ALLIANCE RESEARCH

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Results Review

Sunway REIT

Buy ↑

REIT | Bloomberg Ticker: SREIT MK | Bursa Code: 5176

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12-month upside potential

Previous target price	1.34
Revised target price	1.44
Current price (as at 24 Jan)	1.26
Capital upside (%)	13.9
Net distribution (%)	5.9
Total return (%)	19.8

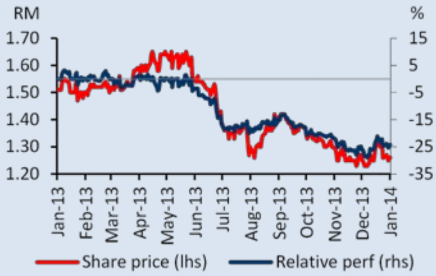
Key stock information

Syariah-compliant?	No
Market Cap (RM m)	3,683.8
Units outstanding (m)	2,923.7
Free float (%)	42.6
52-week high / low (RM)	1.65 / 1.23
3-mth avg volume ('000)	956.0
3-mth avg turnover (RM m)	1.2

Unit price performance

	1M	3M	6M
Absolute (%)	0.8	-7.4	-7.4
Relative (%)	2.6	-6.7	-7.5

Unit price chart



Source: Bloomberg

2QFY14: Slightly better than expected

Sunway REIT's 2QFY14 results came in slightly better than expected, with 1HFY14 annualised core income making up 105.9% and 103.6% of ours and consensus full year forecasts. We see value emerging in SREIT after share price retraced 24% from its peak in May 2013. We believe market has overpriced the risk of bond yield expansion in the next 12 months given that the current risk free rate is only 4.2%. Hence, we upgrade the stock from neutral to BUY with a revised TP of RM1.44 (+7.1%), based on DDM-valuation model with key assumptions such as, (1) risk free rate of 4.5%, (2) beta of 0.71x, (3) market risk premium of 5.0%, and (4) long term growth rate of 2.0%. Our revised TP implies net yield of 6.0% for CY15.

2QFY14 results were slightly better than expected

- Sunway REIT's (SREIT) 2QFY14 realised net income (RNI) came in slightly better than expected, with 1HFY14 annualised net income representing 105.9% and 103.6% of ours and consensus full year forecasts.
- 2QFY14 revenue grew by 4.2% y-o-y and 10.1% q-o-q, mainly driven by (1) solid performance from key retail malls with double-digit rental reversion, and (2) additional income contribution from Sunway Medical Centre, which was acquired on 31 Dec 2012. We are pleased by the top line performance as it is more than enough to mitigate revenue loss from Sunway Putra Mall which has been closed for major refurbishment.
- Net property income (NPI) achieved growth of 8.1% y-o-y and 9.5% q-o-q in 2QFY14. Given that the NPI growth was stronger than revenue growth, SREIT management has once again demonstrated good cost control capability. The cost savings stemmed from lower operating expenditure and utilities expenses at Sunway Pyramid as a result of energy saving upon the completion of the chiller retrofit exercise.
- 1HFY14 financing cost implies effective interest rate of 3.75% p.a., which was lower than our full year estimate of 3.80%.
- All in, 2QFY14 core EPU grew by 1.9% y-o-y and 11.6% q-o-q, bringing 1HFY14 core EPU to 52.9% of our full year forecasts.
- Sunway REIT declared its second interim DPU of 2.23 sen (net: 2.04 sen), which was 105.3% of its RNI in 2QFY14. This brought its 1HFY14 distribution to 52.1% of our full year DPU. The ex-date and entitlement date for the second interim DPU are 10 Feb and 12 Feb respectively.
- On foreign shareholdings level, it continues to ease from 20.2% in Sept 2013 to 19.9% in Dec 2013.

No change to earnings projection

- While results came in slightly better than expected, we keep our forecasts unchanged as we see the risk of higher operating cost (utilities and assessment) in 2HFY14, if management decided not to fully pass on cost escalation to their tenants.

