PRIVATE EQUITY

COMMENTARY

Newcomers up the ante in governance index for trusts

NetLink NBN Trust debuts in GIFT 2019 at No. 1; Keppel-KBs US Reit, also a newcomer, is in joint sixth with two other listed trusts

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Singapore

THE third edition of the Governance Index for Trusts (GIFT) assesses the governance and business risk of 46 real estate investment trusts (Reits) and business trusts (BTs) listed on the Singapore Exchange (SGX).

Four trusts are new to GIFT in the 2019 edition, having more than a year of listing status to allow us to assess them meaningfully. They are Cromwell European Reit, Keppel-KBS US Reit, NetLink NBN Trust and Sasseur Reit.

The trusts that are ranked in the top five in GIFT 2019 are NetLink NBN Trust, Mapletree Commercial Trust, Keppel DC Reit, AIMS APAC Reit and Mapletree North Asia Commercial Trust (joint fourth).

The average combined governance and business risk score has continued to improve since the first edition, increasing from 62.2 in 2017 to 65.6 in 2018 and to 68.0 in 2019. The four new entrants to GIFT have generally fared well.

NetLink NBN Trust debuts in GIFT 2019 at No.1. Its overall score of 90 puts it well ahead of all the other trusts. It has adopted most of the practices that we consider to be "best practice" in the governance area, including that of allowing unitholders to endorse the directors of the trustee-manager before they get re-appointed at the annual general meeting (AGM) of the trustee-manager.

Another debutant, Keppel-KBS US Reit, has also done well, with an overall score of 78.5, making it joint sixth with Manulife US Reit and Far East Hospitality Trust.

Excluding the four new trusts, the overall average score for those trusts that were in both last year's and this latest edition increased by just under one point.

Far East Hospitality Trust showed one of the greatest improvements, gaining 15 points from last year and moving up from last year's 29th place to joint 6th this year. It was able to do so through improvements in many areas, including appointing independent directors with relevant experience to replace non-executive directors who retired from the board (83 per cent of independent directors on board, highest of all trusts).

In addition, the trust was more prompt in releasing its financial results and posted minutes of its AGM – simple gestures that go a long way to improve engagement with unitholders.

Compared to 2018, the average business risk score in GIFT 2019 has remained relatively flat, although the average governance score has improved.

Areas of improvement

The greatest area of improvement in 2019 is the posting of detailed meeting minutes on the website of the trusts. Last year, we found the CapitaLand-related and Mapletree-related Reits doing so. This year, 29 of the 46 trusts have done so. Overall, communication with unitholders continue to be the area where the trusts fare particularly well.

Some other areas where there have been improvements include having nominating and remuneration committees (or a combined NC/RC), and disclosure of non-executive director (NED) fee structure.

In the business-risk section, trusts have reduced their refinancing risks as more have average debt maturity of more than three years, fewer have more than 25 per cent of their debt expiring in 12 months, and more have locked in at least 70 per cent of their interest costs. These have provided more stability to the trusts and improved the visibility of cash flows and financing costs.

Going backwards

Some trusts have, however, gone backwards. One stopped the practice of allowing unitholders to endorse the appointment of directors because it deemed that it has complied with the requirements for half the board to be independent and endorsement was no longer required by the rules. This suggests a minimum compliance mindset.

Another stopped disclosing the remuneration of each individual director, the chief executive and top five executive officers on a named basis, whether in exact quantum or in bands of S$250,000, and the total remuneration paid to the top five key management personnel.

This contributed to it suffering one of the biggest falls in score of 11 points, compared to 2018.

Some trusts justify the independence of certain directors when these directors have certain relationships with the manager, the trust, substantial shareholder of the manager or substantial unitholder of the trust. Some independent directors who retire from a trust after having served for nine years promptly joined another related trust as independent director. Hypothetically, if there are four related trusts, such directors can still be independent after 36 years!

While extensive justifications are given for such cases, we believe these trusts should just cast their net wider when appointing independent directors.

In cases where directors have other business relationships with the substantial shareholder of the manager and/or the substantial unitholder of the trusts, we have re-designated the independent directors from independent to non-independent in our assessment and this could affect a number of items in GIFT.

