Manulife Investment Management

2023 outlook series: AP-REITs

Dec 2022

Like all risk assets, Asia-Pacific REITs (AP REITs) experienced a volatile 2022. Higher rates globally were driven by surging energy prices and inflation, and there were concerns of cap rate expansion leading to pressure across the asset class. Moving into 2023, Hui-Min Ng, Portfolio Manager, believes that given a potentially more normalised macro landscape, investors should refocus on the region's fundamentals, such as strong balance sheets, positive rental growth, and sustainable dividend payouts.

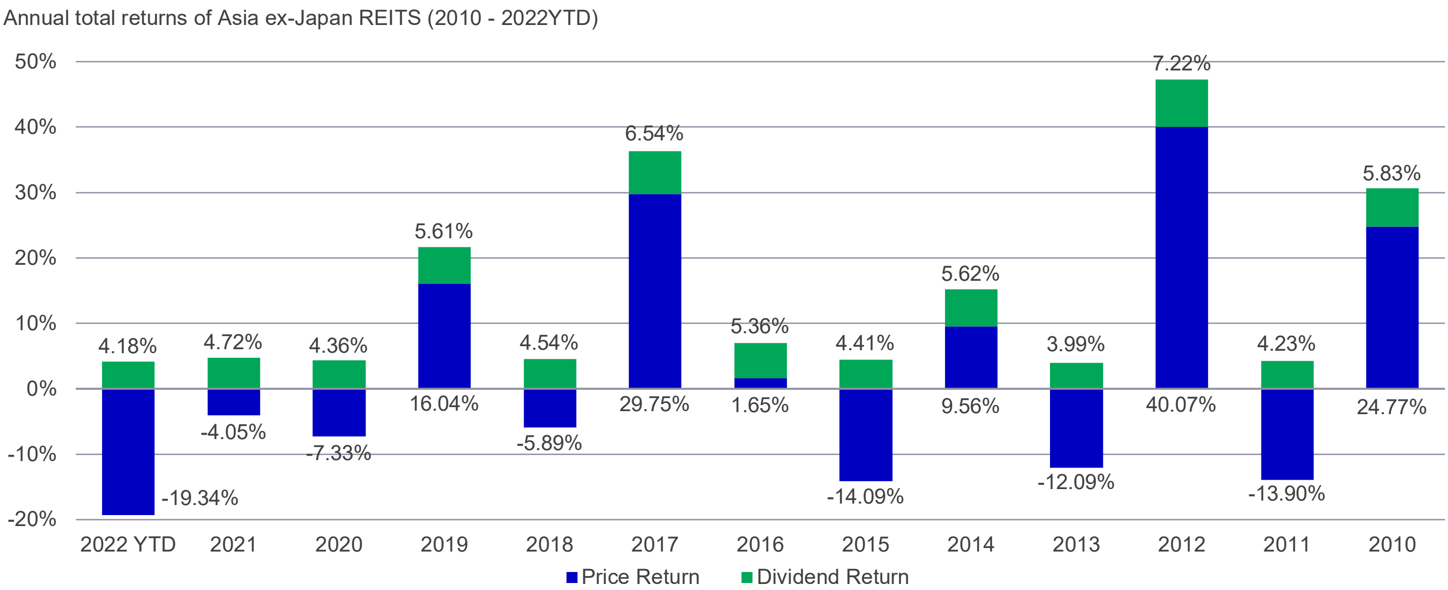
AP-REITs: A return to fundamentals

2022 was a challenging year for all asset classes, but AP REIT fundamentals remained resilient despite the risk-off environment. This was evidenced by their earnings results and guidance. In addition, asset values remained buoyant, driven by healthy rental growth and growth in distribution following the cessation of rental relief measures.

We believe that investors will shift their attention in the new year to the underlying fundamentals of AP REITs – as the volatile interest rates that dented overall REIT performance in 2022 begin to stabilise. In turn, this should pave the path for a more normalised market environment.

From an asset-class perspective, investors should remember that dividend returns are a central feature of the REIT asset class – when markets decline, dividends help compensate for any price losses. And regardless of the market environment over the past decade, dividend return *has* remained positive (See Chart 1). So, when markets move higher, dividends augment total return.

Chart 1: AP REITs total return: 2010-2022 (YTD)[1]