Upgrade from neutral to BUY with higher TP of RM1.44 (+7.1%)

- SREIT's share price has corrected by approximately 24% from its peak in May 2013. At last closing price of RM1.26, we view the yield offered in FY14 (5.9% net) and FY15 (6.4% net) attractive, given that the REIT is projected to achieve the highest 3-year earnings CAGR of 8.6% (FY14-FY16) in the industry, thanks to its AEI on Sunway Putra Place.
- With an overall upside of 19.8% based on the revised TP of RM1.44 (+7.7%) as we roll forward our valuation, and update the key assumptions in our DDM valuation model to reflect the existing market expectation, we upgrade SREIT from neutral to BUY.
- To note, our updated key assumptions include (1) beta of 0.71, (2) risk free rate of 4.5%, (3) market risk premium of 5.0%, and (4) long term growth rate of 2.0%.
- Key risks include:- (1) rising interest rate which could result in higher cost of equity that undermines our DDM valuation model, and (2) a sharp economic slowdown which will affect domestic consumptions and investment activities.

SNAPSHOT OF FINANCIAL RESULTS

Figure 1 : Results commentaries

	2QFY14	2QFY13	% y-o-y change	% q-o-q change	6MFY14	6MFY13	% y-o-y change	Comments
Key financial highlights								
Gross rental income (RM m)	110.3	105.8	4.2	10.1	210.5	205.6	2.4	2QFY14 revenue grew by 4.2% y-o-y and 10.1% q-o-q, mainly driven by solid performance from key retail malls, office segment and new income contribution from Sunway Medical Centre. Key retail assets continue to enjoy double-digit rental reversion.
Operating costs (RM m)	-25.8	-27.7	-6.6	12.2	-48.8	-54.5	-10.4	Operating costs were lowered by 6.6% y-o-y but higher by 12.2% q-o-q, thanks to lower operating expenditure and utilities expenses from Sunway Pyramid as a result of energy saving upon the completion of the chiller retrofit exercise.
Net rental income (RM m)	84.5	78.2	8.1	9.5	161.6	151.1	7.0	
Others (RM m)	0.6	0.3			1.2	0.6		
Total trust income (RM m)	85.1	78.5	8.5	9.6	162.8	151.6	7.4	
Financing cost (RM m)	-16.0	-15.7	1.8	2.6	-31.5	-30.4	3.6	
Other trust expenditure (RM m)	-7.1	-6.7	6.8	5.9	-13.9	-13.1	6.1	
Net income (RM m)	62.0	56.1	10.5	12.0	117.4	108.1	8.6	
Core net income (RM m)	62.0	56.1	10.5	12.0	117.4	108.1	8.6	All in, 2QFY14 core net income came in slightly better than expected; bringing 1HFY14 annualised net income to 105.9% and 103.5% of ours and consensus full year forecasts.
Realised net income (RM m)	62.0	56.1	10.5	12.0	117.4	108.1	8.6	
Per share data								
EPS (sen)	2.12	2.08	1.9	11.6	4.02	4.01	0.2	
Core EPS (sen)	2.12	2.08	1.9	11.6	4.02	4.01	0.2	
Net DPU (sen)	2.04	2.01			3.88	3.87		2nd interim DPU of 2.23 sen (net: 2.04 sen) also came in slightly better than expected, with 1HFY14 annualised distribution making up 104.1% of our full year estimate.
NAV/share (RM)	1.20	1.12			1.20	1.12		
Other key indicators								
Gearing (x)	0.32	0.38			0.32	0.38		
Net rental margin (%)	76.6	73.9			76.8	73.5		
Core net margin (%)	56.2	53.0			55.8	52.6		
Payout ratio (%)	105.2	105.3			105.2	105.2		
Revenue by segment (RM m)	110.3	105.8	4.2	10.1	210.5	205.6	2.4	
Retail	74.9	75.5	-0.9	6.6	145.1	148.8	-2.5	
Hotel	19.9	20.0	-0.4	39.6	34.2	36.3	-5.8	
Office	10.8	10.2	5.4	-1.6	21.7	20.4	6.5	Office segment revenue growth was mainly attributed to, (1) additional NLA (+5%) and higher average occupancy rate in Menara Sunway, and (2) higher rental reversion in Sunway Putra Tower due to alignment to the market rates arising from the low rental base.
Hospital	4.8	0.1			9.5	0.1		

