"My first REIT investment was way back in 2002 when I bought Ascendas REIT. How I wish this book was available at that time. I would have made less mistakes and more profits!"

— Mohamed Salleh Marican
Founder and CEO, Second Chance Properties Ltd

"*Building Wealth Through REITs* is a great contribution to the nascent REIT market in Asia. We believe REITs are a perfect investment vehicle for Asian investors, yet to date the popularity and investor enthusiasm in Asia for REITs is still lacking. This comes down to various misperceptions that Bobby sets out to debunk with this ground-breaking book."

— Raymond Wong
Executive Director, Saizen REIT

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BUILDING WEALTH THROUGH REITS

THIRD EDITION

Bobby Jayaraman

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high leverage to trade REITs without regard to fundamentals. The resulting volatility caused by the action of such traders is something long term REIT investors need to get used to.

Another effect of the rising popularity of REITs is the influx of a string of dubious IPOs with mediocre properties and high headline yields (late 2012–early 2013) to grab investor dollars. The market still seems unable to discriminate between REITs with high quality properties and genuine cash flows versus ones with questionable assets that engage in financial engineering to deliver dividends.

A more challenging interest rate and operating environment will favour REITs with strong fundamentals. These will be the ones that will continue to generate strong cash flows and obtain financing at favourable rates.

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CHAPTER 9

REITS IN A POST-COVID WORLD

When the history of our times is written, the Covid-19 pandemic of 2020 is sure to feature prominently. While the total number of fatalities of around 2.8 million (as of April 2021) is unlikely to ever reach the 1918 Spanish flu levels of 50 million or so deaths, the impact has been colossal given the globalised nature of the world we live in.

Lockdowns instituted by governments around the world to combat the lethal virus have brought normal life to a standstill. Basic assumptions such as the need to travel, shop in malls and work from an office are being questioned.

While some sectors like technology and e-commerce have benefited as people buy more laptops, smartphones and iPads to work and shop remotely, others such as airlines and commercial

real estate have suffered as people spend most of their time at home.

As a result, hospitality, retail and office REITs despite low interest rates have taken a huge hit. Unlike the 2008–09 financial crisis where the key issue was around the financing model of REITs, now the worry is simply the relevance of commercial real estate in a world where people seem scared to venture out of their homes and resume normal lives.

As government-mandated lockdowns shut down malls and hotels, landlords had to offer high rental rebates to their tenants, hitting their cash flows.

Dividend investors who took the safety of regular dividend payouts for granted were shocked to see hefty dividend cuts of as much as 70% even by well-regarded REITs such as Frasers Centrepoint Trust and CapitaLand Mall Trust. This did not happen even during the darkest days of the 2008–09 financial crisis.

Are the best days for REITs truly over?

To answer this, we need to move away from the current gloom and doom scenarios perpetuated by the media and ask ourselves whether REITs in the hard-hit sectors of retail, office and hospitality are fundamentally impaired from a long-term perspective? Let us delve into specific sectors to gain a better perspective.

RETAIL REITS

The obituary for brick-and-mortar shops has been written numerous times since the advent of e-commerce. The Covid pandemic appears to have delivered a final blow to many household names. In the US, venerable stores such as JCPenney, J.Crew, Brooks Brothers and Neiman Marcus have all filed for bankruptcy.

In Singapore, the biggest closure so far has been the

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160-year-old Robinsons department store. There is no doubt that parts of the retail landscape are seeing stress but this does not automatically imply that all of them will cease to exist and malls will no longer be relevant.

Many of the recent retail closures and bankruptcies had been clinging to an outdated model and limping through the years. Robinsons department store, for instance, had been making losses for six years before finally capitulating in 2020. Covid-19 just happened to be the tipping point.

Store closures are nothing new – they have been happening since the advent of the first modern malls in the 1950s. Curiosity, fashion and toy stores, department stores and big box retailers have all had their heydays. The real question for malls is whether new retail formats will take the place of the fallen ones as they have always done through the years.

The other important question is whether people will even be bothered to go to malls for shopping or simply be content to shop through their mobile phones and laptops as tech firms would have us believe.

