SUNWAY

REIT

APREA Workshop
Capital Management of a REIT

14 March 2013

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1. What is capital management?

What is capital management?

A strategy involving efficient management of capital combined with effective risk management framework in achieving an optimal capital structure matching the funding requirements of the organisation.

Capital Management

Optimisation of capital structure
(debt vs equity)

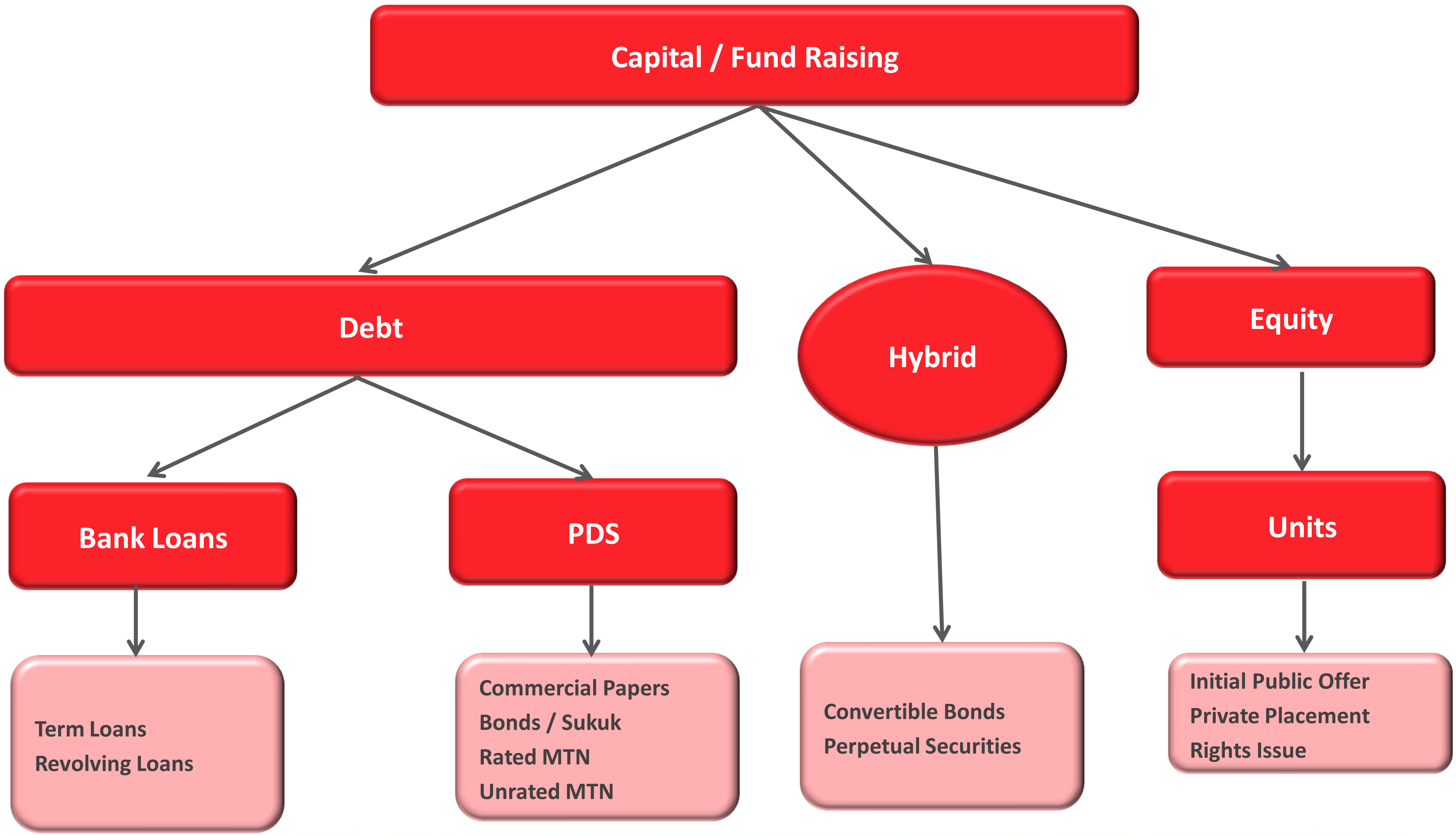
Optimisation of cost of capital
(WACC)

