Phipps sale expected to sponsor set to cut Manulife US REIT's leverage as Mirae's exclusivity period lapses

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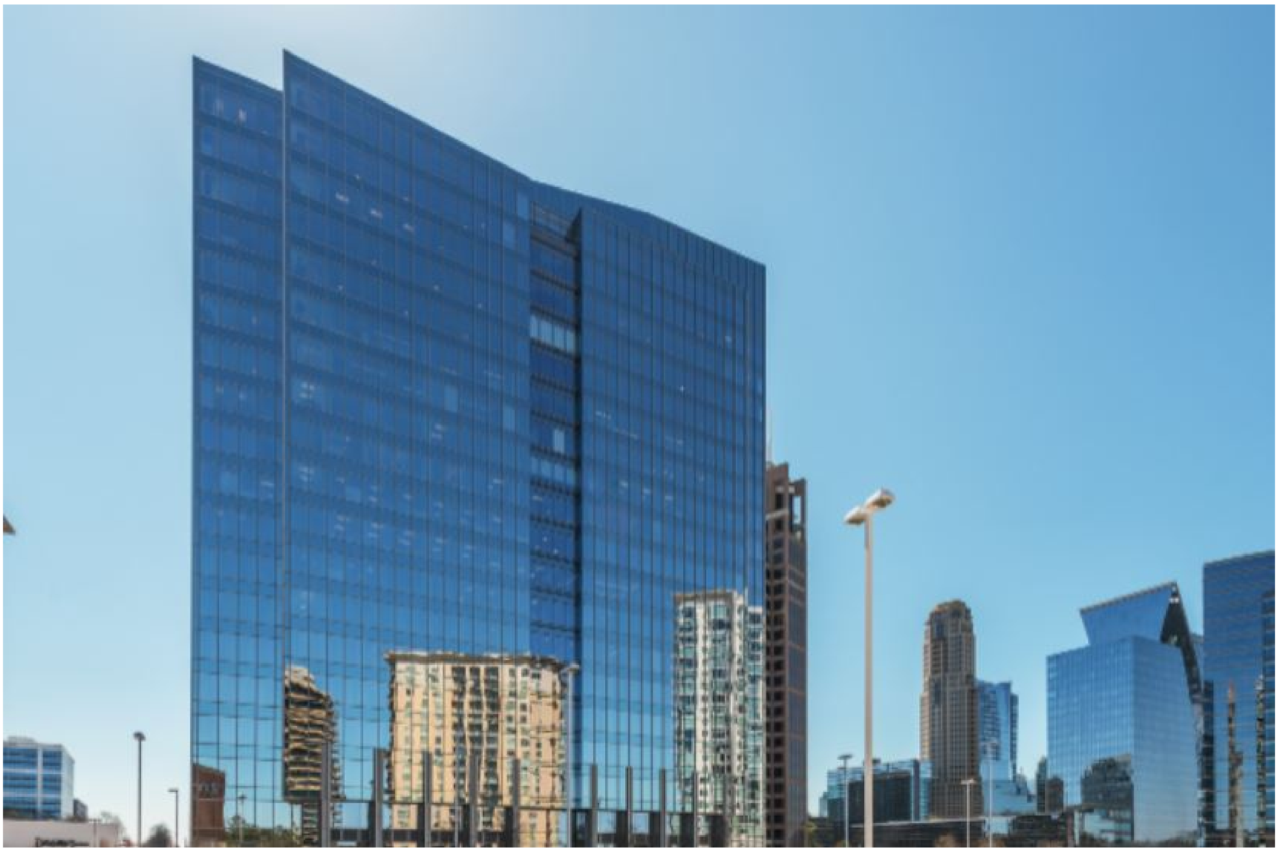

On May 24, the manager of Manulife US REIT (MUST) announced that it had entered into a letter of intent with its sponsor Manulife concerning the proposed sale of Phipps Tower in Atlanta.

Divesting the asset looks like the best option for Manulife US REIT (MUST), analysts, investors and market watchers agree. This is because selling a meaningful property would lower aggregate leverage, demonstrate sponsor support and trigger a rebound in MUST's unit price.