There is reason to believe that the answer to both questions is yes in the Singapore context.

Some formats such as department stores may be dead but others which satisfy specific consumer needs at competitive prices continue to do well. Japanese lifestyle discount stores like the immensely popular Daiso are a good example of this trend. One can find similar discount stores in virtually all suburban malls. The economics of shipping a $2 product simply doesn't make sense, hence such stores are likely to proliferate in malls.

Similarly, the beauty industry needs physical presence. Customers like to get advice (even biased!) from beauty consultants,

sample makeup shades, get a whiff of the new perfume and generally enjoy the ambience of the store. This experience cannot be replicated online.

No surprise then that even at the height of the pandemic, there was a spate of new store openings, such as local beauty brand RE:ERTH opening its first physical store in Tangs; Dr. Hauschka, a German skincare brand, in Parkway Parade; and Maison 21G, a French perfumery, in ION Orchard.

Even the bookstore, one of the first casualties of e-commerce, seems to be well and alive. Taiwan's largest bookstore, Eslite Spectrum, recently announced its expansion plans into Malaysia and Southeast Asia.

One can also find many specialised pet stores, restaurants and bars continue to open despite the weak economic environment. Despite the churn, the occupancy of malls so far is mostly resilient.

Will Singaporeans continue to shop in malls?

In Singapore – as explained elsewhere in the book – malls are a way of life. The economics of a suburban mall (city malls have less attractive economics) in Singapore with its huge catchment and lack of competing activities is something that is structural. It is certain to outlive the pandemic!

This is why lines formed outside most shops when Singapore reopened after more than two months of strict lockdowns. All the items could have been bought online but customers preferred to queue instead.

E-commerce and tech firms would have us believe that everyone will be shopping online over the next decade. The reality so far looks different, though. During Jan–July 2020, which included the lockdown period in the US when most stores were ordered to

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shut, online spending only represented 19% of total retail sales. In China, for 2019, online sales made up around 21% of retail sales. It wouldn't be hard to imagine online sales making up a third of retail sales over the coming years; anything more would imply a complete rewiring of basic human nature.

As long as malls have shops that satisfy the needs of customers, they will be well patronised. While the pandemic has closed borders, preventing tourist spend, it has also stopped local leakage of spending power. This dynamic has helped suburban malls more than the Orchard Road ones, which rely on tourists for one-third of their spending.

While all shopping malls are unlikely to hollow out and the general trend of shopping in malls is likely to sustain, this does not mean that things will be the same in the mall REIT world as they were a decade ago. This trend was increasingly visible even before the pandemic. Certainly, the days when you could build a mall anywhere and achieve 100% occupancy with good rentals are gone for good. There will be more and more malls that will need to be repositioned or even closed. Fortunately, listed retail REITs hold some of the most productive and well-located malls.

Even so, within the mall landscape, there will be winners and losers, much more so than before. REIT managers cannot afford to be complacent, hoping that tenants will flock to well-located malls. More creativity will be needed to get the mall mix right to encourage both mall traffic and tenant sales. Rentals based on turnover will likely play a larger role than they have in the past (usually less than 10% of rentals). New anchor tenants will need to be found to replace the multiple floors the department stores have vacated. Pop-up stores already a fixture in some malls may become even more common.

All of these changes will impact the valuations of retail REITs, and investors will need to evaluate the attractiveness of specific malls rather than apply broad-brush valuation metrics to retail REITs as a whole.

On the positive side, supply over the next few years is expected to be weak. Developers will think hard before using precious land to build yet another mall. After many years of oversupply, this will be a welcome development.

OFFICE REITS

The phrase "work from home" or WFH has now become ubiquitous. The notion that work can be done effectively from home is being touted by the media and select tech company CEOs (of course, the ones whose products/services benefit from work at home) as the breakthrough of the century.

In their world, offices even post the pandemic would be relegated to the dustbin of history.

After all, why travel somewhere to work when you can work from the comfort of your bedroom or kitchen, stare at your screen all day doing Zoom calls, stay away from the glaring eye of your boss, not meet pesky colleagues and even relocate to a cheap place to save costs while still drawing a high salary and living the life of a freelancer.

