Manulife US REIT

(MUST SP/MANU.SI)

Acquisition update: Penn & Phipps

BUY - Maintain

Price as of 17 Apr 2018	0.93
12M target price (US$)	1.01
Previous target price (US$)	1.01
Upside, incl. div (%)	14.6

Trading data

Mkt Cap (S$m) / (US$m)	1,262 / 964
Issued Shares (m)	1,036
(3-Month) Vol / Val	1.8m / $1.7m
52 week lo / hi	$0.77 / $0.99
Free Float	91.6%

Major Shareholders

Manulife Financial Corp	5.3%
DBS Group Holdings	4.0%

Previous Recommendations

Date	Rating	Share Price (US$)	Target Price (US$)
20-Feb-18	BUY	0.92	1.01

MUST SP (1yr) VS STI

Source: Bloomberg

Event

Manulife US REIT (MUST) has entered into sale and purchase agreements with John Hancock Life Insurance Company, an indirect, wholly-owned subsidiary of The Manufacturers Life Insurance Company (The Sponsor) to acquire two properties for an estimated aggregate purchase consideration of US$387mn. Post-acquisition, the REIT's Assets under Management (AUM) will total US$1.7bn, compared to US$1.3bn, pre-acquisition. This acquisition will bring MUST closer to its AUM target of US$2.6bn by 2020.

Impact

A potentially yield accretive deal with improved portfolio operational statistics. The two prime properties in Washington, D.C. and in Buckhead, Atlanta, will be acquired at a 1.8% discount to valuations of two independent appraisals. Structure of the deal has not been finalised, but could potentially lead to an immediate DPU accretion of 1.4%, assuming a combination of debt and perpetual securities are used, at a ~4.5% interest rate and ~5.9% coupon respectively; a lower cost of funds would translate to a higher DPU accretion.

Established a US$1bn multicurrency debt issuance programme to increase flexibility by diversifying source of funds. Net proceeds from the issue of securities under the programme will be used for refinancing of borrowings, financing of acquisition opportunities and for general working capital requirements. The final decisions regarding the funding mix of the acquisitions are still in talks and are subject to prevailing market conditions.

Valuation & Action

Maintained BUY with no change to our target price of US$1.01. No changes were made to our assumptions as we wait for further clarity on the final decision regarding the funding and the actual impact on DPU. Nonetheless, we still like MUST for its organic growth mechanics embedded in majority of its leases, as well as its active pursuit of high quality properties.

Risks

Main risks include a faster-than-expected rate hike in the US, which could have a negative impact on the REIT in the medium term (currently 100% of debt is fixed), and unfavourable demand and supply dynamics in the respective micro-markets, which would have a direct impact on market rents.

Financials & Key Operating Statistics

YE Dec USD mn	2016	2017	2018F	2019F	2020F
Gross revenue	47.5	92.0	111.7	128.4	144.9
Net property income	30.0	58.4	70.3	80.9	91.3
Distributable income	22.3	46.7	62.9	71.1	79.3
DPS (US cents)	3.6	5.8	5.8	6.6	7.3
DPS growth (%)	-	62.5	0.4	13.2	11.5
Div Yield (%)	4.7	6.4	6.4	7.2	8.1
NAV (USD)	87.0	82.0	111.1	112.9	115.0
Price / Book (x)	0.9	1.1	0.8	0.8	0.8
NPI Margin (%)	63.1	63.4	63.0	63.0	63.0
Net Margin (%)	108.8	63.0	37.1	38.0	38.7
Gearing (%)	33.6	33.5	33.2	32.8	32.4
ROE (%)	9.4	6.8	4.8	5.6	6.3

Source: Company Data, KGI Research

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See the last page for important disclosures.

Key updates

Enhanced portfolio defensiveness with quality tenants

Penn: The two major tenants in Penn are the U.S. Department of Treasury and the U.N. Foundation, which together occupy 80% of the property's Net Lettable Area (NLA) and have leases expiring in 2022 and 2028 respectively. This offers stability and resilience to MUST's overall tenant base and also lengthens its overall Weighted Avareage Lease Expiry (WALE) from 5.7 years to 6.3 years. Penn was acquired at an NPI yield of 5.2%.