For trusts that fared less well in GIFT 2019, it is usually due to corporate actions related to the sponsor and/or controlling unitholder and less favourable business conditions, such as a drop in the weighted average lease expiry and higher refinancing risks.

GIFT 2019 – a ranking of S'pore's listed trusts

Governance Index For Trusts (GIFT) – August 2019

RANKING	REIT/BT	GOVERNANCE SCORE	BUSINESS RISK SCORE	GIFT 2019
1	NetLink NBN Trust	74	16	90
2	Mapletree Commercial Trust	60.5	20.5	81
3	Keppel DC Reit	64	16.5	80.5
4	AIMS APAC Reit	61.5	18.5	80
4	Mapletree North Asia Comm Trust	62	18	80
6	Far East Hospitality Trust	65.5	13	78.5
6	Keppel-KBS US Reit	62.5	16	78.5
6	Manulife US Reit	62.5	16	78.5
9	CapitaLand Mall Trust	59	18.5	77.5
10	CapitaLand Commercial Trust	58.5	18.5	77
11	Frasers Logistics & Industrial Trust	60	16.5	76.5
12	Soilbuild Business Space Reit	60	16	76
13	CapitaLand Retail China Trust	59.5	16	75.5
14	Keppel Reit	61.5	13	74.5
15	Ascendas Reit	58	15	73
15	Ascott Residence Trust	60	13	73
17	Cromwell European Reit	57	15.5	72.5
18	Ascendas Hospitality Trust	53.5	18.5	72
18	Mapletree Industrial Trust	53.5	18.5	72
18	Parkway Life Reit	55	17	72
21	Mapletree Logistics Trust	52	18	70
22	SPH Reit	55	14	69
22	Suntec Reit	54	15	69
24	Ascendas India Trust	56	11.5	67.5
25	BHG Retail Reit	57.5	9.5	67
25	Cache Logistics Trust	51	16	67
27	Frasers Centrepoint Trust	54.5	12	66.5
27	Frasers Hospitality Trust	55	11.5	66.5
29	Frasers Commercial Trust	50	16	66
30	CDL Hospitality Trusts	49	15.5	64.5
31	Sasseur Reit	52.5	11	63.5
32	ESR-Reit	52.5	10.5	63
33	IREIT Global	53.5	9	62.5
33	OUE Hospitality Trust	45.5	17	62.5
35	Keppel Infrastructure Trust	48	14	62
36	Sabana Reit	53.5	8	61.5
37	Starhill Global Reit	48.5	12	60.5
38	Dasin Retail Trust	48	11.5	59.5
39	Asian Pay Television Trust	48	10	58
40	First Reit	42	15.5	57.5
41	EC World Reit	49	6.5	55.5
41	First Ship Lease Trust	47.5	8	55.5
43	Accordia Golf Trust	42	12.5	54.5
44	OUE Commercial Reit	45.5	8	53.5
45	Hutchison Port Holdings Trust	40	5	45
46	Lippo Malls Indonesia Retail Trust	40	2.5	42.5

Note: The main Governance score and Business risk score add up to 80 and 20 points respectively. In the two columns above, the scores include merit and demerit points. Mapletree Commercial Trust scored more than 20 points in the business risk section due to merit points awarded.

Source: Mak Yuen Teen/Chew Yi Hong

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Fewer isolated showers but four seasons in Singapore?

In past reports, we highlighted some trusts that had faced various types of challenges. The good news is that this year has been less eventful in this regard. Two trusts that showed large improvements in their GIFT scores appear to have put their worst behind them as they resolved their governance and operational issues.

That being said, the operating conditions and the structure of certain trusts continue to put downward pressure on their distributions to unitholders and unit prices.

A Reit that languished in the bottom three in all the GIFT editions cut its distribution per unit by 40 per cent in the past year. A business trust lost more than 70 per cent in value at its lowest point in the past year when it reduced its distribution by 80 per cent.

Rather than isolated showers last year, four seasons may be upon us in Singapore as more foreign trusts choose to list here and Singapore-based trusts with strong local sponsors venture overseas.

