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ASIAN REITS: DEMYSTIFYING EQUITY FUNDRAISING STRATEGIES

New equity raised by Asian REITs is usually used to finance growth initiatives such as new property acquisitions. Such initiatives, if proven to be 'accretive', allow REIT managers to reward their unitholders at a later stage – investors just need to understand the impact of different fundraising strategies.

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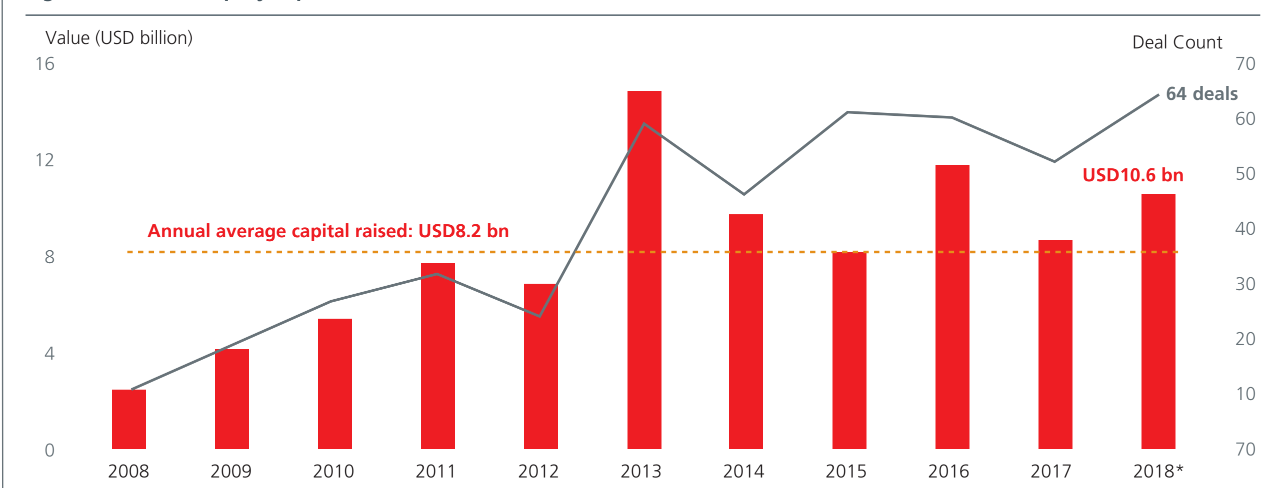
Asian real estate investment trusts (REITs) raised USD10.6 billion of equity capital in 2018, with both the capital raised and the number of deals exceeding 2017 levels (see Fig. 1). Breaking down the new capital raised, over 86.5% of the proceeds came from secondary share offerings (72.5% from private placements and 14.0% from rights issues), with the rest from initial public

Fig.1: Asian REITs equity capital raised[1]



offerings, according to Bloomberg data[1].

The thriving fundraising activity, despite the challenging macro environment in 2018, suggests that investors are willing to embrace Asian REIT managers' initiatives to take on new acquisition opportunities as long as they are perceived to be positive for future distributions and share prices.

LIFTING DIVIDEND DISTRIBUTIONS

REITs need capital for growth. REIT managers, however, only have small earnings retention for future growth initiatives as they are obliged to pay out most of their recurrent earnings as dividends. Moreover, they are also bound by debt-to-asset caps that limit their exposure to bonds or bank loans – both of which are the cheapest source of funding. Singapore, for example, has a maximum gearing limit of 45% for REITs and requires at least 90% of taxable income to be distributed as dividends[2].

Furthermore, as a buffer to any potentially adverse business conditions, REIT managers often maintain a gearing ratio below 40%. Adverse conditions can refer to a decline in asset values, which would raise gearing levels since the denominator of the debt-to-asset gearing level increases. A diligent manager must assess a REIT's comfortable gearing levels and tap into the funding source of lowest cost before going to equity markets looking for new capital to finance a REIT's asset acquisitions.

An acquisition must be 'accretive'. By this we mean that the dividend per unit (DPU) increases after taking into account the new asset income generation, net financing costs and increased number of shares (units).

Singapore-based CapitaLand Commercial Trust, as an example, made its first foray into Europe in early 2018 with an acquisition of a 94.9% stake in a freehold grade A property in Frankfurt, funded by a private placement of new shares (units) and bank borrowings. Despite the increased number of units, the new asset increased the REIT's overall DPU by 1.4% to 2.15 cents on a pro forma basis[3]; the acquisition is therefore 'accretive'.

