A challenging year for REITs

[Goola Warden]

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Joshi: The strong foundation that led to the growth of the S-REIT industry in the last 21 years remains intact today

It's been a challenging 12 months of S-REITs against a backdrop of rising interest rates at the fastest pace the world has known. As a result, S-REITs unit prices have come under pressure although most of the S-REITs have weathered this storm the same way they weathered Covid-19 — by focusing on their tenants. Nupur Joshi, CEO of REITAS (REIT Association of Singapore), gives her views on how the S-REITs have coped and also on Singapore as a global REIT hub.

The Edge Singapore: It's been 21 years since the first two REITs were listed on the Singapore Exchange (SGX). As with any coming of age, we are witnessing some challenges for our S-REITs. In the view of REITAS, what are the challenges we have seen and could continue to experience in the next year or so?

Nupur Joshi: The S-REIT sector has successfully weathered previous challenges in its 21-year history, including the Asian Financial Crisis, Sars, Global Financial Crisis (GFC) and Covid-19.

The biggest challenge for REITs in the last 1.5 years has been the unexpectedly sharp rise in interest rates. While rising interest rates are not necessarily bad for REITs if they are accompanied by strong economic growth, the unexpectedly large and rapid increase in interest rates by the Fed hit the sector hard. The US Fed has raised its Fed funds target rate 11 times since March 2022 by a total of 500 bps, which is quite unprecedented. As REITs need capital to fund their business and do not keep much cash in their balance sheet (due to regulatory and tax reasons), this rapid increase in rates impacted them negatively.

Secondly, as REITs are predominantly yield instruments, a key metric that determines their attractiveness to investors is the spread between the yield it offers and other yield products e.g. the benchmark government 10-year bond rate. With rising interest rates, this yield spread has narrowed, reducing their appeal to investors.

Other factors that have challenged the sector in the recent past, especially REITs with overseas assets, are foreign exchange losses (due to a strong Singdollar) which impact DPU and lower property valuations in some instances.

Moving forward, the actions of the US Fed will continue to have a big impact on REITs. A reduction in interest rates will provide some reprieve whereas the situation could continue to be challenging if rates stay higher for longer.

On the whole, lower gearing limits post-GFC have made the REIT sector today financially stronger. Moving forward, balance sheet resilience will be key to the success of individual REITs and for the sector as a whole.

Edge: How will REITAS help the S-REITs to navigate these challenges? The highest cost among the S-REITs is interest expense. The aggregate leverage of many S-REITs is nearing 40%. What was the rationale for the regulators to raise the aggregate leverage ceiling back in 2020?

Joshi: REITAS plays a key role in liaising between REIT managers and our various regulators. We take regular feedback from our members and have ongoing engagement with the Monetary Authority of Singapore (MAS), Singapore Exchange (SGX) and other regulatory bodies to explain the issues and challenges faced by the industry. This approach has served the sector well in the past. For example, in 2020, when the onslaught of the pandemic severely impacted REITs, we worked with MAS to raise the aggregate leverage limit of REITs from 45% to 50% and delayed the introduction of interest coverage ratio as a determinant for leverage. We also worked with the authorities to extend the time given to REITs to make distributions. This package of measures gave REITs some buffer on their aggregate leverage which may have come under pressure due to lower economic activity during the height of the pandemic. It also allowed REITs to preserve cash during that uncertain period.

Edge: REITAS organises a lot of training programmes for the industry. Why is there so much focus on this area?

Joshi: The regulatory and business environment is evolving rapidly and the industry has to keep up with it. Training by an industry association such as ours is an efficient way for industry participants to quickly get up to speed on such matters. We organise training for all levels, from junior staff to board directors.

The difference between our courses compared to others in the market is that our courses cater exclusively to what REIT managers need to know as the application of the same regulation in different industries is a bit different.

As an example, climate reporting was made mandatory for REITs and REIT managers since FY2022 which means the whole industry had to quickly understand this new area and prepare for the change. To help our members, over the last two years, we conducted many seminars and courses on different aspects of sustainability to help the industry upskill in this relatively new area.

We have also just published a report jointly prepared with EY that does a comprehensive study of the coverage and quality of climate risk disclosures made by S-REITs so that it can serve as a benchmark to measure future progress on this front. EY also recommended several areas for improvement and we will implement these systematically over the coming months. We have also recently set up a Sustainability Taskforce that will help drive these initiatives forward.

Edge: REITAS and S-REITs are focusing on sustainability. To be sure, there are advantages to a portfolio of green buildings such as higher rents and better tenants such as MNCs. However, there is a cost to the REITs for AEIs. How can this be addressed?

Joshi: As REITs are a long-term investment instrument, future-proofing a REIT's portfolio is critical. Future-proofing involves not only ensuring that buildings can withstand potential extreme weather events like floods and the rise in sea levels but also that they remain relevant and attractive to the evolving requirements of tenants. As such, initiatives such as AEIs and building retrofits are a necessary ongoing cost. Prudent planning can ensure that resources are allocated over time in a manner that aligns with the financial goals and sustainability targets of REITs.