Diversification of sources of debt funding
(bilateral vs PDS)

Debt maturity profile management
(refinancing risk)

2. Financing Options

Financing Options



Considerations for raising capital

- Reliant on the objectives

Considerations	Objectives
Debt vs equity	-Yield pickup, speed to raise fund
Gearing Limits	- Debt covenants, SC Guidelines, Internal policy, debt headroom
Interest rate environment	-Vary gearing levels according to interest rate outlook -Managing the debt maturity profile and fixed vs floating rate profile
Equity market environment	NAV premium / discount, investors sentiment window

3. Gearing profile of a REIT

Gearing Profile of REIT

- Gearing Limits is capped at 50% by Securities Commission

- Based on Securities Commission's REIT Guidelines, total borrowings should not exceed 50% of the total asset value of the fund.

$$\text{Gearing Ratio} = \frac{\text{Total borrowings}}{\text{Total asset value}}$$

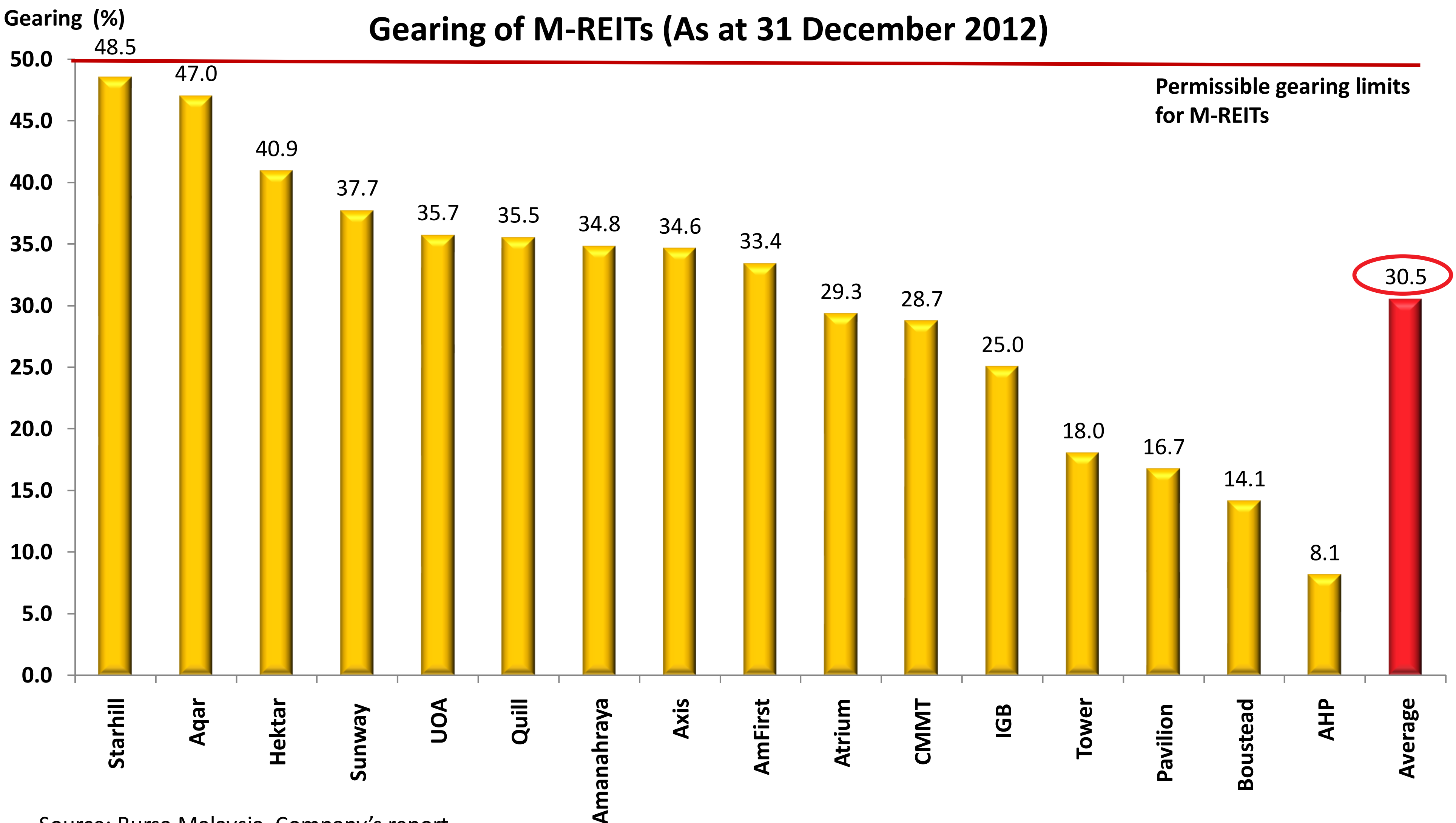
- The average gearing for M-REITs stood as 31% as at 31 December 2012. Investors are generally comfortable with gearing of up to the low 40%.

