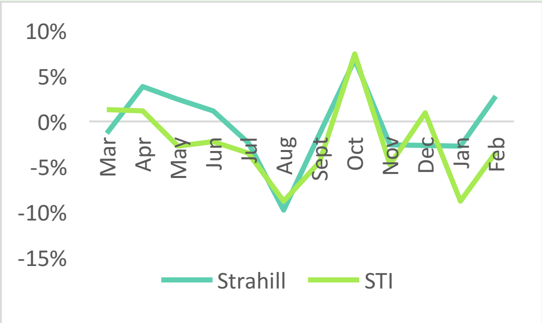
# *Starhill Global REIT*

**Target Price: 0.82 SGD (+10.8%)**

**14th February 2016**

| | |
|---|---|
| Last Closed Price: | 0.74 SGD |
| 12M Target: | 0.82 SGD |
| Upside Potential: | 10.8% |
| GICS Sector: | Real Estate |
| GICS Sub-Industry: | REIT |
| Bloomberg Ticker | P40U.SI |

**1Y Price v. Relative Index**




**Company Description**

Starhill Global REIT ("Starhill") is a Singapore-based real estate investment trust investing primarily in real estate used for retail and office purposes, both in Singapore and overseas.

**Key Financials**

| | |
|---|---|
| Market Capitalization (bil) | 1.60 SGD |
| Shares Outstanding (bil) | 2.181 |
| Free Float (%) | 62.80% |
| 52-Wk High | 0.890 SGD |
| 52-Wk Low | 0.695 SGD |
| P/E (ttm) | 13.61 |

| (USD mil) | FY13A | FY14A | FY15E | FY16E |
|---|---|---|---|---|
| Revenue (mil) | 201 | 295 | 222 | 238 |
| NPI (mil) | 158 | 238 | 173 | 187 |
| P/E (x) | 7.0 | 9.5 | 7 | 7 |
| P/B (x) | 0.87 | 0.89 | 0.77 | 0.77 |
| ROE (%) | 12.7 | 9.6 | 19.0 | 5.4 |
| DPU | 0.05 | 0.08 | 0.05 | 0.05 |
| Div Yield (%) | 6.5 | 10 | 7 | 7.2 |
| Gearing (%) | 28.7 | 35.4 | 34.7 | 34.6 |

**Key Executives**

| | |
|---|---|
| Chairman | Yeoh Sock Ping "Francis" |
| CEO | Ho Sing |
| CFO | Alice Cheong |
| Senior VP: Legal/Joint Secy | Lam Chee Kin |
| Senior VP: Investor Relations | Jonathan Kuah |

**Research Analysts:**

Ong Zi Hao

Woo Kai Mun Dennis

Wu Yuchen

Xu Chen

## Premium Assets owner

Starhill focused on acquiring and managing assets located at the prime area, it remains profitable despite the weak macro-economic environment globally with their special positioning at having high-end brands as tenants.

## Lacklustre Retail Demand

Affected by the weakening global economy, Singapore and its other major markets, such as Australia and Malaysia, are facing slower than expected growth. This had resulted in slower sales for the tenants, contraction in net the retail space absorption, as well as lesser tourist travelling to Singapore and Australia. Which all in turn, contributed less to consumption of the luxury products.

## Popularity of E-commerce

The rising popularity of e-commerce is no longer news to many investors; it channels relatively cheaper products from India and China to the rest of the world. Singapore itself has seen 50% of its online netizens making purchases online. In the recent years, even luxury physical stores are affected by these trends. According to McKinsey's, by 2020, a projected 20% of the total sales revenue to all the luxury brands will be earned through e-commerce platform.

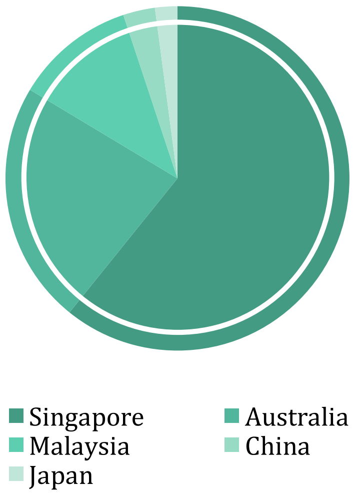
## Key Investment Risks

Weakening AUD/SGD and MYD/SGD remains a key issue to the overseas income segment of Starhill as, 30% of the group's portfolios are from the two countries. It is the same for the strengthening US interest rate which will draw investor's attention away from REITs to relatively safer assets. In the long run, despite the effort of hedging currency and interest rate risk through financial instruments, the long term general trend will still inevitably affect the group's earning.

