Recovery theme sustains short-term interest in M-REITs

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By CECILIA KOK
cecilia_kok@thestar.com.my

WHILE higher interest rates are a disadvantage to real estate investment trusts (REITs), investors appear to have shrugged off the implication of the recent hike in the overnight policy rate (OPR) on the sector for the time being.

The performance of Malaysian REITs, or M-REITs, has remained fairly resilient despite the surprise increase of 25 basis points (bps) in OPR about a week ago, as the "recovery theme" continues to drive investor interest in the asset class, according to analysts.

"The sector in general is expected to post strong earnings recovery for the quarter ended March 31, 2022, following the reopening of the country's economy in the fourth quarter of last year after a prolonged period of Covid-19-induced lockdowns," an analyst with a local brokerage tells *StarBizWeek*.

"While a hike in interest rates tends to dampen sentiment towards M-REITs due to the narrowing of the yield spread between the instrument and bonds, expectations that the sector will continue to gradually recover to pre-pandemic levels, especially now with the country in the endemic phase, will likely sustain interest in M-REITs over the short term," he says.

M-REITs have rallied since early March, resulting in the Bursa Malaysia REIT Index gaining 2.3% year-to-date (y-t-d) as of Thursday, outperforming the benchmark FTSE Bursa Malaysia KL Composite Index, which has declined 1.2% y-t-d.

On May 11, Bank Negara raised the OPR to 2% from 1.75%.

The unexpected move by the country's central bank came amid a rising interest rate environment as major economies revise their monetary policies to contain the rising inflationary pressures.

Popular choice: A file picture of shoppers at Sunway Pyramid undergoing temperature checks. Sunway-REIT continues to be a top pick in the segment with its well-diversified income base, encompassing retail malls, offices, hotels and hospitals.

There are growing expectations that Bank Negara will undertake another round of OPR hike by 25-50 bps in the second half of this year.

"M-REITs have gained grounds in recent weeks ahead of the earnings season.

"The sector's report card is expected to reflect an encouraging rebound, especially for the retail and industrial segments," a broker points out.

"However, we remain cautious on the sector and advise investors to remain selective as the appeal of M-REITs will increasingly diminish in an environment of rising interest rates.

"At present, we are positive on the retail and hospitality segments, underpinned by rising footfalls in malls and reopening of Malaysian borders to international travellers, as well as the industrial segments, underpinned by eCommerce growth ... the office segment, on the other hand, may still face some challenges," he adds.

In its recent report, AmInvestment Bank Research (AmInvest Research) notes that M-REIT distribution yields continue to be unattractive due to declining yield against the 10-year Malaysian Government Securities (MGS).

It says higher interest rate expectations in the United States and a further increase in the yields of the 10-year MGS and 10-year US Treasury Bills could result in a deeper contraction in the yield spread between M-REITs and the 10-year MGS.

"The yield spread of companies under our coverage is now mostly negative against the 10-year MGS.

"We believe that market sentiment on M-REITs will remain lacklustre in the near term due to the unappealing offering to yield-seeking investors," the brokerage argues, adding that its targeted average 2023 forecast distribution yield for M-REITs under its coverage is 6.4%.

AmInvest Research has a "neutral" stance on M-REITs.

"Although the first quarter of 2022 saw improvements in retail sales, footfalls and consumer sentiment, we expect a decline in consumer spending ahead due to higher interest rates and inflationary pressures," it says, noting higher interest rates and inflation are anticipated to weigh on personal consumption expenditure due to higher borrowing costs and prices for consumer goods.

Hence, tenant sales ahead are likely to soften as consumers may turn cautious in spending on discretionary goods, it says.

"The spillover effect of a weakening consumer spending is envisaged to hold back the recovery in tenant sales.

"Hence, we expect rental reversion to stay flattish for malls in prime locations and possibly adverse reversion for less established malls," it explains.

AmInvest Research's top "buy" for the sector is Sunway-REIT, with an ascribed fair value of RM1.66, underpinned by its well-diversified income base, encompassing retail malls, offices, hotels, universities, hospitals and industrial property across Malaysia.

The brokerage says this could provide a cushion against potential downside risks.

Meanwhile, Public Investment Bank Research (PublicInvest Research) points out that the recent OPR hike would increase the funding costs of M-REITs, with floating-rate borrowings. Nevertheless, the impact for M-REITs under its coverage is likely minimal at less than 2%, hence it will keep its earnings estimates unchanged for now.

Among the M-REITs under its coverage, Sunway-REIT's floating rate loans accounted for around 62% of total borrowings, while that of Axis-REIT were around 32%. IGB-REIT's debt, on the other hand, is all at fixed rates.

"Interest costs (for affected M-REITS) are estimated to be higher by between 1% and 2%, with this increase in OPR," PublicInvest Research says in its recent report.

The brokerage remains "neutral" on its outlook for M-REITs, citing narrowing spreads (with the 10-year MGS yield currently at 4.4%, compared with around 3.2% a year ago), hence, rendering M-REITs fairly valued for now.