Lack of fresh catalyst expected for REIT sector in near term

Real estate investment trust sector

Maintain neutral: Third quarter of 2019 (3Q19) earnings for real estate investment trusts (REITs) are largely in line. Out of the eight REITs in our universe, five met our full-year earnings estimates while three missed mainly due to higher-than-expected property and/or non-property expenses.

Five REITs, namely, Axis REIT (+1%), IGB REIT (+5.4%), Sunway REIT (+1%), KLCC Stapled Group (0.8%) and AmanahRaya REIT (+3.6%) registered positive cumulative year-on-year (y-o-y) growth. REITs that registered flat core net income were Pavilion REIT and Al-'Aqar Healthcare REIT. CapitaLand Malaysia Mall Trust is the only REIT that registered a decline in earnings at 21% lower compared with a year ago.

Minimal impact is seen from the overnight policy rate (OPR) cut on REITs. We note that the impact of the 25-basis-point OPR cut in May on REITs' 3Q of financial year 2019 (3QFY19) has been minimal as most REIT managers increase their floating rate loans by less than six percentage points (ppts) compared with a year ago with most hovering below a 60:40 float to fixed ratio.

Some REIT managers maintain most of their loans at high fixed ratios. Our house economists expect the OPR to maintain at 3% this year and one rate cut in 2020, bringing the OPR to 2.75% in 2020.

Ten-year Malaysian Government Securities' (MGS) yield averages at 3.75% year-to-date (YTD). The spread between MGS' 10-year yield and REITs under our coverage stood at 1.4ppts, which is not very attractive at the moment. MGS' average yield to date is largely unchanged compared with the previous quarter. However, on a YTD basis, the Kuala Lumpur REIT sector index is sitting at a return of 5.15%, outshining the FBM KLCI's 7.51% decline.

Property expenses climbed for some REITs, mitigating the growth in rental income. During the quarter, we notice, the core net income (CNI) of several REITs did not climb as much as their rental income.

Pavilion REIT's revenue grew by 7.7% y-o-y but earnings dipped by 0.3% during the period as property expenses rose by 16% y-o-y.

We maintain "neutral". Our top pick is Sunway REIT (target price [TP]: RM2.02). We continue to prefer Sunway REIT ("buy"; TP: RM2.02) among the REITs we cover for its stable income growth from Sunway Pyramid Shopping Mall and a more balanced asset portfolio. We have downgraded AmanahRaya REIT to "neutral" (previously "buy"; TP: 79 sen) as we anticipate a more challenging environment for some of its assets, which may taper its income growth going forward. — *MIDF Research, Dec 6*