- High gearing is perceived to be taking higher risk and exposure to refinancing risk. Higher gearing leading to lesser debt headroom may also impede the speed of completing acquisitions when the opportunity arises.

- Higher gearing may face higher risk of breaching the gearing limits in the event of devaluation of assets.

Gearing Profile of REIT

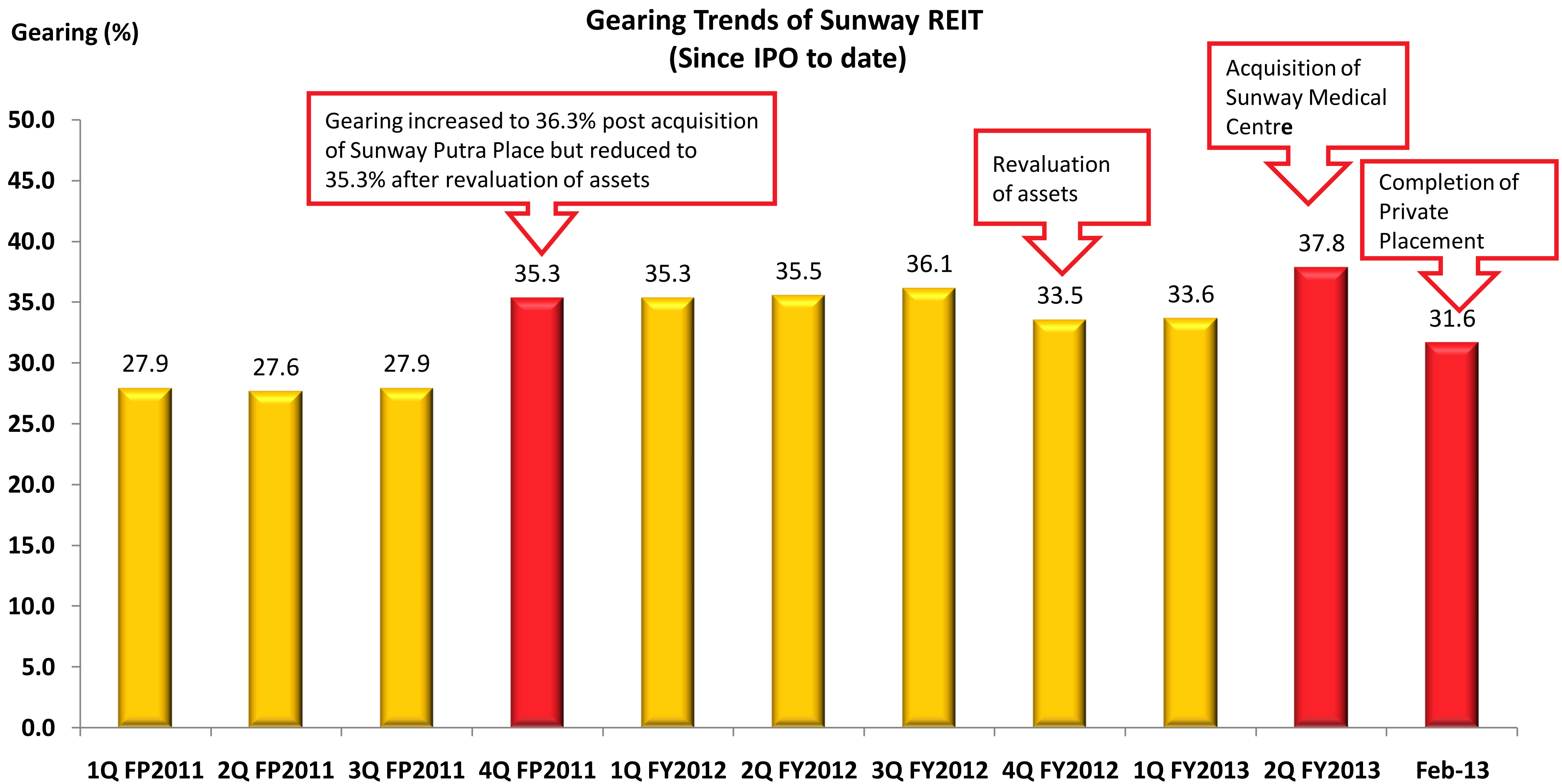
- M-REITs' average gearing stood at 31%; providing debt headroom for acquisitions