Phipps: Carter's (NYSE: CRI), a major American designer and marketer of children's apparel, is Phipps' largest tenant by Gross Rental Income (GRI), accounting for 65% of GRI. Carter's 15 year lease, which expires in 2030, substantially increases MUST's overall WALE as well. Exposure to the Retail Trade sector has also risen from 11% to 16% with the addition of Carter's. Phipps was acquired at an NPI yield of 5.9%.

Figure 1: Percentage of portfolio with and without rental escalations

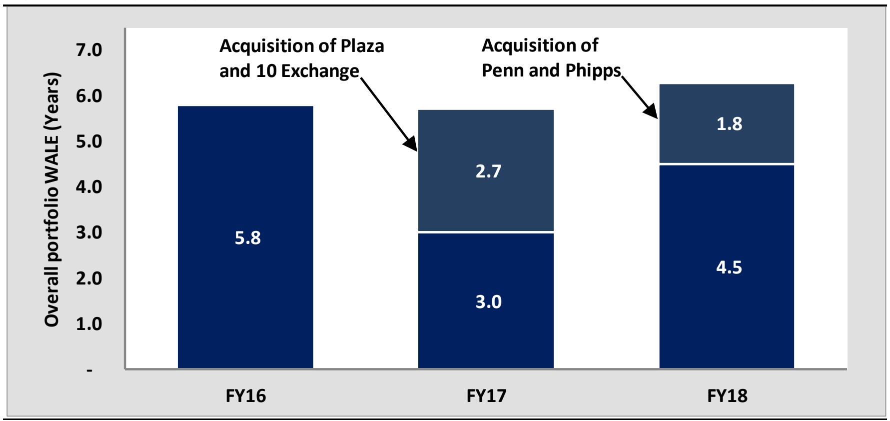
	Total NLA (mn sq ft)	Built-in rental escalations: With %	With sq ft	Without %	Without sq ft
Pre-acquisition	**3.0**	**75%**	**2.2**	**25%**	**0.7**
Penn	0.3	47%	0.1	53%	0.1
Phipps	0.5	99%	0.5	1%	0.0
Post-acquisition	**3.7**	**76%**	**2.8**	**24%**	**0.9**

Source: Company Data, KGI Research

Enlarged portfolio strengthened with longer lease expiries

The leases in Penn and Phipps are long-tenured, with over 90% of the leases, by NLA, expiring in 2022 and beyond. As at 31 December 2017, the WALE, by NLA, for Penn and Phipps are 6.8 years and 10.0 years respectively. In Penn, 47% of the leases, by NLA, have built-in annual rental escalations between 2 – 3%, while in Phipps, 99% of the leases, by NLA, have either annual rental escalations between 2 – 3% or periodic escalations of ~1.3% annually over the course of the lease. With the inclusion for Penn and Phipps, the enlarged portfolio would have 76% of its leases with built-in rental escalations, a slight increase from before.

Figure 2: Effect of acquisitions on overall portfolio WALE; Increase in WALE from 5.7 to 6.3 years



Source: Company Data, KGI Research

Figure 3: Cap rates in Washington, D.C. and Atlanta since 2016

	Cap rates (Grade A): Washington, D.C.	Atlanta
1H16	4.50% – 4.75%	5.25% – 5.75%
2H16	4.50% – 4.75%	5.50% – 6.00%
1H17	4.25% – 4.75%	5.50% – 6.00%
2H17	4.25% – 4.75%	5.25% – 6.00%