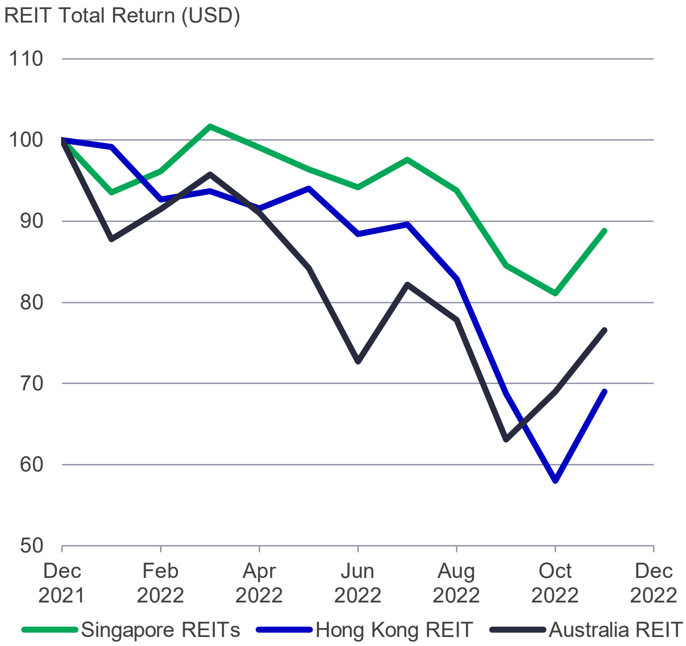
[1] Source: Bloomberg as of 30 November 2022 Asia ex-Japan REITs are represented by FTSE EPRA/NAREIT Asia ex Japan REITs Index (capped). Performance in USD.

2022: Higher rates amid inflationary pressures

Worries about the impact of both higher rates and energy costs on the asset values and profitability of AP REITs characterised a challenging 2022. This translated into market uncertainty about the ability of these asset managers to maintain their distributions to investors.

As interest rates rose over the year, investor concerns persisted on potentially lower asset values due to rising cap rates. However, we felt the level of drawdown priced into AP REITs, due to higher rates, was not indicative of their underlying operational performance (See Chart 2).

Chart 2: AP REITs total return by market, December 2021-Nov 2022[2]



Additionally, the re-opening tailwinds in Asia over the year provided some ballast for the asset class, but these are expected to fade (except for Hong Kong SAR and mainland China) heading into 2023.

From a geographic perspective:

- **Australian REITs** tend to be more sensitive to movements in 10-year bond yields than other major REIT markets. The first half of 2022 made this dynamic clear: the Australian 10-year government bond yield started at 1.67%, reaching a peak of 4.2% by mid-June. The rapid and largely unanticipated increase in rates, which reflected the Reserve Bank of Australia's aggressive monetary stance, weighed on the REIT sector – the region's weakest performer through the first half of 2022.

- **Hong Kong REITs** were impacted by negative investor sentiment toward China for most of the year. Despite the continued loosening of COVID-19 measures locally, the financial distress in the mainland's property sector and the closure of the China-Hong Kong border spilt over into related sectors, including REITs.

- **Singapore REITs** were the relative outperformer in Asia-Pacific, despite broader concerns about the asset class. Singapore REITs benefited from the reopening of the economy, leading to expectations of a recovery in the retail and hospitality sectors, given more convention and exhibition activity. Notwithstanding renewed optimism stemming from the post-COVID economic recovery, macro concerns outweighed operationally positive data points.

Central bank policy still a factor in 2023 – but largely priced in

Moving into 2023, the US Federal Reserve is likely to gradually reduce the quantum of rate hikes and should pause as upward inflationary pressures decelerate. However, the risk of persistent sticky inflation and lower growth in the US and abroad still exists, particularly in the second half of next year. Any potential easing of global inflation and labour markets (rising wage pressure) could offer central bankers more monetary room to balance growth versus inflation.

Although the impact of higher rates and energy costs should still be felt in 2023, the impact has been well communicated by corporates.

Indeed, as interest-rate volatility starts to normalise, it may provide a better environment for risk assets, including REITs. As such, we believe the incremental

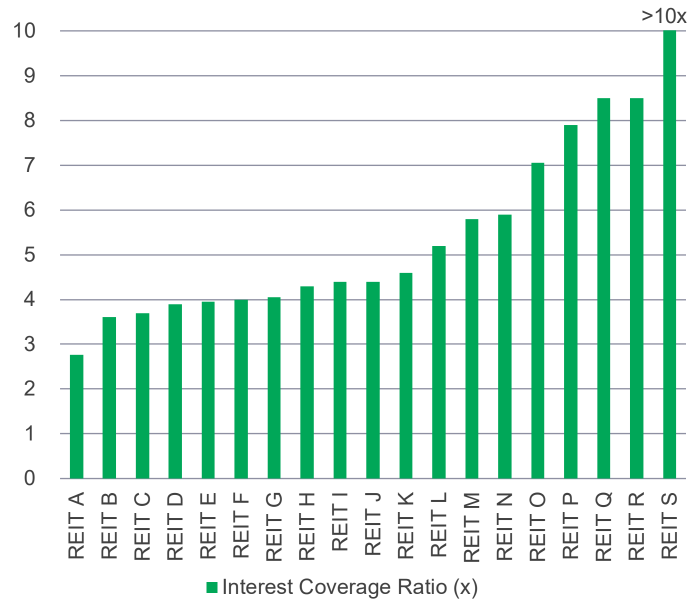
[2] Source: Bloomberg, 30 Nov 2022. Singapore REITs measured by FTSE ST Real Estate Investment Trusts Total Return Index, Hong Kong REITs measured by Hang Seng REITs index; Australia REITs measured by S&P/ASX 200 A-REIT Total Return Index. USD, total return.

impact of higher rates on interest costs should subside and investors can focus more on AP REITs' operational performance and underlying fundamentals.

