

SECTOR UPDATE

REITs – Malaysia

Less Appealing Risk-to-reward

2Q22 results were in line with our expectations, boosted by the festivities and additional cash from EPF withdrawals. 2H22 earnings may be at risk but should be buoyed by the holiday season. Additionally, the rising interest rate environment coupled with high inflation poses near-to-medium term headwinds. With the narrowing yield spread to MGS, the risk-to-reward looks less appealing. Downgrade the sector to MARKET WEIGHT. Top pick: Sunway REIT.

WHAT'S NEW

- **2Q22 results round-up: Within our expectations.** Out of the seven REITs in our coverage, five were within expectations, with one above and one below our expectations. Earnings dipped 3.6% qoq (higher opex) but improved 52.4% yoy (lesser rental assistance and higher turnover rent). Tenant sales and footfall have sustained their recovery momentum since Dec 21, with footfall at about 80% of pre-pandemic levels. Having said that, the momentum may not be sustainable as: a) the additional cash in hand runs out, and b) inflationary concerns creep in.
- **2H22 earnings at risk but to be buoyed by festivities and inbound tourists.** Earnings may be at risk in 3Q22 due to: a) 3Q usually being uneventful and hence is the weakest quarter, b) dampened consumer sentiment from inflationary concerns, and c) depleting cash in hand from the special EPF withdrawals. However, the festivities and holiday season in 4Q22 should spur spending, in addition to the inbound tourists, domestically and internationally. Having said that, we expect the sector to deliver 36% and 4.6% earnings growth in 2022 (96% of 2019 earnings) and 2023 respectively.

ACTION

- **Downgrade IGB REIT (IGBREIT MK/Target: RM1.75) and KLCC Stapled Securities (KLCCSS MK/Target: RM7.19) to HOLD**, while maintaining their forecasts and target prices. Both IGBREIT's and KLCCSS' forward yield spread to MGS have already narrowed to their historical mean. With the expectations of further narrowing of yield spreads in view of rising MGS, these stocks look less appealing compared to MGS. 2022-23 yields of 5.1-5.5% for both IGBREIT and KLCCSS are close to their implied yields of 5.1% and 5.0% respectively.
- **Downgrade sector to MARKET WEIGHT.** Share prices have appreciated 5.6% from ytd's low, outperforming the FBMKLCI by 4%. The rising interest rate environment coupled with high inflation poses near-to-medium term headwinds. Given the scope for interest rates to rise further, the current yield spread of 230bp (+0.7SD) should narrow further. Assuming that the 10-year Malaysia Government Securities (MGS) rises to 4.5% from the current 4.1%, REITs yield spread would narrow closer to the historical mean of 180bp, hence the risk-to-reward does not look appealing enough. Hence, with the less appealing yields, we downgrade the sector to MARKET WEIGHT.
- **Prefer retail REITs.** We prefer the retail segment, particularly prime/niche malls for their proven business resilience. Moreover, the increasing international tourist arrivals would benefit the retail segment. Our sector BUY calls are Axis REIT, Pavilion REIT, and Sunway REIT. Our top pick is **Sunway REIT** as a border reopening play as their malls and hotels would benefit from the influx of tourists.

PEER COMPARISON

Company	Ticker	Rec	Share Price		Market Cap (US\$m)	Net Profit (RMm)			DPU (sen)		Div Yield (%)	
			13 Sep 22 (RM)	Target Price (RM)		2022F	2023F	2024F	2022F	2023F	2022F	2023F
Axis REIT	AXRB MK	BUY	1.88	2.04	684	156.7	166.8	168.1	10.7	11.4	5.7	6.1
Pavilion REIT	PREIT MK	BUY	1.29	1.47	874	229.1	246.4	255.3	7.4	8.0	5.8	6.2
Sunway REIT*	SREIT MK	BUY	1.45	1.61	1,102	336.8	358.2	371.9	9.3	9.9	6.5	6.9
CapitaLand Malaysia Trust	CLMT MK	HOLD	0.545	0.58	261	82.2	88.7	93.1	4.0	4.4	7.4	8.0
IGB REIT	IGBREIT MK	HOLD	1.61	1.75	1,280	308.2	325.6	335.5	8.5	9.0	5.2	5.5
KLCCP Stapled Group	KLCCSS MK	HOLD	6.86	7.19	2,747	703.8	722.7	746.4	35.1	36.0	5.1	5.3
Sentral REIT	SENTRAL MK	HOLD	0.895	0.90	213	70.7	65.3	67.4	6.3	5.8	7.0	6.4

*2021 refers to 18M ending Dec.