Source: Bursa Malaysia, Company's report

Gearing Profile of REIT

- Managing gearing to create larger debt headroom

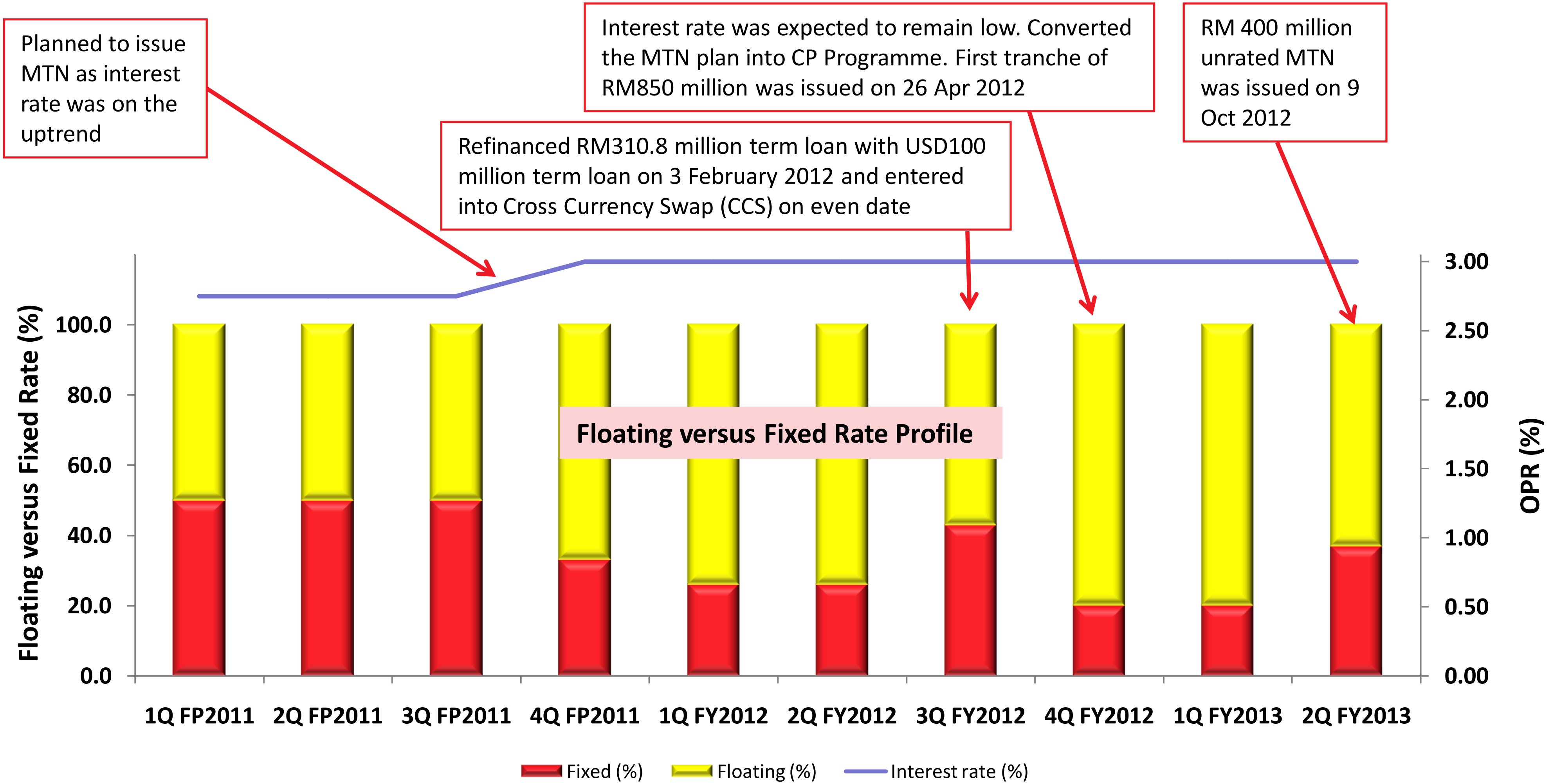


Source: Sunway REIT

- REITs with larger total asset size will have advantage in terms of debt headroom in the absolute term; facilitate large ticket size acquisition.

Gearing Profile of REIT

- Proactive Capital Management to exploit interest rate environment



- The manager plans to use interest rate swap (IRS) to gradually convert the floating rate into fixed rate in anticipation of interest rate hike.

4. Why gearing is important?

Why Gearing is Important?

- Advantages over equity financing

- Cost of debt is typically lower than cost of equity
- Non-dilutive to unitholders
- Yield pickup in the context of acquisition and capex
- Speed to raise fund

Why Gearing is Important?

- Financial leverage to increase yield accretion

Illustration of impact of financial leverage	New acquisition without financing 100% equity	New acquisition with financing (50% equity, 50% debt)
Investment outlay required for new asset acquisition (RM mil)	1,000	1,000
Equity (@ RM1 per Unit)		
- Existing equity (RM mil)	4,000	4,000
- New equity (RM mil)	1,000	500
Total equity (RM mil)	5,000	4,500
Debt on new acquisition (RM mil)	-	500
Income statement		
Net property income		
- Existing portfolio of assets (RM mil)	400	400
- New acquisition (RM mil)	100	100
	500	500
Less: Interest expenses @ 4% p.a (RM mil)	-	(20)
Net profit (RM mil)	500	480
DPU (sen)		