Operating fundamentals should drive performance in 2023

We currently do not see balance sheet or liquidity risk for AP REITs given healthy levels of leverage and, more importantly, the ability to service debt. As highlighted in Chart 3, current interest coverage ratios (ICR) for key Singapore REITs are well above the typical minimum threshold (Adjusted EBITDA 2 times interest payments).

Chart 3: Interest coverage ratio for key Singapore REITs[3]

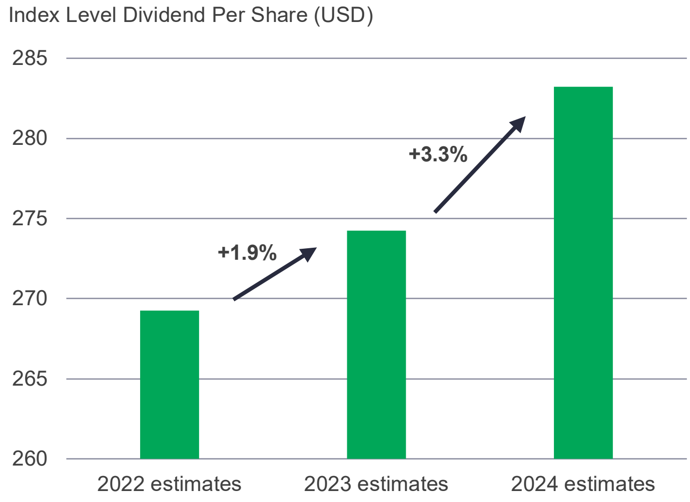


Even if we factor in the possibility of higher interest rates, refinancing risks are staggered over a few years. Additionally, rising net property income would help mitigate the overall impact of higher rates on ICR[4].

Further, rental reversions are likely to be positive in the industrial, hospitality, and retail sectors in 2023. Given the high occupancy and continued demand in e-commerce and logistics warehousing, we could see continued positive rental reversions, which should help partially mitigate the impact on asset values from cap rate expansion.

Finally, we also expect dividend growth to continue. After downward revisions in analyst expectations, given some of the challenges mentioned, there are still expectations for DPU growth through 2024 (see Chart 4).

Chart 4: Dividend growth tapped to increase[5]



2023 sector outlook: Positive on industrials and retail over offices

We are more constructive on industrials and retail than offices in 2023 (see Chart 5).

- **Retail:** In Hong Kong, neighbourhood malls have generally outperformed during times of economic uncertainty given its non-discretionary nature. The upward adjustment for minimum wage in 2023 should also provide support. In Singapore, the continued recovery in tourist arrivals should continue to drive an increase in traffic and revenue for malls. The strong rebound in tenant sales has brought down occupancy cost to healthy levels which allows for more room for potential upside to rental rates.

- **Industrials** should continue to perform. High occupancy and amplified demand for e-commerce and third-party logistics warehousing should continue into the new year. Longer WALEs should provide some defensive to cash flows with more visible rental income.

[3] Source: Bloomberg, as of 30 November 2022.
[4] Source: Manulife Asset Management Analysis and company reports.

[5] Source: Bloomberg consensus estimate, as of 24 October 2022. Asia REITs measured by FTSE/EPRA Nareit Asia ex Japan index (capped).

Chart 5: 2023 AP REIT segment outlook[6]

Singapore	Hong Kong	Australia
Industrial We like its defensiveness and visible cashflows	**Retail** Neighborhood malls shown resilience amid pandemic	**Industrial** Strong end demand from third party logistic and e-Commerce
Retail Discretionary malls to benefit from re-opening of borders	**Office** Slower recovery pace with upcoming supply from 2022 - 2023	**Office** Slower than expected return to office
Office Expectations of peak spot rents in 2023 after strong 2022. Leasing demand slowdown from key sector		
Hospitality No quota restrictions, RevPAR and asset value recovery, MICE events to resume		

Positive Neutral Negative

- We believe that **offices** should face a challenging year across the region. In Australia, the segment is suffering from a slower-than-expected return to the workplace. Hong Kong should experience a muted recovery with significant supply coming online in 2022-2023. Singapore could see a slowdown in leasing demand and slower pace of rental growth.

Conclusion

After a difficult 2022, investors in AP REITs should likely look at the asset class's robust underlying fundamentals in the new year, which we consider as core earnings and cashflow strength, strong capital management, and quality real estate which generally provides greater resilience to rental rates during times of economic uncertainty – all factors which provide support to sustainable dividend payouts.

[6] Source: Manulife Asset Management analysis. RevPAR = revenue per available room. MICE = meetings, incentives, conferences, and exhibitions.

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