Source: CBRE, KGI Research

Accretive acquisitions at attractive purchase prices

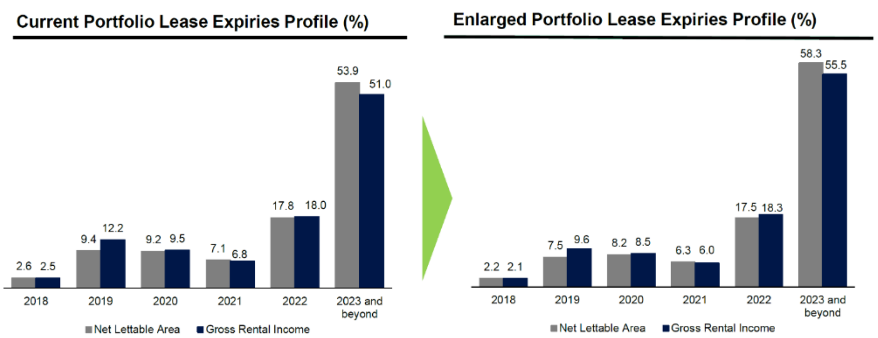
The agreed-upon purchase price of Penn and Phipps of US$387mn represents a discount of 1.3% to Cushman & Wakefield's total appraised value of US$392.2mn and a discount of 2.3% to Colliers' total appraised value of US$396.2mn. The discount, the properties were acquired at, was the average of the two; 1.8%. We believe this offers decent value for unitholders, allowing for revaluation gains, on the back of rising capital values in both Washington, D.C. and Buckhead, Atlanta.

Based on FY2017 financials, the inclusion of Pen and Phipps to the portfolio at the start of FY2017 would have increased DPU by 1.4%, from the actual FY2017 DPU of 5.77 US cents, to the pro forma DPU of about 5.85 US cents. These calculations were based on management's assumption that the acquisition was financed with a combination of 45% debt and 55% perpetual securities.

A significant increase in AUM of 31%; but still a long way to go before doubling pre-acquisition AUM

Post-acquisition, the REIT's Assets under Management (AUM) will total US$1.7bn, compared to US$1.3bn, pre-acquisition. While this acquisition brings MUST closer to its target of achieving an AUM of US$2.6bn by 2020, there is still significant room to grow from now till 2020. Given the sponsor's robust pipeline of potential acquisition opportunities, and yet another accretive acquisition (Penn and Phipps), we remain optimistic on the management's ability to deliver its plans in the next few years.