## Valuation

Using multiple valuation models, including discounted dividend, discounted cashflow, and relative valuation methods, we have arrived at a base case intrinsic value of $0.82. Our upper and lower intrinsic value are $0.63 and $0.89 respectively. Our detailed methodology is described in the valuation segment.

**Figure 1. Revenue by Country**




*Source: Company Data*

## Company Overview

### Company Description

Starhill Global REIT ("Starhill") is a Singapore-based real estate investment trust investing primarily in real estate used for retail and office purposes, both in Singapore and overseas. Starhill remains focused on sourcing attractive property assets in Singapore and overseas, while driving organic growth from its existing portfolio, through proactive leasing efforts and asset enhancements.

### Revenue Breakdown

Starhill derives over 66% of its revenue from two prime real estate located along the high traffic Orchard Road of Singapore, namely Wisma Atria and Ngee Ann City. Additionally, over 90% of Starhill's revenue comes from Singapore, Malaysia and Australia. Hence, these are the three key geographical segments that we will analyse from.

### Economic Moat Analysis

Starhill have quality assets with strong fundamentals strategically located with high shopper traffic that attracts international luxury retailers. This is a source of economic moat – control of scarce resource (prime location). Given that Singapore constitutes over 60% of revenue, it is likely to generate sustainable rental income for shareholders.

Next, Starhill also have acquisition plans to expand its retail reach in the region by acquiring high end retail and office spaces. The latest acquisition was the Myer Centre Adelaide, Australia. This resulted in a 160% boost in revenue from Australia, up from $9.8 million to $25.7 million over a period of one year. We believe that acquisitions of strong assets will continue to spur growth in property income. In addition, it will strengthen Starhill's economic moat by controlling more scarce resource such as prime real estate.

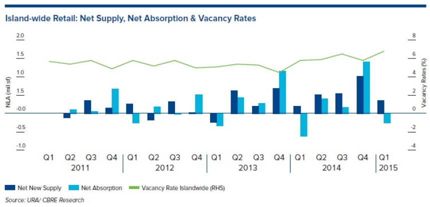
# Industry Analysis & Competitive Positioning

## Demand Drivers (Retail Segment)

### Overview: Lacklustre Retail Demand

According to the Urban Redevelopment Authority (URA), Singapore's annual island-wide net absorption for retail spaces declined 11.9% from 1.36 million sf in 2013 to 1.19 million sf in 2014. There was also a negative net absorption of 270,000 sf of retail space island-wide for Q1 2015. Furthermore, island-wide retail vacancy rates reflected a similar trend, with Q1 2015 numbers increasing 1.0% y-o-y to 6.8%. This is in addition to the general uptrend that island-wide retail vacancy rates have been for the past five quarters.

**Figure 2: Island-wide Retail: Net Supply, Net Absorption & Vacancy Rates**



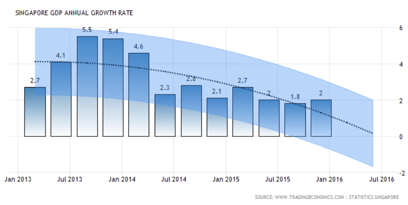

*Source: URA/CBRE Research*

Collectively, such trends converge and point towards a weakening demand and take-up rate in the retail sector. The softening retail industry in Singapore can be explained using a series of factors such as slowing economic growth, decreasing tourist arrivals, as well as the rising popularity of e-commerce spaces.

### Slowing Global Economic Growth

For the rest of the decade (till 2020), the Singapore economy is expected to grow at a slower-than-expected pace of 2-4% per year, as opposed to the 3-5% expansion calculated by the Ministry of Trade and Industry (MTI) previously. The trend of this data is also in sync with that of the forecasted global growth figures. The International Monetary Fund forecast that the world economy would grow at 3.4% in 2016 and 3.6% in 2017, both years down 0.2% from the previous estimates made. Slowing GDP growth implies weakened consumer sentiments; hence it is likely that there will be lesser demand for retail spaces over the next few years.

**Figure 3: Singapore GDP Annual Growth Rate**

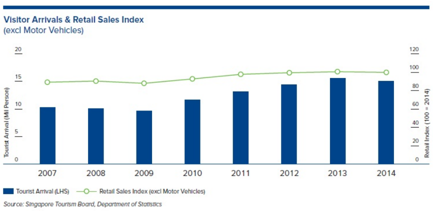



*Source: Statistics Singapore*

### Continued Softness in Tourist Arrivals

According to numbers from the Singapore Tourism Board (STB), tourist arrivals dipped 3.1% from 15.6 million in 2013 to 15.1 million in 2014. In addition, overall tourist numbers continued to decline in the first eight months of 2015, falling by 0.6% to 10.2 million as compared to the same period last year. This happened despite the STB's efforts in launching a $20 million global marketing campaign capitalising on Singapore's Golden Jubilee year and other promotional initiatives to attract tourists. The continued fall in tourist arrivals is likely to follow suit in the next few years and will have an adverse impact on the retail sector due to its close reliance on the tourism industry.