Acquisitions require a REIT manager to have various funding sources; typically, there are three types of equity fundraising issuances:

- Placement of ordinary shares
- Placement of preference shares
- Rights issue

All three will increase the equity base which, in turn, lowers the gearing of a REIT and, in doing so, creates more headroom for debt issuance.

At the same time, each strategy can have different implications for the REIT and existing unitholders. Since all equity fundraising routes lead to a larger share base, the nature of the acquisition is important to ensure that the DPU outcome is not compromised. REIT managers must be strategic about their available options, and they should follow the most 'accretive' route.

ORDINARY SHARES

If the REIT's share price is performing well (for example, price-to-book ratio is more than one), it would be optimal for the REIT's manager to offer new ordinary shares[4], especially for acquisitions that must be completed quickly. This strategy enables REIT managers to take advantage of the REIT's higher share price and raise a sizeable quantum of capital in a short period at a lower dividend yield[5], thus a lower cost of capital.

Existing unitholders, however, are occasionally left out of private placements, which are mostly made to institutional investors at a discount to the prevailing share price. For this reason, it would be wise for existing unitholders to keep a close eye on the dilutive impact on DPU.

If the capital raised for the acquisition is not immediately DPU accretive, it should – at least in the long-term – improve the quality (diversification

benefits, extension of leased terms etc.) or growth profile of the REIT, such as offering the opportunity to participate early in a rent upcycle.

If the REIT's share price is not performing well, the REIT manager can look to place out preference shares to fund the acquisition instead.

PREFERENCE SHARES

Their guaranteed dividend payment and a higher priority claim to assets allow preference shares[6] to function much like bonds, thereby incurring a lower cost of capital. Also rating agencies often treat preference shares as part debt and part equity – thus gearing can improve upon preference share issuance.

As preference shares often include a call-in option, a REIT manager has the flexibility to redeem the issued preference shares with a new issuance, which carries a lower dividend yield (a lower cost of capital). This exercise results in direct savings to the unitholder especially when interest rates edge lower or share price edges higher, potentially leaving more cash to boost the dividend distributions.

Rights issues, compared with private placements, are more equitable to existing unitholders.

RIGHTS ISSUE

In a rights issue, the company gives all its existing unitholders the right to subscribe to newly issued ordinary shares, resulting in little dilution of ownership. A 'one for five' rights issue, for example, allows an existing unitholder to buy one extra share (unit) for every five held.

The good news is that a rights issue incurs no broker commissions. In addition, unitholders can sell the rights if they do not want to participate in the issuance.

If the new units are issued at a big discount, however, the share price may react negatively. This is, however, fundamentally not justified as the ownership of existing unitholders is not diluted (should they choose to exercise the rights); and the discount benefits the existing unitholders.

Ultimately, existing unitholders need to assess the quality of the acquisition and determine whether it adds to the portfolio's attributes. If the rights issue is offered at a heavy discount to the share price, but existing unitholders do not like the acquisition, they are often left with little choice but to subscribe to the rights so as to reduce their ownership dilution.

WHAT MAKES A GOOD STRATEGY?

Overall, investors should never overlook the fundamentals of new property assets, and a REIT manager's ability to add value. More specifically, investors need to look at the manager's scope to increase rental income or raise the value of the assets (lower cap rate[7]). This comes from better tenant management or asset renovations, which in turn results in better occupancies or rental rates.

The cost of the fundraising is another aspect that investors should consider. If funds are raised via rights issues or through placements of ordinary shares, the cost is measured by the dividend yield.

A higher dividend yield will raise the hurdle for future acquisitions as any new asset will need to result in a higher yield to make the acquisition 'yield-accretive'.

If funds are raised by issuing preference shares, the cost is likely to be higher than the cost of bonds but lower than that of ordinary shares.

LOOKING FORWARD

In 2018, the FTSE EPRA/NAREIT Asia REITs index recorded a total return of 4.5% and a standard deviation (volatility) of 8.2%. This outperformed the MSCI AC Asia Pacific Index, which fell 13.5% and became victim to highly volatile trading as a result of slowing global growth and the ongoing

US-China trade tensions (see Fig. 2).