Figure 4: Strengthening portfolio resilience by lengthening lease expiries



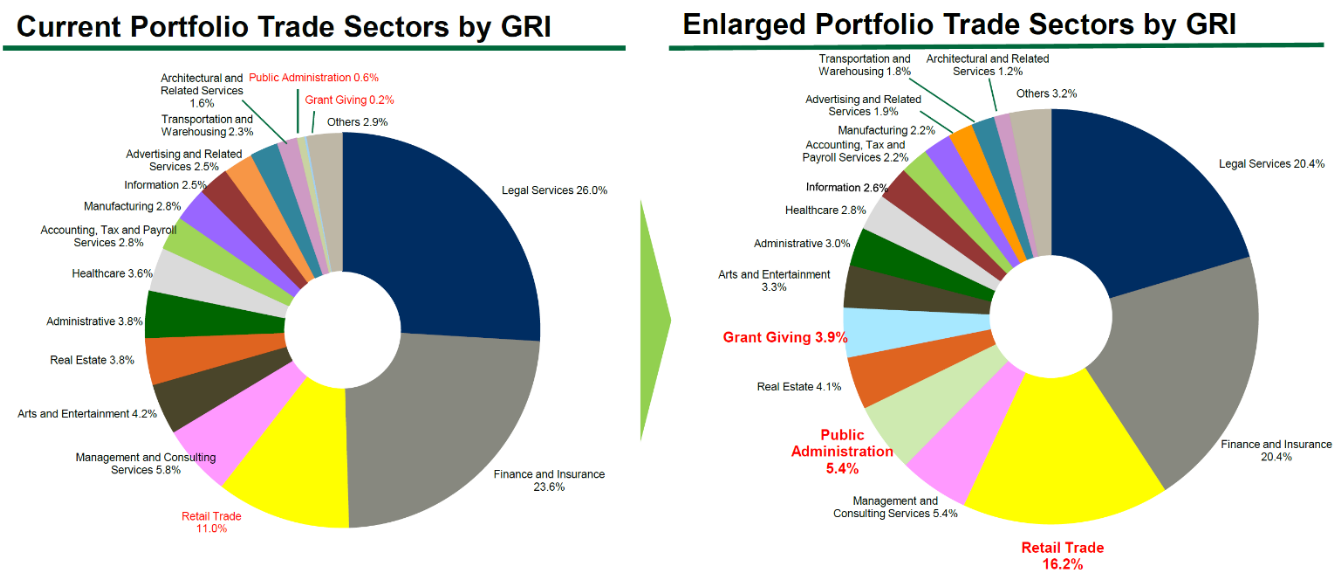
Source: Company

Figure 5: Fortifying trade sectors and quality of tenants; Acquisition introduces three new quality tenants into the top 10 tenants

Current Portfolio		Enlarged Portfolio	
Tenants	**% Gross Rental Income**	**Tenants**	**% Gross Rental Income**
Kilpatrick Townsend	6.7%	**Carter's**	**7.4%**
TCW Group	6.4%	Kilpatrick Townsend	5.2%
Hyundai Motor Finance	5.8%	TCW Group	5.0%
The Children's Place	5.4%	Hyundai Motor Finance	4.5%
Quinn Emanuel Trial Lawyers	4.5%	The Children's Place	4.3%
Amazon	4.4%	**U.S. Department of Treasury**	**4.2%**
Quest Diagnostics	3.5%	**United Nations Foundation**	**3.7%**
Gibson Dunn	3.2%	Quinn Emanuel Trial Lawyers	3.5%
LA Fitness	3.0%	Amazon	3.5%
Rabo Support Services, Inc	3.0%	Quest Diagnostics	2.8%
Total Top 10 Tenants	**45.9%**	**Total Top 10 Tenants**	**44.1%**

Source: Company

Figure 6: Change in tenant mix with higher sector exposures to grant giving, public administration and retail trade



Source: Company

Conquering the Capital of the United States

Figure 7: Penn – Operating statistics

Land Tenure	Freehold
NLA	277,243 sq ft
Parking Lots	287
Year of Completion	1964
Purchase Price	US$182mn
Valuation	Colliers: US$186mn | C&W: US$184mn
Occupancy Rate	97.2%
WALE (by NLA)	6.8 years
Tenants	10

Source: KGI Research

Penn – 1750 Pennsylvania Avenue, Washington, D.C.

Located in the CBD, which is one of Washington, D.C.'s premier submarkets due to its central location and extensive accessibility by road, rail and air, Penn offers views of the National Mall landscaped park and various monuments. Penn is a 13-storey Class A office building located a block away from the White House in Washington, D.C. It is also in close proximity to the International Monetary Fund, the World Bank and the Federal Reserve.

Penn has undergone US$6mn of asset enhancements in the past six years and has over 90% of leases, by NLA, expiring in 2022 and beyond. Penn also has leases that have built-in rental escalations (typically mid-term or annual). Currently, its current passing rents average US$48.90 psf, and are ~11% below market gross rents of US$55.00 psf, offering potential for positive rental reversions as MUST renews or signs new leases. As at 31 December 2017, government agencies account for 86% of Penn's GRI.

Figure 8: Penn – 86.2% of tenants are defensive high quality government and global agencies

No.	Tenants	Profile	% of Gross Rental Income
1	U.S. Department Of Treasury	Government agency that manages the finances of the U.S. Federal Government.	41.7%
2	United Nations Foundation	Global organisation - fosters global peace, prosperity and justice.	37.4%
3	U.S. Chemical Safety Board	Independent federal agency charged with investigating chemical accidents.	4.8%
4	United States Postal Service	Mail processing and delivery services to individuals and businesses	2.3%
5	AOL	Leading source of news, opinion entertainment and digital information.	6.3%
6	Board of Regents of the University Texas	Governing body for the University of Texas system.	4.4%
7	VIPS Catering	Catering company servicing the surrounding area and special events.	1.0%
8	Taylor Gourmet	Food service company servicing various areas in the CBD.	0.9%
9	General Nutrition Corporation	U.S. company selling health and nutrition related products.	0.7%
10	Export-Import Bank of India	Export finance institution providing financial services in India.	0.5%
	Total		**100.0%**

