REITAS

How Investors of a REIT should read the Annual Report

Every listed corporation in Singapore publishes an annual report as a statutory requirement. These reports provides rich insights into the companies for investors to make a learned investment decision. The question is what and where to look for these insights.

Why do corporations publish annual reports

An annual report, in its traditional form, is a document that provides a summary of the issuers' financial performance in the preceding year. It also contains information such as the details and opinion of the auditors, names and background of its directors, executives, company secretary, contact information, shareholders, among others. Singapore Exchange (SGX) requires listed companies on the exchange to publish an annual report (Rulebook Chapter 12) annually with stated rules and guidelines on the information provided in the document (Rule 1204). Recently, issuers are also required to provide a sustainability report, which can be embedded in the annual report or as a standalone report, no later than five months after the end of the financial year. For the list of information required, please refer to Appendix A.

Who are the audience

Parties that are usually interested in the annual report of the issuer are its investors, bankers/lenders, clients and suppliers, authorities, current and prospective employees, competitors and students. The interest of each group of readers is vastly different but we will focus on the needs of investors for this article.

What should investors be looking for in the Annual Report?

Investors typically examine the financial statements and the performance trends against prior years. However, such approach may be too general. A preferred approach would be to start with understanding one's personal investment objectives. Some investors have a higher tolerance for risks and prefer high growth stocks while others might be a little more conservative and prefer the surety of an annuity income. Sometimes, an investor may structure a portfolio with allocation to both spectrum of risks. As this article relates to real estate investment trusts (REITs), we will look at the broad investment objectives of REITs investors.

Globally, most REITs offer investors high, steady dividend income and long-term capital appreciation. In other words, REIT investors are attracted by the long-term total returns. With that in mind, let us dive into the annual report with the objective of understanding the quality and sustainability of the income, the growth of the income as well as prospect of growth through acquisitions.

Quality and sustainability of Income Stream

Before we begin, investors of REITs should be cognisant that the income performance of REITs should be its cashflow and not its accounting profits. 'Income Available for Distribution', 'Distributable Income' and 'Distribution Per Unit' are the financial numbers to focus on. Accounting profits (i.e. Net Profits) takes into account non-cash items such as valuation gains and/or changes to fair value of derivatives and are not so important to the assessment of REITs investments.

Asset Performance: Generally, the volatility of historical revenue stream over a period of five years does provide investors some idea of the sustainability of the income generating capability of the assets. To get a better sense of the quality of the assets, other indicators such as the historical swing in occupancy rates or rental reversions will provide some sense of the rental demand. These statistics should be compared to peers to gauge the relative performance of the assets which could be affected by the macro cyclicality of the business environment.

Corporate Actions: Areas that could distort the revenue trend include acquisitions, divestment or asset enhancement of assets which could potentially boost or disrupt revenue stream. It is thus important for investors to read the 'Letter to Unitholders', 'Significant Events' and 'Financial Highlights' during the year to understand the flow of business activities and to take note of corporate activities and the impact on the income stream.

Master Leases: Master leases, especially long tenured ones, would typically provide landlords with secured occupancy and rents, thus providing stability of rental income. However, investors should also attempt to understand the structures of the master leases. For instance, a typical long-term master lease should have some rent adjustment elements embedded to account for inflation or evolving market rents. The credit risk of the counterparty providing the master lease is also important as it signifies the ability to claim against the master tenant for premature rent termination. This information is usually found in the 'Property Highlights' section which will also highlight other key details of the properties such as the lease tenure, net lettable area, address, occupancy, valuation etc.

Investors should also try to benchmark the master lease rents (especially one with income support) against the rents around the same location to gauge if the property can be rented out at similar rates or higher when the master lease ends. However, investors might have to ask the management about this as the information might not be readily available in the annual report.

Capital Payout: Capital payout should not be considered in the calculation of dividend yield in normal circumstance. Capital payout does not come from the regular ongoing rental income and is a payment to investors from the capital of the company, which is unsustainable. However, it is not unusual for REITs to utilize its capital to support any short-term income disruption caused by redevelopment or asset enhancement work. Investors should therefore look a little further and assess the viability of the redevelopment or enhancement work after completion. This information can be found in the annual report or circulars published when the project was announced.

Understanding the Business:
Investors should spend more time to understand how the REIT's portfolio and revenue split when they invest in REITs. Most REITs will provide such information graphically (eg. pie charts) in the 'Property Portfolio Summary'. For example, a REIT with a large exposure to Hong Kong will inherently be affected by the recent riots in Hong Kong in spite of its Singapore listing. Knowing and understanding the segmented weightage of the REITs' portfolio will help the investor to react faster to changes in policies and market environment.

Where is the Growth
Unlike bonds, REITs can grow either by benefiting from higher rents, enhancing the assets to garner better rents, or acquisitions. Such information is usually found across the annual report.