Such is the fantasy that has become a consensus view and caused the price of office buildings and REITs to wobble. Even serious investors are questioning the value of office buildings and business districts in major hubs like New York, London and Singapore.

While not at the same scale, there have been overblown reactions before too. For instance, the September 2001 terror attacks

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in New York saw similar aversion to high-rise buildings, with people moving away from NYC to work from the suburbs.

The reality is that working from home has been an option since the widespread adoption of broadband and online communication tools such as Skype, and indeed many have been doing so for a long time. The pandemic might have given this trend a boost but it is hard to see people eschewing offices and working from their homes forever.

Just because something can be done does not mean it is ideal. Social interaction, spontaneous brainstorming of ideas, developing company culture and training of junior employees are simply not as effective remotely. As the pandemic recedes from our collective memory, these basic needs will reassert themselves.

The implications of WFH if it really takes hold post-pandemic will be far-reaching. If work can be done productively from anywhere, then it will severely challenge the ability of high-cost countries to attract workers. Why should an employer pay high wages for Singaporeans working from their HDB flats when the work can be outsourced at a fraction of the cost to Philippines or India?

Regional hubs such as Hong Kong and Singapore are synonymous with their bustling CBDs (central business districts); a permanent WFH culture would hollow out the hubs and permanently impair commercial land values.

How probable is such a scenario? The jury is still out on this. There have been reports of major global banks surrendering part of their space. while at the same time tech giants like Amazon have been adding space as have fintech companies from all over the globe that are making Singapore their home.

A more likely scenario is some sort of a hybrid model where companies retain offices and allow more flexibility for employees

to work from home. This might not change space requirements meaningfully as companies balance the need for employees to work from home and larger offices to allow for social distancing, leading to a "de-densification" of office space.

In Singapore, office REITs typically have 3-year leases. Barring a few tenants that would have been anyway planning on cutting office space, most are likely to take a longer-term view on office space decisions. There might well be reconfigurations such as splitting one big space into several smaller ones and increasing use of flexible workspaces; however, despite fanciful predictions, it is quite unlikely that Singapore will see ghost offices and an empty CBD anytime soon.

HOSPITALITY REITS

Hotels and serviced residences have been the most severely hit as international travel has virtually ground to a halt. Hotels in countries with large domestic markets such as China, US and India have fared better as they cater to domestic tourists. Unfortunately, Singapore does not have this option, with staycations providing only minimal support.

The issues confronting hotels are somewhat different from malls and offices. Hotels will likely be the last to recover fully as countries will only fully open their borders without quarantines and other restrictions once there is a vaccine or effective treatment for the virus.

However, unlike malls and offices, there is not much debate about the relevance of hotels in a post-Covid era.

While some companies claim they would not need their employees to travel as much even after the pandemic subsides, it remains to be seen whether they will follow through once they see

their competitors travelling and meeting clients in person.

Leisure travel is expected to bounce back fast once the pandemic clears. There will be plenty of pent-up demand from travellers sick of being cooped up in small spaces.

Investors should thus look for or hold on to hospitality REITs that have the balance sheet strength to tide them through these tough times. The REITs should have master leases with credible entities that can service the leases even with minimal occupancies. Unencumbered properties that can be sold as a last resort to raise cash also offer some protection.

As travel resumes gradually, a lack of supply will allow for strong pick up in RevPARs (revenue per available room), leading to higher hospitality REIT prices.

LOGISTICS REITS

Consumers fearful of contracting the virus have taken to online shopping in a big way, leading to strong investor interest towards the logistics and data centre sectors, which are seen as "defensive". Apart from hospital REITs, they are the only sector to have mostly preserved their dividends even during the height of the pandemic, thus it is no surprise that most of the REITs in this sector are trading at all-time highs.

While much of the enthusiasm for this sector is for a good reason, one should keep in mind that increased supply will surely follow rise in demand. The capital needed for constructing warehouses is much lower than offices and malls, as is the time taken to complete. Covid-19 has not changed these fundamentals.