Source: Company, Alliance Research

Figure 2 : Key financial data

FYE 30 June	FY12	FY13	FY14F	FY15F	FY16F
Revenue (RM m)	406.4	415.9	421.1	458.4	512.6
EBITDA (RM m)	270.2	281.2	289.0	319.1	360.2
EBIT (RM m)	270.2	281.0	288.8	319.0	360.1
Pretax profit (RM m)	420.5	392.3	221.9	242.2	280.5
Reported net profit (RM m)	420.5	392.3	221.9	242.2	281.5
Core net profit (RM m)	190.3	218.8	221.9	242.2	280.5
EPU (sen)	15.6	14.1	7.6	8.3	9.5
Core EPU (sen)	7.1	7.9	7.6	8.3	9.5
Alliance / Consensus (%)			97.8	96.7	98.4
Core EPU growth (%)	12.8	11.3	-3.6	8.8	15.4
P/E (x)	17.8	16.0	16.6	15.3	13.2
EV/EBITDA (x)	18.3	18.7	19.4	18.2	16.1
ROE (%)	14.0	11.2	6.3	6.9	7.9
Gearing (%)	33.4	31.0	35.2	37.0	36.7
Net DPU (sen)	6.9	7.7	7.4	8.1	9.3
Net distribution yield (%)	5.5	6.1	5.9	6.4	7.4
NAV/share (RM)	1.12	1.20	1.20	1.20	1.20
P/NAV (x)	1.1	1.0	1.0	1.0	1.0

Source: Alliance Research, Bloomberg

Figure 3 : SREIT's DDM valuation model

Key Assumptions:	
Market Risk Premium (MRP)	5.0%
Beta (*B*)	0.71
Risk free rate (Rf)	4.5%
Constant DPU growth rate (g)	2.0%
Cost of equity (r) = Rf + (*B* x MRP)	8.1%

Equity value per share (RM) = Present value of future dividend + Terminal value

$$= \frac{D1}{(1+r)^{n}} + \frac{D2}{(1+r)^{n+1}} + \frac{D3}{(1+r)^{n+2}} + \left[\frac{D3 \times (1+g)}{(r-g)} \times \frac{1}{(1+r)^{n+2}} \right]$$

$$= \frac{0.056}{(1.081)^{1}} + \frac{0.081}{(1.081)^{2}} + \frac{0.093}{(1.081)^{3}} + \left[\frac{0.093x\ (1.02)}{(0.081 - 0.02)} \times \frac{1}{(1.081)^{3}} \right]$$

$$= 0.052 + 0.069 + 0.074 + 1.241$$

$$= 1.44$$

* n = period

Source: Alliance Research

DISCLOSURE

Stock rating definitions

Strong buy	-	High conviction buy with expected 12-month total return (including dividends) of 30% or more
Buy	-	Expected 12-month total return of 15% or more
Neutral	-	Expected 12-month total return between -15% and 15%
Sell	-	Expected 12-month total return of -15% or less
Trading buy	-	Expected 3-month total return of 15% or more arising from positive newsflow. However, upside may not be sustainable

Sector rating definitions

Overweight	-	Industry expected to outperform the market over the next 12 months
Neutral	-	Industry expected to perform in-line with the market over the next 12 months
Underweight	-	Industry expected to underperform the market over the next 12 months

Commonly used abbreviations

Adex = advertising expenditure
bn = billion
BV = book value
CF = cash flow
CAGR = compounded annual growth rate
Capex = capital expenditure
CY = calendar year
Div yld = dividend yield
DCF = discounted cash flow
DDM = dividend discount model
DPS = dividend per share
EBIT = earnings before interest & tax
EBITDA = EBIT before depreciation and amortisation

EPS = earnings per share
EV = enterprise value
FCF = free cash flow
FV = fair value
FY = financial year
m = million
M-o-m = month-on-month
NAV = net assets value
NM = not meaningful
NTA = net tangible assets
NR = not rated
p.a. = per annum
PAT = profit after tax

PBT = profit before tax
P/B = price / book ratio
P/E = price / earnings ratio
PEG = P/E ratio to growth ratio
q-o-q = quarter-on-quarter
RM = Ringgit
ROA = return on assets
ROE = return on equity
TP = target price
trn = trillion
WACC = weighted average cost of capital
y-o-y = year-on-year
YTD = year-to-date

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