- Before acquisition	10.00	10.00
- After acquisition [1]	10.00	10.67
Increase DPU resulting from leveraged financing		6.70%
Dividend Yield (Market price=RM1.00)	10.00%	10.67%

[1] Assuming no yield accretion arising from 100% equity

5. Types of debt structures available to the Manager

Types of debts structures & Features

	Key features
Term Loan	- Most common secured debt structure. - Required debt service reserve account. - Fixed or floating rate.
Revolving Loans	- Short term debt and could be secured/unsecured. - Ability to drawdown up to facility amount within short time. - Commitment fee will be imposed. - Floating rate.

Types of debts structures & Features

	Key features
Commercial Paper (CP)	- Short term debt (CP maturity ranges from 1 to 12 months) - Rating from rating agency is required. - Once CP programme is established, the Issuer can issue CP at any time (usually within 1 to 2 weeks) up to the programme limit and up to programme maturity, subject to market demand and interest/coupon rate. - Issue at discount (the investor purchases CP at less than face value and receives the face value at maturity). - Cheaper source of funds compared to bank. - Highly liquid and transferable. - Backed by asset/liquidity or earnings of the Issuer. - Underwriting required by rating agency (for structuring purpose, may need to vary programme limit in accordance to funding requirement to minimise underwriting fee). - Floating rate usually benchmarked against bank's fixed deposit rate.