**Figure 4: Visitor Arrivals & Retail Sales Index**




*Source: Singapore Tourism Board, Department of Statistics*

### Growing Popularity of E-commerce

With online shopper penetration accounting for over 50% of local Internet users, the online retail market in Singapore is considered to be relatively advanced. Therefore, traditional brick and mortar retailers such as Watsons and Adidas are exploring digital strategies by launching online platforms to remain competitive and ride on the trend of online consumerism. This increasing popularity of e-commerce stands to be a threat to the demand of physical retail space since retailers are likely to slow down their expansion in the physical space as they divert resources to expand their online business.

## Industry Supply (Retail Segment)

### Overview: Increasing Total Retail Supply

From data tracked by CBRE Singapore, the total projected island-wide retail supply for the next four years from 2015 to 2018 is set to increase by approximately 4.20 million sf. Bulk of this new supply (57.4%) will be located in the Outside Central Region of Singapore. Increasing supply of retail spaces means that tenants are likely to have more choices when it comes to selecting

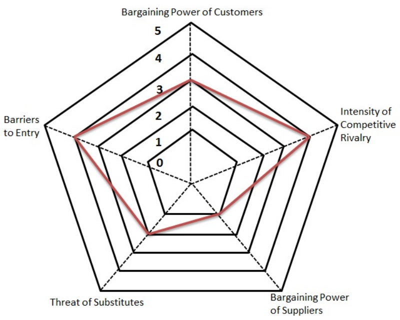
**Figure 5: Future Retail Supply**


*Source: URA, CBRE Research*

**Figure 6: Future Office Supply**


*Source: CBRE Research*

**Figure 7: Porter's Five Forces**




*Source: Team Consensus*

### Lack of New Completions in Orchard

Due to the lack of new completions in the next four years, fresh retail supply in Orchard is limited. Most of the new supply in the area will have to be added via asset enhancement initiatives (AEI) works on existing developments as landlords attempt to remain competitive and keep up with new trends. This also means that landlords in the Orchard vicinity retains higher bargaining power as compared to their peers in other areas due the limited supply of retail spaces in Orchard.

## Office Segment Overview

### Bearish Outlook on Overall Office Sector

Given the huge incoming wave of quality office spaces in 2016 (estimated to be 4.3 million sf worth of new office space), the office leasing market is set for challenging times ahead. With only an average annual demand of 1.2 million sf (calculated from last 10 years' data), overall office vacancy rates are forecasted to increase dramatically in 2016. Furthermore, office spaces in prime locations such as Orchard Road are expected to face additional downward pressures. This is due to a shift in demand from firms in the financial, telecommunication and technology sectors as they plan to consolidate their operations and re-locate to sub-urban locations and business parks to cut down on costs.

The expected surge of new office space supply, coupled with weaker demand in areas like the Central Business District (CBD) and Orchard Road, will shift the bargaining power of office space rentals in tenants' favour. This does not bode well for landlords like Starhill since they will have to settle for lesser rents.

## Competitive Landscape

### Mixed Prospects at Orchard: Falling Retail Rentals amidst Resiliency

Based on research data from DTZ, for the whole of 2015, average island-wide first-storey retail rentals fell at a faster pace of 5.9%, compared to the slower decline of 0.3% in 2014. In addition, the average monthly rent recorded in Q3 2015 is the lowest since the first quarter of 2006, further highlighting the declining nature of retail rents in Singapore. This situation is hugely driven by the fall of island-wide occupancy rate for retail spaces. Based on the Q2 2015 statistics from URA, island-wide occupancy rate for retail space continued its downward trend by falling another 0.4% to 91.8%.

With increasing amount of their retail spaces becoming available, landlords are now more inclined to renting out these spare spaces as compared to tenants demanding them. This shifts the bargaining power towards the tenants as they attempt to negotiate for a lower rental price.

Despite the overall trend that the retail industry is in decline, Starhill's portfolio is still holding up relatively well since retail spaces in the Orchard vicinity are supposedly more resilient as compared to that in other various regions across Singapore. While prime ground floor retail rents in the City Hall-Marina and the CDB areas fell by 4.5% from 2Q15 to 3Q15, average first-storey retail rents in Orchard Road saw a gentler decline by recording a fall of 3.5%. Rents in Orchard Road are slightly more resilient as the area remains highly sought after by many international brands such Coach, Tag Heuer. This is perhaps the only positive point for Starhill as it actively looks for ways to mitigate the effects of a weaken retail sector.

