manager, explains: "We're proposing to prepare the token amount of debt [to be paid] to get the LTV down to below 60%. Then we won't be in a technical breach. From there, negotiations and discussions will be more conducive, because the respective lenders will then be able to say we are not in default."

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"We've got to work through a solution whereby the lenders will either waive the covenants or relax them to give us a bit more runway to execute our divestment plan to release more capital into the REIT and to pay down the debt," he adds.

The covenant breach would result in a cross-default of MUST's interest rate swaps, which have fixed the interest rate. If this materialises, MUST would be subjected to higher interest rates for its loans which would impact the interest coverage ratio (ICR).

The existing loans contain a financial covenant which states that MUST's ICR shall not be less than 2x. If the banks do not agree to waive the breach of the financial covenant, the ICR would fall below 2x.

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During its IPO back in 2016, MUST was listed with three assets sold to it by the sponsor Manulife. These were Michelson, Figueroa and Peachtree. MUST swiftly acquired two more properties, Plaza in Secaucus and The Exchange in Jersey City, which was from the sponsor. In 2018, MUST acquired a further two properties from the sponsor: Penn and Phipps. Centerpointe I and II in Fairfax, Virginia and Capitol in Sacramento were also acquired in 2019.

MUST raised equity in 2017, 2018, 2019 and 2021 when it acquired three more smallish properties in the so-called "Sun Belt" of the US. Of these, Tanasbourne was divested to Manulife in April this year. MUST's manager announced that Manulife would acquire Phipps following a valuation exercise to infuse the REIT with cash.

The problem for MUST unitholders could be the absence of distributions for DPU. "We can't make any distributions because all the loans are considered due right now," Wong points out. "The lenders have listened to our near-term, mid-term and long-term plan. Between now and the results, we can't get a ton of resolutions on whether they can waive the current breach in covenants. The possibility of distribution in the 1HFY2023 is limited but it doesn't mean that it's going to be permanent. Once we can work out something with the lenders, things will be back to normal," he says.

William (Tripp) Gantt, chief executive officer of MUST's manager, says: "Over the mid-term, we're going to continue to look at ways of raising proceeds in order to continue to pay down debt."

As Gantt tells it, MUST has three ways to raise proceeds to pare debt, excluding the rather unpopular avenue of preferred placements to new investors. These are raising equity via a dilutive rights issue, divesting assets either to the sponsor or a third party or getting a shareholder loan from the sponsor.

"The property sales are the most obvious; another alternative is some kind of lending [agreement] and [for the sponsor] to become a lender to pay down near-term debt. That's something we'll continue exploring with the lenders," Gantt says.

Separately, the regulatory guidelines on aggregate leverage have an ICR component. S-REITs are required to keep their aggregate leverage ratios no higher than 50%, subject to a minimum ICR of 2.5x. If the ICR is below 2.5x, aggregate leverage ratios need to be no higher than 45%.

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S-REITs used to be more conservative with aggregate leverage ratios. However, the quest for higher assets under management (AUM) has led even large, previously well-managed REITs like CapitaLand Integrated Commercial Trust to move their aggregate leverage above 40%.

Sponsors that used to be supportive of their REITs have restructured as real estate investment managers (REIM) or alternative real asset managers focused on AUM growth and fee income. Whether these restructurings disadvantage their REITs and property and business trusts remain to be seen.

A sponsor's role

In the first couple of decades of S-REITs, the external manager model worked well as sponsors supported their REITs with a pipeline and the financial support to acquire that pipeline. Sponsors also supported their REITs financially during stressful occasions, such as the global financial crisis.

Increasingly though, REITs are being pushed to acquire more assets — not just from the sponsor but from third parties — and some of these acquisitions have been questionable. In particular, CapitaLand Ascendas REIT's (CLAR) acquisition of The Shugart, Seagate's R&D facility in Southeast Asia, is an acquisition from a troubled company, which signed on as a master lessee of the property. The second issue is the property's limited land lease of 20 years.

As CLAR is large and diversified, it can weather declines in valuation. For its part, CLAR's US portfolio continues to perform a lot better than either Keppel Pacific Oak US REIT (KORE) or Prime US REIT.

RHB Group Research believes MUST's sponsor should step up.

"The sponsor, Manulife, with its strong financial position, could help offer support in the form of i) the completion of the proposed acquisition of The Phipps from the REIT, preferably at an average of year-end (December 2022) and latest valuation as well as potentially buying back few more assets from the REIT; and ii) working with the lenders in resolving and offering continued financial support to the REIT, and, if needed, provide a shareholder loan or act as a lender of the last resort," RHB says.

Alternatively, despite articulating a wish to exit office property, Manulife could lead the formation of an office property fund to acquire distressed assets. This would infuse MUST with cash without breaching the 9.8% ownership rule.

In the meantime, Gantt has an unenviable task ahead of him. The excuse cited for Manulife's inability to render more support to the REIT is because of a widely held rule where no single investor can hold more than 9.8% of the REIT in order for MUST unitholders to enjoy a waiver of the US's 30% withholding tax on distributions.

"Our sponsor is limited to a 9.8% holding in the REIT, which somewhat limits their ability to put equity directly into the REIT. We're continuing to work with the sponsor on the Phipps transaction. We have been engaged with brokers, looking at disposition options in the US. We've remained engaged, trying to gauge the market for opportunities to sell assets. We are working with a broker right now to identify which assets we think that we would be able to sell," Gantt explains.

"Going forward, we need to have the sponsor in the room to express directly what the appetite is and what their objectives are. What I can tell you is they're in the trenches with us, involved in the lender phase, they understand they're the critical part of the solution but I can't speak on behalf of them in terms of appetite and what they're going to do moving forward," he adds.

Valuation declines

According to a briefing by MUST's manager on July 18, the key drivers of the valuation declines were widening discount and terminal capitalisation rates. The discount rate used in its valuation exercise increased by 50–125 basis points (bps) while the terminal cap rate increased by 25–100 bps. The cap rate in the income capitalisation valuation method expanded by 75 bps to 7%.

Patrick Browne, chief investment officer of MUST's manager, says: "I just want to re-emphasise that the main driver of valuations in the US valuation process is the discounted cash flow (DCF) model, which is primarily driven by discount rates and terminal cap rates to arrive at a valuation."

Other inputs in DCF are operating cash flow, which depends on costs, rents and occupancies, including their outlook. Costs have risen and occupancies have fallen because of the work-from-home trend. In MUST's portfolio, a few large tenants downsized.

"We made the voluntary decision to take this [revaluation] action early. And as soon as we got wind of these valuations, we began looking at options right away. We are in the early stages of trying to figure out the solutions for this and the sponsor is engaged with us," Gantt says.

DBS Group Research has downgraded MUST to "fully valued". "We are late in this change in call and we take responsibility for that. We have previously, in our past reports, envisioned a roadmap which highlights a more urgent response from their sponsor (through asset sales and/or equity injection) towards MUST in order to prevent an incidence of any breach of the financial covenants, but found the timing to be lacking. With another round of asset write off (25% year-to-date) signalling further stress in the balance sheet and in the face of a spiralling debt crisis and a near-term 'dividend stopper', we

believe that there is a rising risk that equity shareholders will not be compensated to wait out a recovery," the DBS update says.

These issues are not peculiar to MUST's portfolio. Tech companies are rightsizing their headcount. KORE's manager has articulated that its portfolio is tech-heavy from a tenant perspective. Unit prices of KORE and Prime are down by 30% and 51% respectively.

Analysts need to relook at KORE and Prime to see if the stresses that materialised for MUST could surface for the other two US-based S-REITs.