Source: Company

Figure 9: Penn is close proximity to the IMF, World Bank and White House

Source: Company

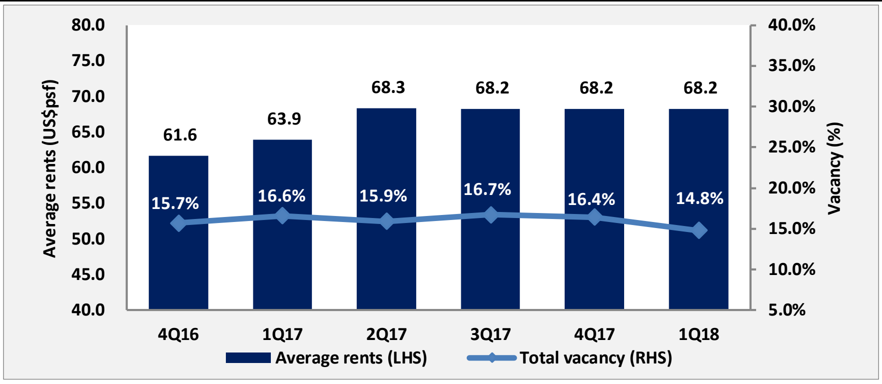
Washington, D.C. outlook – Growth slows as supply outpaces demand

According to JLL, the CBD submarket is historically Washington, D.C.'s strongest fundamentally, carrying a 10-year average vacancy rate of 10.7%, the lowest in the city. A large development pipeline, combined with continued give-backs and consolidation from key users is exacerbating a flight to quality and divergence in vacancy trends. Due to its diversity and geographic advantages, the CBD has been more resilient than other submarkets, and as a result, annual rents and vacancy trends have been relatively stable over time.

However, in the near to medium term, JLL is expecting supply to outpace demand as 4mn sq ft of office space will be added to the exisiting inventory in Washing, D.C. this year. Growing technology companies such as Yelp, Facebook and Mapbox remain the main drivers of occupancy growth, along with WeWork, working to offset consolidation among federal agencies and law firms rightsizing.

With 7.6mn sq ft under construction and only 52% preleasing commitments, leverage in the Trophy and Class A segments will be in tenants' favour as office spaces remain plentiful.

Figure 10: Washington, D.C. (Class A) average asking rents and total vacancy rates – Penn



Source: Jones Lang LaSalle, KGI Research

Long WALE and below-market passing rents to cushion any impact on Penn

While we expect the oversupply situation to weigh on market rents, we take comfort in the fact that almost 50% of Penn's leases, by NLA, have built-in annual rental escalations. We also note that Penn's current passing rents are below market gross rents, and believe any impact on its rental revenues will be marginal, given that only 10% of leases are expected to be renewed over the next 3 – 4 years.

Exposure to Strongest Office Submarket in Buckhead, Atlanta

Figure 11: Phipps – Operating statistics

Land Tenure	Leasehold (with rights to acquire freehold)
NLA	475,091 sq ft
Parking Lots	1,150
Year of Completion	2010
Purchase Price	US$205mn
Valuation	Colliers: US$210.2mn | U23 C&W: US$208.2mn
Occupancy Rate	97.3%
WALE (by NLA)	10.0 years
Tenants	9

Source: KGI Research

Phipps Tower, Atlanta

Phipps is a 19-storey Trophy quality office tower totaling 475,091 sq ft in the heart of Buckhead, Atlanta. Buckhead is one of the primary business districts of Atlanta, with high-end retail and entertainment venues and is surrounded by an upscale residential area. Building amenities include a fitness centre, a conference centre, a farm-to-table café, and covered pedestrian access to over a hundred shops and restaurants at the adjacent Phipps Plaza shopping mall.

Phipps has over 90% of its leases, by NLA and GRI, expiring in 2023 and beyond. Similar to Penn, Phipps' leases also have built-in rental escalations (typically mid-term or annual). Current passing rents average US$22.20 psf, and are ~26% below market gross rents of US$30.00 psf, also offering potential for positive rental reversions as new leases are signed.