As convenience and speed take on greater importance, much of e-commerce will require urban logistics centres rather than large distribution centres in far-flung locations. In the US,

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Amazon is already in talks with major mall owners to use empty retail space as fulfilment centres. Such trends can have knock-on implications for REITs that have acquired large out-of-town warehouses at peak prices.

SUMMARY

The Covid pandemic has certainly impacted the way people live, play and work more so than any event in recent memory. However, history shows that from wars to famines to depressions, humans have gone through many such calamities and emerged just fine.

The media and many so-called "experts" have a tendency to extrapolate current circumstances to the future. The basics of human nature, though, don't change that easily. In all probability, people will continue to travel, work in offices most of the time, eat out at restaurants and shop in malls.

High-quality REITs that cater to these needs will continue to do well.

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Interviews with S-REITs CEOs

PARKWAY LIFE REIT

Interview with Yong Yean Chau, CEO,
and Loo Hock Leong, CFO

Have the changes in the ownership structure of your Sponsor over the years impacted Parkway REIT in any meaningful way? Do you see your Sponsor competing for asset acquisitions?
While there were changes, it is important to stress that PLife and our Sponsor IHH have enjoyed a good working relationship for many years. We view our relationship to be a long-term collaborative win. When our tenants' performance improves, it benefits both the Sponsor and PLife, hence it is in the interest of both parties to continue with this fruitful, synergistic relationship.

We actively collaborate with our Sponsor on the asset management of our existing properties. Together with the Sponsor, we look to offer reasonable rates and to rejuvenate the assets to make them more efficient for the operators. Our skill sets are complementary: IHH is focused on the operational side, while PLife is focused on real estate investment.

Do you see any change in the 2022 lease renewal agreements for Singapore hospitals with your Sponsor?
Our initial agreement was 15+15 years, which implies that the core features of the lease agreements, for example inflation indexation, will not change; any variations to the original lease would have to be justified. We do, however, need to set a new base rent, for which two international valuers have been appointed. Needless to say, we remain confident that we will reach an agreeable arrangement that is beneficial to both our Sponsor and to PLife.

Moving on to your Japanese assets, even in the current ultra-low interest environment, the Japanese nursing homes continue to yield around 6%–7%. Why have these yields not compressed over the years given the attractiveness of this asset class?
The yields have definitely compressed over the years. When we first entered this asset class in 2009, the yields were as high as 8%. Since then, plenty of new competitors have emerged, with Daiwa Securities, Shinsei Bank and SMBC setting up healthcare REITs with some partners. Now, the stabilised yields for the nursing homes are in the range of 5%.

However, quality assets continue to be heavily sought after and this has allowed the asset class to remain attractive. Having established a strong presence across the Japan nursing home market, PLife continues to enjoy strong relationships and we remain confident of our ability to continue securing yield-accretive assets in Japan.

How did you hone in on Japanese nursing homes in 2009 and what gave you the conviction in the rather unknown asset class during the financial crisis? What edge do you have over competition to secure the best assets at attractive prices?
In the early days, we conducted a strategic review to explore the investment landscape in Asia Pacific. We concluded from the review that to achieve a balanced portfolio, we should have about 60% in hospitals and medical centres, 35% in nursing homes, and 5% in other opportunistic acquisitions. We also wanted to invest

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in more developed markets where there is regulatory certainty, such as Singapore, Australia and Japan.

Putting these two criteria together, we concluded back then that we wanted to invest in hospitals and medical centres in Singapore, Australia and Malaysia, and in nursing homes in Japan. Japan offered best-in-class nursing homes investments because of its high quality and excellence in care.

In 2008, we became one of the first foreign players to invest in nursing homes in Japan. This has given us a first-mover advantage and allowed us to build strong long-term relationships with the nursing home operators through our local Japanese team. We help the operators in asset enhancement to increase the productivity of the asset, for example by converting an outdoor swimming pool to a day care centre. As their top line improves, we receive a share of their revenue, which provide a good kicker to PLife's yields. This collaborative approach with the nursing home operators has helped us gain a right of first refusal (ROFR) with the biggest private nursing home operator in Fukuoka, K.K. Sawayaka Club.

