

# REITS - Appealing Valuation With Widening Yield Spread | I3investor

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## Investment Highlights

- **The results for CY23 were mixed.** Out of the 6 companies under our coverage, 2 were in line, 2 beat expectations and the remaining 2 fell short. **IGB REIT**, **Pavilion REIT** and **YTL REIT** posted stronger YoY CY23 results while **Sunway REIT**, **Hektar** and **UOA REIT** registered weaker YoY CY23 results. The following are the salient highlights of the companies' performance:
  - **Better rental reversion and occupancy rates for prime malls.** **IGB REIT** and **Pavilion REIT** registered stronger earnings in CY23 as a result of favourable rental reversions and improvement in occupancy rates in their malls. Notably, the stronger distributable income growth of 20% YoY in Pavilion REIT was primarily attributed to recognition of a 7- month contribution from the newly acquired PBJ, after its injection on 1 June 2023.
  - Despite **Sunway REIT** experiencing improved revenue from retail and hotel segments, its FY23 earnings declined by 3% YoY. This decrease can be attributed to increased utility and finance costs, as well as the discontinuation of lease income from Sunway Medical Centre (Tower A & B) after its disposal was finalised on 30 August 2023.
  - **Less established and suburban malls did not fare as well compared to prime counterparts.** YoY, the 21% drop in **Hektar's** distributable income was mainly attributed to the increase in finance cost and negative rental reversion in FY22.
  - Given **UOAREIT's** flattish rental reversion in FY22, its YoY rental growth was inadequate to offset an electricity tariff hike and increased finance cost in FY23, which resulted in a 12% YoY decline in its FY23 distributable income.
  - **YTL REIT's** 1HFY24 adjusted distributable income surged 38% mainly due to the realisation of final deferred rental totalling RM27mil pursuant to the rental deferred programme upon expiry of JW Marriott Hotel's lease agreement in December 2023.

- **QoQ, the earnings of REITs showed a mixed performance. IGB REIT, Pavilion REIT and YTL REIT** posted stronger results, mainly attributed to better rental reversions as well as improving occupancy rates in both retail and hospitality segments.
- **Sunway REIT** recorded a 16% QoQ decline in distributable income mainly due to the absence of lease income from Sunway Medical Centre (Tower A & B) following their disposal at the end of August 2023, coupled with elevated marketing expenses for its retail segment. Separately, **Hektar** and **UOAREIT** registered weaker QoQ distributable income caused by increased direct operating costs.
- **Stronger rental revenue for retail malls in prime locations, partially offset by higher electricity tariff and increased finance cost.** In CY23, the net profit margin of retail REITs was impacted by the increase in electricity tariff surcharge that took effect on 1 January 2023. Nevertheless, this was mitigated by the stronger rental revenue in CY23 as a result of substantial improvement in tenant sales and footfalls in retail malls. Looking ahead, we expect the retail sector to maintain its revenue growth momentum in CY24F on the back of higher private consumption growth of 5.7% in 2024F vs. 5.6% in 2023.
- Hence, we maintain our assumptions of rental reversions of 5%-6% in CY24F, mirroring the figures observed in CY22, particularly for malls situated in prime locations such as Mid Valley Megamall, Pavilion Kuala Lumpur and Sunway Pyramid. However, rental reversions for less established malls are likely to remain flattish or slightly positive. For these smaller malls, increasing occupancy rates through more affordable rents will be imperative .
- **Occupancy and rental reversion rates in office segment expected to be flattish.** Challenges persist for offices in Kuala Lumpur city centre due to oversupply, impacting recovery in occupancy and rental reversion rates. Competition from The Stride Strata Office in Bukit Bintang City Centre and The Exchange TRX further adds to increased supply of office spaces in the Klang Valley. Meanwhile, we anticipate flattish rental reversions for offices and limited improvement in occupancy rates in CY24F, given persistent oversupply of office spaces amid corporate decentralisation and flexible working arrangement trends.
- **Hospitality segment is on a growth trajectory, witnessing a robust recovery in occupancy rates and average daily rates since 2QCY22.** YTL REIT's Australian portfolio achieved a historically-high average daily rate (ADR) of A\$326 (+5% YoY) vs. pre- Covid 2019 level of A\$271. Moving forward, we anticipate ADR to remain robust in 3QFY24, supported by festive and summer holiday seasons following the similar trend in previous financial years. Additionally, YTL REIT's 2QFY24 average occupancy rate stood at 84% (+8%-point YoY), rebounding

close to the pre-Covid level of 85%. With the gradual recovery of domestic travelling in Malaysia and Australia coupled with an influx of foreign tourists, we expect the average occupancy rate of hotel properties of YTL REIT and Sunway REIT to gradually improve in FY24F and fully recover to pre- Covid levels by FY25F.

- **Buying opportunities from widening yield spread against 10-year MGS yield amidst the tail end of monetary policy tightening and potential 2H2024 interest rate cuts in developed economies.** Our in-house economist anticipates the Fed fund rate to peak at current levels of 5.25%-5.5%. Our economics team also expects the Federal Reserve to start cutting interest rates in mid-2024 by 75 bps to 100bps. This will eventually bring the Fed funds rate to 4.5%-4.75% by end-2024. Meanwhile, 10-year MGS yield is projected to be lower at 3.63% in 4QCY24 from the current level of 3.82%. We see buying opportunities in Malaysian REIT stocks given widening yield spreads against 10-year MGS , supported by appealing distribution yields of 6%-8%.
- **Maintain OVERWEIGHT with stable occupancy rates across key assets (retail, office and hospitality).** We anticipate retail REITs to continue experiencing healthy growth in 2024F, driven by stable occupancy rates and positive rental reversions. This is underpinned by a stable labour market, modestly higher inflation rate of 2.5%-3.5% accounting for the impact of subsidy rationalisation and service tax increase, coupled with a continued gradual recovery in tourist arrivals. Meanwhile, the hospitality segment of REITs is poised to benefit from government policies aimed at boosting tourism. The gradual influx of international tourists back to pre-pandemic levels is expected to contribute to retail sales improvement.
- **Selective criteria.** We like REITs with high-quality assets situated at strategic locations and decent dividend yields. We also favour REITs with exposure in retail and hotel segments, both of which are anticipated to further recover in CY24F.
- **Our top BUYs are Pavilion REIT (FV: RM1.64/unit) and IGB REIT (FV: RM1.95/unit).** For **Pavilion REIT**, its earnings tend to be resilient, mainly underpinned by a prime asset portfolio anchored by Pavilion Kuala Lumpur and Elite Pavilion Mall, which are tourist hotspots that benefit from the return of international tourists. Further increase in earnings is expected from Pavilion Bukit Jalil (PBJ) in CY2024F. We believe PBJ is positioned for a positive rental reversion in CY2024F, supported by improving footfall traffic and occupancy rates.
- **We like IGBREIT** due to its long-term resilient outlook underpinned by the group's strategically located assets in the heart of Klang Valley. Robust demand for its retail lots is evidenced by the near-full occupancy rates of its retail assets.

- **Downside risks to our forecasts are:**

**(i) Escalation of geopolitical tensions that could disrupt global trade and supply chains, leading to a prolonged period of elevated inflation. Consequently, 10-year MGS yield may persist at a higher rate if expected benchmark interest rate cuts in developed economies do not materialise; and**

**(ii) continued high interest rates and inflation could weigh further on personal consumption expenditures due to higher borrowing costs and prices for consumer goods. This could lead to the softening of tenant sales and hotel occupancy rates as consumers turn cautious in spending on discretionary goods and leisure activities.**

Source: [AmInvest Research](#) - 12 Mar 2024