Source: Bloomberg, UOB Kay Hian

MARKET WEIGHT

(Downgraded)

SECTOR BUYS

Company	Rec	Price (RM)
Axis REIT	BUY	2.15
Pavilion REIT	BUY	1.54
Sunway REIT	BUY	1.69

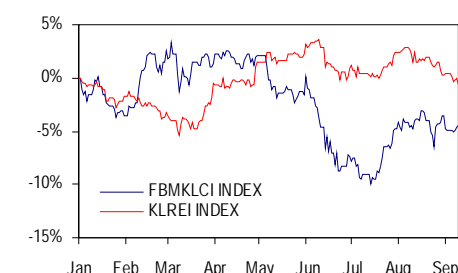
Source: UOB Kay Hian

CORE EARNINGS

Company	2Q22 (RMm)	1Q22 (RMm)	yoy % chg	qoq % chg
Axis REIT	42.9	39.1	38.8	9.7
CLMT	23.1	20.5	101.2	12.6
IGBREIT	83.5	85.4	88.4	(2.2)
KLCCSS	165.2	161.4	14.7	2.3
PREIT	55.0	65.2	169.4	(15.7)
SENTRAL	18.5	20.4	(2.3)	(9.4)
SREIT	74.5	88.1	122.3	(15.4)

Source: Respective companies, UOB Kay Hian

KLREIT INDEX OUTPERFORMED THE FBMKLCI



Source: Bloomberg, UOB Kay Hian

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ESSENTIALS

- **Interest rate hike impact to earnings is at most 3% for every 25bp increase.** In our previous sector report, we have calculated the REITs' earnings impact for every 25bp increase in interest rate. Overall impact is well managed; impact to earnings is at most 3%. Gearing levels are also well below the threshold of 50% at 37% on average.
- **Retail: Recovery in tandem with consumer sentiment; prefer prime/niche malls.** Tenant sales at malls continued its momentum since 4Q21 amid the festive season, in addition to the special EPF withdrawal scheme. Furthermore, the opening of borders since April will further boost footfall and sales. Having said that, the momentum may not be sustainable as: a) the additional cash in hand runs out, and b) inflationary concerns creep in. We prefer prime retail, given their proven business resilience.
- **Hotels/hospitality: Recovery from 2H22 onwards.** Malaysia has fully opened its borders to international arrivals since April and has removed PCR testing requirements for fully vaccinated individuals since May. We expect a gradual recovery with substantial traction from 2H22 onwards, during the holiday season.
- **Office: Oversupply persists. Assets in strategic locations continue to be resilient.** Offices in strategic locations will continue to be resilient as evidenced by KLCCSS' and Sentral REIT's steady earnings. However, average rental rates in the Kuala Lumpur City Centre continue to remain under pressure at RM6.90 psf. Although the industry is still grappling with oversupply, we believe selected office REITs (located in strategic locations with good connectivity, eg KL Sentral) will benefit from higher demand for office space amid the need for physical distancing.
- **Industrial: Resilient business.** The segment will continue to thrive with businesses continuing as usual.

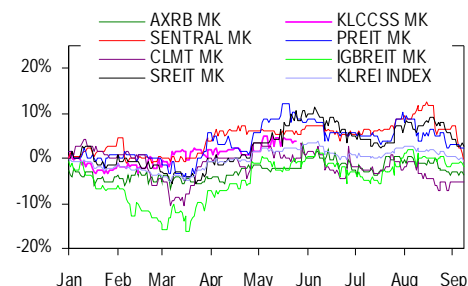
EARNINGS REVISION/RISKS

- **No change to earnings forecasts.** We have assumed minimal to almost no rental assistance and 1-2% rental reversion for 2022-23. We do not discount the fact that retailers may need some assistance if the recovery is slower than expected.
- **Risks include:** a) prolonged high inflation which may dampen sentiment, and b) higher-than-expected rental assistance.

SECTOR CATALYSTS

- Higher-than-expected rental reversion.

YTD SHARE PRICE PERFORMANCE



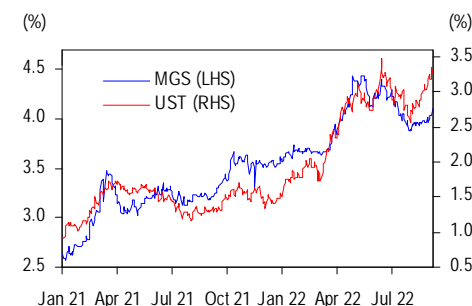
Source: Bloomberg, UOB Kay Hian

MREITS VS MGS YIELD SPREAD



Source: Bloomberg, UOB Kay Hian

MGS AND UST YIELDS



Source: Bloomberg, UOB Kay Hian

SECTOR FORWARD YIELD AT +1SD



Source: Bloomberg, UOB Kay Hian

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