Types of debts structures & Features

	Key features
Rated Medium Term Notes (Rated MTNs)	- Medium to long term secured debt. - Rating from rating agency is required. - Once MTN programme is established, the Issuer can issue MTNs at any time up to the programme limit and up to programme maturity, subject to market demand and interest/coupon rate. - Required debt service reserve account. - Tradable in the bond market. - Different tranches of the LTV result in lower LTV with the same pool of assets but result in lower cost of debt compared to term loan. - Fixed coupon rate is usually benchmarked against MGS plus spread.

Types of debts structures & Features

	Key features
Unrated Medium Term Notes (Unrated MTNs)	- Medium to long term secured debt - Rating from rating agency and debt service cover reserve with bank are not required. - Once MTN programme is established, the Issuer can issue MTNs at any time up to the programme limit and up to programme maturity, subject to market demand and interest/coupon rate. - Cheaper source of funds compared to bank. - Not tradable in the bond market. - Lesser potential subscribers compared to Rated MTNs. - Fixed coupon rate is usually benchmarked against Rated MTNs and depending on market demand and supply.

Types of debts structures & Features

	Key features
Convertible Bond (CB)	- Convertible into a predetermined amount of the company's equity at certain times during its life, usually at the discretion of the bondholder. - From the investor's perspective, a convertible bond has a value-added component built into it; it is essentially a bond with a stock option hidden inside. - Given convertible feature of CB, it tends to offer a lower fixed coupon rate compared to a conventional bond in exchange for the value of the option to convert the bond into stock.
Perpetual Bond (PB)	- A bond instrument with no maturity date. - Given perpetual feature of PB, it may be treated as equity, not as debt. Therefore, gearing computation will not be affected. - Perpetual bonds pay coupons forever, and the Issuer does not have to redeem them. - PB's cash flows are, therefore, those of a perpetuity. - Higher fixed coupon rate compared to CB and MTNs.

Types of debts structures & Features

Islamic Papers

	Key features
Sukuk	- An Islamic financial certificate which closely resemble bonds except interest paying bond structure is not permissible under Islamic Law. - Sukuk can be issued for short term or long term. - The asset on which sukuk are based must be shariah-compliant. - Under sukuk, the Issuer sells an investor group the certificate, who then rents it back to the issuer for a predetermined rental fee. - The Issuer also makes a contractual promise to buy back the bonds at a future date at par value. - Ability to tap Islamic market.

Comparison of Debts Instruments

	Key features	Term loan	Rated Medium Term Notes (Rated MTNs) [1]	Commercial papers
1	Debt service reserve account (DSRA)	Usually 1 to 3 months of interest cover	Usually 3 to 6 months of interest cover	Not required
2.	Stamp duty on loan amount	Stamp duty of 0.5% on loan amount	Not required	Not required
3.	Loan-to-value (LTV)	Higher LTV Illustration: Assets value 5,000 LTV of 50% 2,500	Different tranches of the LTV result in lower LTV with the same pool of assets but result in lower cost of debt compared to term loan. Illustration: Assets value: 5,000 LTV - AAA rating @ LTV of 32% 1,600 - AA1 rating @ LTV of 34% 100 - AA3 rating @ LTV of 36% 100 - A1 rating @ LTV of 40% 200 - A2 rating @ LTV of 41.% 50 Overall LTV @ 41% 2,050	Lower LTV Illustration: Assets value 5,000 LTV of 45% 2,250
4.	Average interest rate	5-year term loan = 5% p.a * * Vary from bank to bank and the most common spread is 0.75% to 1.25% + Cost of Fund (COF) of bank.	5-year AAA Rated MTNs = 4%	1-month CP (P1) *=3.4 p.a% * Excluding underwriting fee

[1] Different MTN structure and REIT/organisation would have different LTV.

Different REIT may opt for different debt instrument depending on its objective, risk profile and desired capital structure.