We also have strong relationships with other large operators, such as K.K. Habitation, who also periodically divests some of its assets to us as they look to grow. This again provides us with potential opportunities.

These strategic partners – as we call them – do not just want good commercial terms, but also need a friendly landlord who can support and grow their businesses. This contrasts with the transactional approach of private equity funds that need to exit within a certain timeframe.

Do you see this as a sustainable edge?

As other players gain more experience in Japan, they too will

develop strong relationships and ultimately it will be harder for us to compete. However, this will take time, and until then, it is important for us to continue to adapt, innovate, and to proactively look at ways that we can add value to our partners. In the meantime, we will also have to look at entering new markets and new geographies to be even more sustainable.

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I understand you focus on the mid-tier nursing homes. How is this segment different from the rest of the nursing home sector?

This is an important part of our strategy. The high-end segment of the nursing home market is niche, more market-dependant, and would not allow us to scale up to the level we want, while the mass market segment depends heavily on government subsidies, which leads to regulatory risk.

The mid-market sector, however, works differently. There is on average a USD 100K entrance fee and an average USD 3K monthly fee. Out of this, only 30% of the monthly fee is subsidised by the government. Patients thus largely pay out of pocket, making this segment less exposed to government regulations.

Given relatively low capital investments and high yields, why don't we see overbuilding in this sector?

Good question. A key reason is that given the level of government subsidies in this sector, every new room created would mean extra government subsidies, which is not tenable. This puts a sort of ceiling to the supply. While there is a genuine need to be met due to an ageing population, the government also wants to avoid an uncontrolled supply situation, which would put pressure on their health budget.

In fact, even for the nursing homes we own, we need to obtain

permission from the government for every extra room we create.

In contrast, the independent retirement homes are seeing an increase in supply. Unlike nursing homes, there are no government subsidies, so the sector is entirely left to the developers. We have completely stayed away from this sector due to its speculative nature.

The other reason which keeps overbuilding in check is the paucity of skilled medical staff. This has always been an issue in Japan. To overcome this, the bigger operators have their own training schools for nurses and caregivers. Even foreign nurses from Indonesia, Philippines, and other Asian countries are being invited to attend the training schools, unless they have already passed a strict language test and have undergone comprehensive training.

Are the Japanese banks willing to readily finance nursing home assets?

Yes, very much so. In fact, a major Japanese bank has sponsored a private equity fund to acquire nursing homes and become listed. Nursing homes are now well recognised as a credible asset class. We have also issued fixed rate bonds to local Japanese tier 2 bank [and Japanese insurance company].

Around 90% of our debt is in Japanese yen, which matches our asset exposure in Japan, offering us a natural hedge.

Many of your nursing home operators are small-to-mid-sized businesses involved in a variety of activities. Given this, how do you view counterparty risk?

Indeed, all specialised assets to some extent face counterparty risk. In Japan this is mitigated to some extent by the relatively large number of nursing home operators, giving us plenty of options for backup operators. This is a highly fragmented sector with both big and small players. In Singapore, we would be more worried due to very few nursing home operators.

Apart from the number of operators, knowing that most of the operators are actually making money, with around 15% operating margin, gives us comfort. The Covid-19 situation is also accelerating consolidation in this sector as many smaller operators find it difficult to cope with increases in safety costs. We see more instances of bigger players taking over the smaller ones, thereby increasing their scale and cost efficiencies. All these are good for us as we get to work with stronger operators.

Another point which is often overlooked is that while the large hospitals have scale and are very well managed, their cash flow is quite volatile and unpredictable as the average length of stay is only 3–5 days. Their utilisation needs to be consistently high for them to cover their costs. Nursing homes, where the average length of stay is around 5 years, offer better economics once the occupancy is ramped up to a level which covers costs. Their cash flows given the long length of stay are quite stable.

Have you had any operator defaults?

Thankfully no! Our experience so far has been quite good. We have done two batches of asset recycling where we wanted to swap our older properties and small operators with bigger operators and higher-quality assets. So far, we have not had any credit issues with any of our operators, nor did we have to change operators. In one instance, one of our operators was taken over by a bigger operator – Benesse Style Care – which is a positive for us.