Higher Rents: A manager may curate the asset so that it is able to attract improved rental in the next rental cycle. In the case of a mall, this can be achieved by driving shopper traffic into the mall, resulting in higher sales for the tenants. Landlords can also structure a rent escalation clause in their long-term leases. As the rents increase, the asset valuation should rise over time as well.

Asset Enhancements: Renovation initiatives with the objective of enlarging, repositioning and modernizing the assets tend to garner higher rents as well as improve asset valuation. REITs will normally report a projected Return on Investment (ROI). However, the downside of such initiatives is the short-term income disruption to rental income during construction. Investors should note down the standalone viability and the downtime of these initiatives when browsing through the annual report.

REITs may also embark on redevelopment of greenfield projects. However, the statutory limitation is 10% of its Asset Value for such works. Investors should attempt to understand the viability and track the development of such projects as the risk tends to be higher than running an ongoing property.

Acquisitions: This is the fastest way for the REIT to grow its portfolio. However, whilst this will provide a boost to revenue and net property income (NPI), the viability of the acquisition has to take into account the funding cost. There are typically three ways the REITs can attain funding; (1) borrowings; (2) issuance of new shares; and (3) issuance of quasi equity/debt such as perpetual.

When an acquisition is funded by bank borrowings, it will incur borrowing costs. Interest expense will be debited below the NPI line and the net amount will be the 'Income Available for Distribution' or 'Distributable Income'. Alternatively, an acquisition can be funded via issuance of new units in the form of a Right issue, Placement or Preferential offerings. The new shares doesn't incur any interest cost but will increase the number of units resulting in the dilution to distribution per unit (DPU). In the case of Preferential Offerings and Rights issue, existing unitholders will be entitled to subscribe for the new units (which are typically offered at a discount rate to the recorded traded share price).

In reality, funding strategy for most REITs will consist of a mix of both debt and equity to keep gearing level manageable. Thus to evaluate the viability of the acquisition, investors should focus on the eventual DPU. An accretive acquisition should generate an improvement in the DPU to unitholders in due course while a dilutive acquisition destroys shareholder value even though it enlarges the REIT's asset portfolio. The 'Distribution Statement' will clearly provide the post-dilution DPU comparison. However, investors should take account of the commencement of income stream against the date of the issuance of new units to even out the timing mismatch factor.

Financial Health: Aside from income, the health of the balance sheet is paramount for the long-term sustainability of REITs. For Singapore REITs, there is a gearing cap of 45% currently and most S-REITs hover around the range of 35-40%. However, besides a static gearing figure, investors should also review the debt maturity profile to protect against adverse liquidity risk. For instance, if the debt is lumpy and the maturity occurs during a market liquidity crunch, the REIT might not be able to refinance the debt or have to pay a higher interest cost. Spreading out the maturity of the debt will reduce such liquidity risks as the absolute quantum of maturing debt will be more manageable. Investors would also note that Perpetual Securities and Convertible debts may come with a repayment obligation in a specific future date which also carries refinancing risk.

Finally

Some key areas investors should review includes:

Independent Auditors' Report: To know who the auditor is and that they have signed-off on the accounts without any qualified opinion. The valuation methodology will also be covered in this section, which will lend credibility to the quality of the balance sheet.

Corporate Governance: The SGX Rulebook states that companies must report its corporate governance practices with specific reference to the principles and the provisions of the Code. Investors

should be comfortable with the REITs processes and structures to manage the business and enhance long-term shareholder value – such as its risk management and internal control principle such as dealing with related party transactions and conflict of interest.

Flipping through: Simply flip through the entire annual report and try to get a sense of the design flavour. Sometimes it does provide a sense of management's strategy and values. It is also best to review two to three previous annual reports to sense the adjustment of the REIT to market trends and its progression over time.

Seeing is believing: If possible, Investors should try to physically visit some of the assets and relate it to the annual report to get a better understanding of the corporate strategy.

Appendix A

Information required:

1. Name of the company's secretary
2. General information of the company eg. address, telephone number, email address
3. Financial standing and performance of the company and its principal subsidiaries
4. Analysis of the business outlook
5. Background and information of the directors and key management staff
6. Risk management policies and processes
7. Annual audited accounts/balance sheet/cashflow statement
8. Qualification by auditors
9. Confirmation by the audit committee
10. Fees paid to auditors
11. Direct and deemed holdings of directors
12. Interested party transactions
13. Details of top shareholders and the respective direct and deemed holding
14. Board opinion with concurrence of audit committee
15. Details of assets (eg. land and building)
16. Directors' and key executive remuneration
17. Employee share option scheme
18. IPT
19. Dealing in securities by officer of the company
20. Fees paid to sponsor
21. Use of proceeds from funds raised

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