Incorporating Derivatives into structuring of debt

Illustration of using IRS to convert floating rate borrowings to fixed rate borrowings

		At transaction date
Pay IRS 4-year fixed rate		3.40%
Receive 3-month KLIBOR		3.21%
Interest differential		0.19%
4-yr term loan (floating rate)		4.50%
Overall 4-yr term loan converted from floating rate to fixed interest rate via IRS	(a)	4.69%
4-yr term loan (fixed rate)	(b)	5.00%
Interest savings	(a)-(b)	**-0.31%**

- Potential lowering of overall cost of debt by using IRS to convert from floating to fixed rate borrowings.
- Other derivatives in the market include cross currency swap (CCS) to take advantage of the lower cost of borrowings in a foreign currency without exposure to forex risk

6. Structuring debt

Considerations in debt structuring

Types of debt	• The choice of debt depends on needs, rates, covenants, etc • Diversification in source of debts is crucial
Tenure	• The choice of tenure, short-term versus medium to long term in developing a staggered debt maturity profile
Floating vs fixed rate	• A strategy based on interest rate outlook. • If interest rate is expected to increase, a strategy to adopt is to lock in the debts under the prevailing low interest rate.
Debt maturity profile	• Staggering of debt maturity to avoid lumpiness in maturity which potentially lead to refinancing risk in adverse interest rate environment or even of credit tightening
Risk appetite	• The strategy adopted may reflect the level of risk appetite; eg. Plain vanilla debt papers versus use of derivatives, MTN versus CP which require proactive monitoring
Loan-to-value ratio (LTV)	• The ability to secure quantum of financing
Cost of issuance	• Stamp duty and other upfront cost

7. Advantages & drawbacks of balance sheet management strategies

Advantages and disadvantages of balance sheet management

- Managing gearing level and equity

Gearing	
Low Gearing	**High Gearing**
1) Higher debt headroom	1) Devaluation of assets will potentially breach the permissible gearing limits 2) Limited funding options 3) Refinancing risk in the event of credit tightening and interest rate hikes

Equity

Higher Unit in circulation (UIC) may potentially translates into :

1) Higher market capitalisation.
2) Higher investibility
3) Higher liquidity

8. Recent Innovation

Recent Innovation

- Hybrid financial instruments

- A hybrid financial instrument is an investment that blends characteristics of both debt and equity. The most common form of a hybrid instrument is **convertible bonds and perpetual securities**

Convertible Bonds

- A hybrid security that combines the characteristics of equity and bonds
- Provide the bondholder with an option to convert into a predetermined amount of the company's equity at certain point in time.
- Coupons for convertible bonds are lower than conventional bonds due to the conversion rights attached

Recent Innovation

- Convertible Bonds : A debt instrument with equity flavour

Convertible Bond (Unsecured)	
Alternative to equity	Alternative to debt
1) Reduced and delayed dilution to unitholders 2) Possibility of pricing units at a premium 3) Low cost of capital 4) Diversification of investors base	1) Low coupon cost 2) No credit rating requirement 3) Minimal covenants 4) Reduced refinancing risk at maturity if converted

- The dividend protection feature attached to CB will lead to adjustment to conversion price for all cash dividends above the pre-determined dividend yield.
- The quality of assets, ie cash flow generation will determine the coupon rate.
- Potential eventual dilution to existing unitholders upon conversion.

Recent Innovation

- Perpetual Securities:

Perpetual Securities

- A hybrid security with equity features that ranks senior to common equity
- No maturity or very long maturity and classified as equity and therefore gearing computation will not be affected. Hence, it is suitable for REITs with high gearing
- Typically, more expensive than debt due to the equity treatment feature.

Recent Innovation

- Perpetual Securities:

Perpetual Securities

Benefits

1) No implication on gearing level
2) No bank covenant
3) Non-dilutive to existing unitholders

- Drawback of perpetual securities include higher coupon cost

- In Malaysia, the penetration rate of hybrids financial instruments are low on the back of the depth and breadth of the market. Institutional investors' mandates are predominantly conventional assets (ie. equity, bonds) and ringgit denominated products).

Thank You

For further information on this presentation kit, please kindly contact:

Crystal Teh
Sunway REIT Management Sdn. Bhd.
(The Manager of Sunway REIT)
Email: crystalt@sunway.com.my
Contact: +603 5639 8864
Website of Sunway REIT: www.sunwayreit.com