Figure 12: Phipps – Carter's remains the largest tenant

No.	Tenants	Profile	% of Gross Rental Income
1	Carter's (NYSE:CRI)	Major American designer and marketer of children's apparel – OshKosh B'gosh.	64.6%
2	Northwestern Mutual	Financial representative, providing a wide range of financial products and services.	12.6%
3	CoStar (NASDAQ:CSGP)	Commercial real estate information and marketing provider.	9.9%
4	Daugherty Business Solutions	Provides business technology consulting services to local and state governments, organisations and Fortune 500 companies.	3.8%
5	Speakeasy Communication	Provides personal growth, communication development and consulting services worldv	3.6%
6	Cornerstone Investment	Employee-owned registered investment advisor.	2.3%
7	Government of Japan	Consulate-General of Japan.	2.3%
8	Quantum National Bank	Community bank, locally owned and operated.	0.4%
9	Carole Parks	Catering services company.	0.1%
	Total		**99.6%**

JHUSA operated a property management office in Phipps, and accounts for the remaining 0.4% of the gross rental income, but is not listed as a tenant.

Source: Company

Figure 13: Phipps is surrounded by various retail amenities, hotels and restaurants

Source: Company

Synthetic leasehold property with a conversion clause

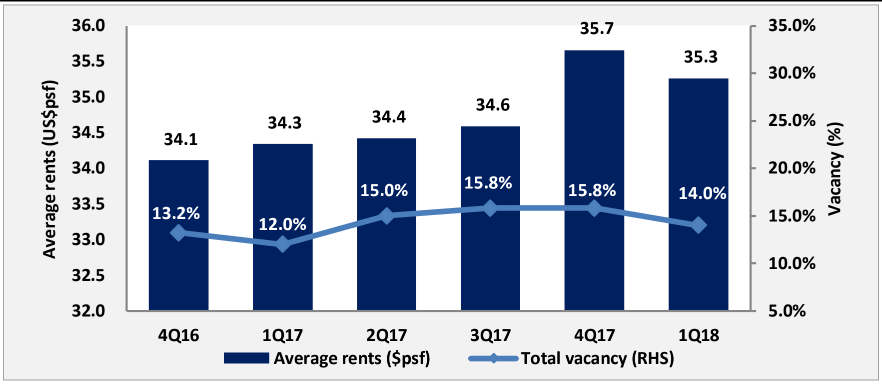
Phipps is currently held in a leasehold until the end of 2020 i.e. 2 more years before it is converted to a freehold property. Properties like Phipps are typically held in a leasehold for the first 10 years of their lives and are subsequently converted into freehold for a fee of US$100. Such properties enjoy certain tax reliefs that are reduced over the 10 years until they are converted to freehold. As Phipps' leases are triple net leases, any negative tax effect, after conversion to freehold, will be borne by tenants.

Buckhead, Atlanta outlook – Robust leasing activity in 1Q18 on the back of strengthening market fundamentals

Atlanta's office market was off to a good start, with 1Q18 recording positive net absorption of 357,357 sq ft, which was largely helped by the delivery of Phase I of NCR's (NYSE: NCR) 485,00 sq ft build-to-suit office building in Midtown. Overall asking rents continued their climb with rents, in general, increasing 8.4% YoY, while asking rents in Buckhead held steady around the US$35 psf range.

In a report by JLL (Office Insight: 1Q18), it was noted that several tenants are actively looking for new spaces to lease and remain an encouring sign for leasing activity in 2018. Two large developments are also expected to come on-stream this year – 4004 Perimeter Summit (delivered in 1Q18 without tenants) and 752 Ponce (expected 4Q18).

Figure 14: Buckhead, Atlanta (Class A) average asking rents and total vacancy rates – Phipps



Source: Jones Lang LaSalle, Colliers Research, KGI Research

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Rating	Definition
	KGI Securities Research's recommendations are based on an Absolute Return rating system.
BUY	>10% total return over the next 12 months
HOLD	-10% to +10% total return over the next 12 months
SELL	<-10% total return over the next 12 months

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