Before unitholders apply for units in a new listing, including foreign ones, in what seems to be assumed to be a "sure-win" Reit sector, they may want to ask themselves why certain foreign trusts are listing in Singapore especially when the sponsor is not local and the assets are overseas.

Of course, this may reflect the success of the Monetary Authority of Singapore (MAS) and SGX in making Singapore a major international listing destination for Reits. Today, this asset class accounts for about 10 per cent of the total market capitalisation of SGX – a larger percentage than in key markets such as Australia, Japan, UK and US, and Singapore is now the second largest Reit market in Asia after Japan.

Nevertheless, we believe it is important for investors to understand what they are investing in under our largely disclosure-based *caveat emptor* regime.

As for local Reits, their risk profile may change as they acquire assets overseas. Investors should consider whether these Reits are operating outside their core competence and their network and knowledge of the local market. Even if managers take out loans in foreign currency and forward-hedge their expected distributions, unitholders still retain significant exposure to foreign-exchange risk associated with these foreign investments.

Bigger, but are they better for unitholders or for the managers/sponsors?

In the past year, there were consolidations and mergers in the market, including several mergers that are in the works.

Unitholders are asked to foot the "acquisition" fee for the "merger" upfront, even if the assets being acquired come from a related trust. Unitholders need to question if there are real operational synergies that would translate into tangible benefits for them. On paper, merging a hospitality trust with a commercial real estate trust can be justified by various textbook reasons. Ultimately, it is up to the manager to execute it well, based on a good strategy to deliver returns to unitholders.

As long as a trust is externally managed, issues of alignment of interests between unitholders and the manager are more likely to arise, given that the manager has its own financial considerations and ultimately accounts to a different set of shareholders (which are not the unitholders of the listed trust).

Leveraging up

Reits are well-regulated and the MAS has taken a prudent approach in ensuring that any relaxation in operational flexibility for Reits which may increase their risks is accompanied by stronger governance safeguards.

In recent years, we have seen the leverage limit for Reits raised from 35 per cent (and 60 per cent for those with a credit rating) to a flat 45 per cent, which is still relatively conservative compared to other markets.

There was also an increase in the property development limit from 10 per cent to 25 per cent.

Last month, the MAS issued a consultation paper with a view to allowing a higher leverage limit of 50 per cent or 55 per cent, subject to Reits meeting or exceeding certain interest coverage ratio thresholds or having demonstrated strong financial discipline.

These changes, if approved, may lead to further changes in the risk profile of Reits. In line with earlier relaxation being accompanied by enhancements in governance safeguards, the MAS may wish to consider enforcing stricter standards on Reits, such as in how the independence of directors is assessed, or prodding trusts to have independent directors with strong financial, investment or real estate experience.

Out of the 46 trusts included in GIFT 2019, 14 currently issued hybrid securities in the form of perpetual or convertible securities.

Perpetual securities are classified as equity under current accounting standards, even though they have debt-like features. We found that those trusts which have issued perpetual or convertible securities have higher average leverage of 37.5 per cent, compared to other trusts, which have average leverage of about 34 per cent. This is consistent with trusts turning to hybrid securities as an alternative source of financing when their leverage increases.

In fact, for the nine pure Reits that have issued perpetual securities, two of them would have exceeded the 45 per cent leverage limit if the perpetual securities were reclassified from equity to debt. Three other Reits would have adjusted leverage above 44 per cent and be just a whisker away from the 45 per cent cap.

The MAS may wish to take into account whether trusts are using hybrid securities when determining the leverage limit that should be imposed.

What's in store for GIFT 2020?

We are encouraged by the continuing strong interest in GIFT as 34 out of the 46 trusts – or nearly three-quarters – took up our invitation to submit a voluntary self-assessment.

This compares with 29 out of 43 – or two-thirds – which did so last year. We look forward to continuing engagement with the trusts to improve governance in the sector.

For next year's GIFT, we plan to measure weighted average lease expiry (WALE) using Gross Rental Income (GRI) rather than Net Lettable Area (NLA).

We will also be looking for more clarity on long-term remuneration incentives/plans for key management, and examining more closely the competencies of directors and key management as trusts expand their operations overseas. We may also focus more on the use of perpetual securities, especially if the limit on aggregate leverage is raised.

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