Additionally, while there are costs involved, sustainable practices can often lead to operational savings over time. These include installing energy-efficient lighting, optimising HVAC (heating, ventilation & air-conditioning) systems and using advanced building automation to monitor and control energy usage.

Additionally, there are opportunities to be seized in the drive to sustainability. There is a growing pool of capital being allocated to fund green buildings as well as buildings transitioning to green. For example, many banks have their own net-zero targets and commitments and are therefore looking to lend towards such projects. REITs that are similarly moving to green their portfolios will be well aligned with the lending goals of banks.

Equity investors too have their own sustainability criteria and goals and are increasingly looking to invest in REITs that have a credible sustainability roadmap and targets.

Tenants, especially MNCs, also have their own sustainability criteria when leasing a building. REITs that have put in the capex and have buildings that meet their requirements will benefit.

Put another way, the opportunity cost of not taking sustainability seriously is much more than the investment incurred in greening a portfolio. By embracing a longer-term view and factoring in potential cost savings and leveraging on opportunities, REITs will be able to navigate the complexities of sustainability while strengthening their financial and operational resilience.

Edge: Since the sharp rise in interest rates in developed markets has caused capital values to fall, what can REITAS do to help S-REITs navigate this decline in asset values, and rise in aggregate leverage?

Joshi: The impact on asset values and consequently on aggregate leverage is different for different REITs which is largely dependent on the property's asset class and geography. Our recently held REITAS Conference was a forum to exchange views between industry and regulators on this and other topics. The REIT sector is in a stronger financial position today with lower gearing compared to the pre-GFC period. We will continue to monitor the situation, seek feedback from members and engage the regulators when appropriate.

Edge: Interest coverage ratios (ICR) — introduced as part of the raising of the ceiling in aggregate leverage — add another metric that S-REITs are facing some challenges meeting. The ICR of some S-REITs are below the stipulated regulatory floor of 2.5x. What are the views of REITAS on ICR?

Joshi: The introduction of ICR as an additional metric to determine the aggregate leverage limit of a REIT was announced by MAS in April 2020 at the height of the pandemic and became effective from Jan 1, 2022, which was before the Fed began its current spree of interest rate increases. The economic environment has changed dramatically since then and a 2.5x ICR requirement is less meaningful now than at that time especially if interest rate levels should increase going forward.

Edge: Singapore is a small market and inevitably, S-REITs have expanded overseas while REITs with overseas sponsors and assets have listed in Singapore. While S-REITs themselves are hedging their income to be repatriated back to Singapore, S-REITs with overseas sponsors with overseas assets are facing a greater challenge convincing the investing public of an investment case for their REITs. Understandably, REITAS represents the REITs, but how can these REITS mitigate their risks or at least articulate their risks to the investing public?

Joshi: Out of the 40 S-REITs traded currently, 37 have some or all of their properties outside Singapore. There are 17 REITs which have all their properties outside Singapore. Therefore, REITs with overseas assets and foreign-sponsored REITs are a big and important segment of our industry. Equally important, new REITs are likely to have overseas assets or overseas sponsors. As such, the success of this cluster is very important, not only for those listed currently but also for the future growth of our industry.

There is no doubt that S-REITs with overseas assets and foreign sponsors have to put in more effort to communicate their products to investors compared to homegrown local REITs. This is understandable as investors cannot visit the properties and understand the market dynamics in the respective overseas markets.

Having said that, many investors paint all REITs with overseas assets or overseas sponsors with the same broad brush, which is neither correct nor helpful. Each overseas market and sub-market is different and has its own dynamics. For example, the return to office trend is different in China versus the US versus different European countries. Even within each of these countries, different cities would have a different dynamic. Therefore, while we club REITs with overseas assets in one group, each is quite different and an investor who makes the effort to study and appreciate the value proposition of each sub-market will likely make a smarter investment decision. Similarly, each overseas sponsor is different and it is not helpful to cast all of them with the same brush.

Therefore, it is a two-way process — while managers of REITs with overseas assets and foreign sponsors need to demonstrate a good track record and win the trust of investors, investors also need to put in more effort to differentiate between the various REITs and not get tempted to make broad generalisations.

Edge: In the years ahead, where do you think growth in S-REITs could come from?

Joshi: The strong foundation that led to the growth of the S-REIT industry in the last 21 years remains intact today. These are Singapore's strong governance and regulatory framework, efficient tax regime, international investor base, diverse offerings, political stability and a vibrant secondary market. We therefore believe that the critical pillars for the industry’s longer-term growth are intact despite the current challenging environment.

S-REITs currently own properties across 25 countries and the next phase of growth could come from REITs deepening their presence in the markets they are in, expanding to new geographies and expanding to new asset classes. Some new asset classes that are talked about are senior housing and student accommodation.

The introduction of more REIT products like ETFs and futures could be another growth engine, particularly given the increasing trend of passive investments.

Another growth engine could come from S-REITs being recognised not only for their stable income but also for their sustainability credentials. The industry’s current push for greater sustainability could increase its attractiveness to both investors and tenants. For example, the inclusion of S-REITs in various real estate and global sustainability indices could channel more funds to our sector and increase Singapore’s attractiveness as a global REIT hub.