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Could you explain the holding structure of your subsidiaries in Japan? Your 2019 annual report says that "the group does not hold any ownership interest in the SPEs (special purpose entities)". How does one interpret this?

Our assets in Japan are held under a so-called "TK-GK" structure, which is quite common in Japan. We as the "silent partner" own the economic or equity interest in the assets. In other words, we own 100% of the profits or losses associated with the assets, which are managed by the operator we have chosen.

The technical way of phrasing this is to say that we do not have ownership interest in the assets since we are the silent partner. Such a structure allows us to enjoy a 20.42% withholding tax versus the 42% corporate tax we would have been liable for, if we had incorporated a company in Japan, owned the asset 100%, and ran it ourselves.

Japanese assets now account for a sizable 41% of your portfolio. Do you intend to expand further there?

We see 60:40 as a good mix between our Singapore and Japan assets. We do not want to be overexposed to Japan. Over the next 2–3 years, our priority is to build a third key market. We are looking for mature geographies with transparent and developed real estate markets, and a stable political situation. We do not intend to go into emerging markets or large markets like China or India.

Some markets like Australia are well developed but highly competitive, so we are evaluating carefully. We are not ruling out venturing beyond Asia Pacific to markets such as Europe. The UK, Germany, and France definitely meet our criteria of mature and stable health care markets.

Having said all that, we will continue to invest in Japan incrementally as the spreads are highly attractive. For every dollar we put in Japan, we may need to put 2–3 dollars in other countries to achieve the same returns. Despite our aggressive growth, we may be just around 1% of this sector. It is a big asset class.

You already have a presence in Malaysia. Would you be looking at further opportunities there?

Regarding Malaysia, unless we get an opportunity to really scale up, we will not be entering this market in a big way. The political situation recently has also been uncertain.

What is behind Moody's rating of Baa2? What risks does it see?

Moody's has highlighted two factors that constrain our rating. One is the size. It thinks our asset size of around SGD 2 billion is not as optimal compared to others in the S-REIT space such as CapitaLand Mall Trust.

The other part is the high tenant concentration and reliance on IHH.

Parkway REIT usually trades at a high premium to published book values. Do you see any fundamental reasons behind that? Is it because the earning power of the hospital assets are more than what is accounted for by the REIT?

One key reason for this is that unlike retail and office REITs, there are no clear benchmarks for valuing hospital assets. The valuers generally take the present value of the 15+15-year lease cash flows in trying to determine the valuation. This, however, is less than what the assets themselves can generate.

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Our cap rates of around 5% have not changed much since IPO, while the cap rates on other asset classes have compressed quite a bit. The capital appreciation of our assets is a reflection of the rental increases over time. Thus, the published valuations of our assets are quite conservative, and we like it that way as we don't have to account for sharp fluctuations driven by the market. It also helps us to be cautious with our gearing.

Investors appreciate that a conservative asset valuation means reasonable asset management fees.

FRASERS LOGISTICS & COMMERCIAL TRUST

Interview with Robert Wallace, CEO,
and Chung Keat Ng, Investor Relations Head

What led to the decision to list the REIT in Singapore?
From FLCT's perspective, we were clear right from the start that the REIT was to have a global mandate. Our sponsor, Frasers Property, also has a good brand name in Singapore, with three REITs/business trusts already listed. And given the established REIT regime here in Singapore, Singapore felt like a natural home for the REIT.

Are you happy with the relatively low sponsor stake in the REIT?
Yes, we are fine with it. This enables the sponsor to have a credible stake with good co-alignment of interest among the sponsor, REIT and unit-holders, whilst at the same time providing a healthy free float that provides both liquidity and attractiveness to quality institutional investors to invest in us.

Could you talk a bit about your overall strategy and the role of the sponsor. Was the FCOT (Frasers Commercial Trust) merger a planned one?
The sponsor has a deep pool of assets on which we have a right of first refusal (ROFR) which the REIT does consider if the fit is good. The merger with FCOT fits in well with our existing portfolio. Many logistics REITs do have business parks and office space

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