Phipps was valued at US$210 million ($282.63 million) as at Dec 31, 2022, at a capitalisation rate of 5.25%. Its net property income (NPI) in FY2022 was US$12.2 million, up from US$11.9 million in FY2021, and contributed 10.8% to MUST's total NPI in FY2022.

The manager says it will waive the divestment fee. It also says the transaction is "subject to satisfactory completion of due diligence and negotiation of terms of the definitive agreements the parties are targeting to enter into the definitive agreements in relation to the proposed divestment by June 30".

As at Dec 31, 2022, MUST's net asset value was US$1.02 billion, which means the divestment requires unitholders' approval.

Finally, sponsor support

If MUST manages to divest Phipps for about US$180 million to US$190 million, it would take the REIT's aggregate leverage down to a more manageable level of about 43%. In 2018, Phipps, a 19-storey trophy office building which was completed in 2010, was acquired from MUST's sponsor for US$205 million.

At that time, the major tenant was Carter's, the designer and marketer of OshKosh B'gosh with a tenancy that expires in 2023.

In 1QFY2023, MUST's manager said that Carter's renewed 209,000 sq ft of space with an 18% rent reversion from 2025. However, Carter's gave up 69,000 sq ft which MUST's manager says is 20%–30% below market rents and the property has "healthy tenant interest for 10,000 sq ft to 20,000 sq ft".

This means Phipps' FY2023 NPI may be lower than US$12.2 million as it would take time for income to flow from new tenants. However, if new tenants were signed at higher rents, that may have a net positive impact on valuation based on discounted cash flow.

On April 12, MUST's manager completed the sale of Tanasbourne, Oregon, to its sponsor for US$33.5 million. Tanasbourne was acquired in November 2021 for $33.85 million. JLL valued the property at US$33.5 million as at Dec 31, 2022 and Colliers valued the property at US$32.36 million as at March 15. Since the transaction was less than 5% of NAV, no EGM was required.

Market watchers have long believed that the best way for the unit price to rebound would be for the sponsor to step in and acquire a meaningful property. Realising the asset's real valuation would underscore the portfolio's valuation. MUST is trading at just 0.3x P/NAV. A sale of Phipps at a modest discount to valuation could boost its unit price, market observers suggest.

Better options than Mirae

In November 2022, MUST's manager announced a strategic review by Citigroup. On Dec 30, 2022, the manager announced that its portfolio valuation had declined by 10%, taking its aggregate leverage to around 49%. Its options to "cure" this included equity fundraising, divestments or a new partnership. Time and again, the manager had said during results briefings that the review could include a combination of steps to reduce aggregate leverage.

On March 15, MUST's manager confirmed that it and its sponsor were in discussions with Mirae Asset Global Investment. The news unnerved investors. In May 2022, Mirae was unable to complete the planned purchase of the International Finance Center in Seoul

Brookfield Asset Management because it did not receive permission to set up a REIT for the property.

Worse, the Mirae transaction would have been dilutive for unitholders. It included the sale of the manager and a preferred placement to Mirae. Although the transaction could have ensured MUST's survival, it would be at the expense of diluting DPU and NAV for unitholders significantly.

On May 18, in a report, DBS Group Research wondered whether a rights issue would be more equitable than the Mirae transaction. In DBS's calculations of the Mirae impact, dilution to DPU would be 39%–42%. DBS suggests that MUST needs to raise US$175 million to get to a comfortable gearing.

Will the sale of Phipps be sufficient to quell unitholder unease? It already has to an extent. Divesting Phipps should attain the US$175 million cash infusion needed without the painful dilution that the Mirae deal would have caused and could also delay an equitable rights issue.

On May 24, the manager also announced that the exclusivity period with Mirae has lapsed but said it is open to ongoing discussions with Mirae and is also considering proposals from other prospective partners.

Interestingly, on May 23, in a sector update, Nuveen says it sees "pockets of value" in the office sector: "We favour the highest-quality (class A+) properties that are able to retain and attract tenants paying top-of-market lease rates."

Perhaps, the US office sector is about to turn the corner