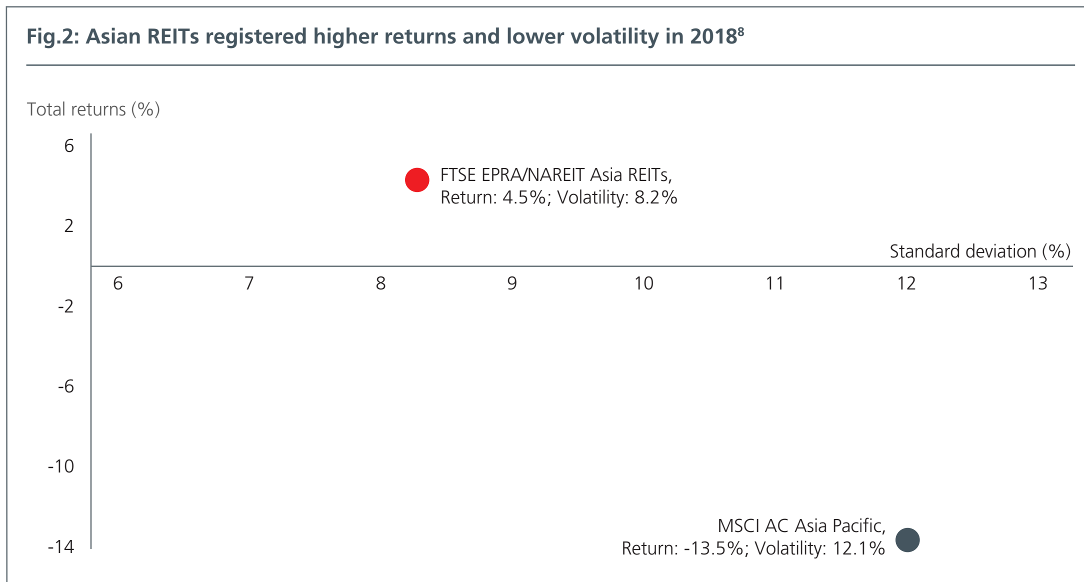
For 2019, investors should take comfort in the resilience and income stream of Asian REITs. There is a strong prospect that the Fed fund interest rate hikes incline is slowing. This will lower funding costs for REITs and, in turn, increase their valuations.

Such higher valuations also make it much easier, and effectively cheaper, for Asian REIT managers to place out new shares to fund their acquisitions. The current price-to-book ratio of 1.2 times[9], for example, implies that investors are willing to pay 20% more for the book value of the REIT's hard assets, suggesting a smaller number of new units is required for fundraising – making it less dilutive to existing unitholders. This will particularly benefit Asian REITs that are eyeing overseas opportunities.

Size has an advantage too. Overseas acquisitions tend to be large, and therefore are largely funded by a combination of placements, rights issues, debt, and preference shares. As such, larger Asian REIT managers – particularly those with the financial support of strong sponsors – will have a head start over smaller ones.

In all, investors will need to assess the different fundraising strategies and identify REIT managers that have a good track record of raising DPUs and rewarding existing unitholders.

Fig.2: Asian REITs registered higher returns and lower volatility in 2018[8]



Sources: [1]Bloomberg, equity raised based on the effective date, *from 1 January to 27 December 2018, in Asia, including Japan. Equity capital raised from initial public offering, new shares, and rights issue. [2]Gearing (leverage) ratio is calculated by taking a REIT's total borrowings and dividing it by its total assets. Singapore REITs are required to distribute at least 90% of their taxable income to their unitholders to enjoy tax benefits. [3]CapitaLand as at 17 May 2018: https://www.capitaland.com/international/en/about-capitaland/newsroom/news-releases/international/2018/may/nr-20180517-cct-makes-first-foray-into-Europe.html. [4]Investopedia: Ordinary (common) shares do not have any pre-determined dividend amounts. In the event of liquidation, ordinary shareholders have rights to a company's asset only after bondholders, preference shareholders and other debt holders are paid in full. [5]Dividend yield = dividend payment per share (aka DPU), divided by the prevailing share price. [6]Investopedia: Preference shares have the advantage of a higher priority claim to the assets of a corporation in case of insolvency and receive a fixed dividend distribution. These shares often do not have voting rights and can be converted into ordinary shares. [7]The Ivy Group and Investopedia: The capitalization rate (aka cap rate) is defined as the first year "stabilized" net operating income (NOI) divided by the present value (or purchase price with cash). Investors (buyers) want to have a high cap rate, meaning the value (or purchase price) of the property is low. Conversely, landlords (sellers) want to see a low cap rate because the selling price is high. [8]Bloomberg, from 31 December 2017 to 31 December 2018, total returns and standard deviation (based on monthly returns) in US dollars, with dividend re-invested. Asian REITs are represented by the FTSE EPRA/NAREIT Asia REITs index (TERASU), covering developed Asian REIT markets including Japan and Australia. The broader Asian equity market (including Japan and Australia) is represented by the MSCI AC Asia Pacific index. [9]Bloomberg, data as at 31 December 2018, represented by the FTSE EPRA/NAREIT Asia REITs index.

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