**Figure 8: Malaysia Ringgit Depreciation**


*Source: XE Currency*

**Figure 9: Australian Dollar Depreciation**


*Source: XE Currency*

## Lack of Suburban Exposure

Since they are less reliant on the tourism market, malls in suburban areas are expected to fare better as compared to malls in prime locations during uncertain economic times. With a portfolio dominated with retail and office assets in prime sites, Starhill's performance is expected to take a hit as we forecast weakening tourism arrivals in the near term.

## Maiden DPU Contribution from Recent Australia Acquisition

To diversify their earnings profile, landlords in Singapore are heading towards overseas markets in search of higher growth opportunities. One of the key markets being tapped into is the Australian market. In May 2015, Starhill acquired Myer Centre Adelaide for A$288m. Located in Adelaide's prime CBD retail core, this property contributes 620,000 sf of retail space and 98,000 sf of office space to Starhill's portfolio. With the inclusion of the Myer Centre Adelaide acquisition, Starhill's Australian income contribution is expected to more than double from 10% to 24%. Driven by this significant additional contribution from Myer Centre Adelaide, Starhill's DPU is expected to remain resilient in the near term despite slowing global economic growth.

## Unfavourable Foreign Exchange Rates

As landlords diversify into overseas markets, it is inevitable that they are exposed to the volatility of foreign exchange movements. Besides the properties in Singapore, Starhill's portfolio consists primarily of Australian and Malaysia assets. However, in recent years, both the Malaysian Ringgit and Australian Dollar have depreciated significantly against the Singapore Dollar. In September 2015, the Malaysian Ringgit hit a new low of 3.1248 against the Singapore Dollar. Similarly, the Australian Dollar hit a new low of $0.9973 in January 2016. If not for the depreciation of these currencies, Starhill's overseas portfolio would have performed slightly better and contributed more to the portfolio's overall DPU.

## Investment Thesis

### Strong DPU Growth From Acquisition and Local Portfolio

Starhill Global REIT's DPU has been increasing with a rate of 9% annually. In the recent quarter released, its gross revenue jumped 13.8% YoY to S$55.6m, which is contributed largely by its strong performance in its portfolio Singapore with new tenants at Wisma Atria Property and full occupancies at its offices spaces. One recent stand-out financial highlight of Starhill is the acquisition of Myer Centre Adelaide. This property locates in the CBD core of Adelaide and brings about a 121.6% increase in Starhill Global REIT's Australian portfolio's NPI. As a result, its DPU grew 2.3% in the last quarter to 1.32S cents.

### Weak Industry Forecast in Long Run

As elaborated in the industry analysis, the overall retail and office industries are not that positive from both the demand and supply sides. With decreasing demand of the retail rentals due to slowing down of global economic affecting the retail sector, the occupancy rate of the whole industry has been dropping accordingly. In addition, with more outlets constructed in the next few years outside the central region of Singapore, the demand will be further diluted. In the short run, due to lack of new completions, it seems that the lack of new completions in Orchard puts Starhill Global REIT in a relatively better position. However, in the long run, with waning demand concentrated in prime areas like Orchard, the high bargaining power Starhill Global has at Orchard may not be that significant.

### Greater Exposure to Currency Risk

As Starhill shows increasing interest into overseas market, indicated by its current acquisition of the Australian, it exposes itself to the fluctuation of the currency rates. Even though the rates may not necessarily be against the interest of Starhill Global REIT, the current trend of the two essential currency pairs, namely Australian Dollars and Malaysian Ringgit, tend to be downwards.

### Recommendations

Financially, Starhill Global REIT's presents an extremely attractive story from its DPU growth. Its overseas diversification also turns out to be rather successful so far. However, our group suspects that the temporary short run outstanding performance may eventually be offset by the shrinking demand. In addition, our group believes that its last year's financial should not be used as a basis for future projection. In the long run, as the retail sector shifts its focus from the traditional central areas such as Orchard, Starhill Global REIT will inevitably face a slowing down of its revenue driver.

Using a few valuation methods, we attempt to project the share value of Starhill Global REIT by projecting based on its FY2013 financial data.

Overall, our recommendation for now is a **HOLD**.

## Valuation

Valuation Target Price: **S$0.82** Recommendation: **HOLD**

**Table 1**: DCF Summary

| DCF Summary | |
|---|---|
| WACC | 8.12% |
| Exit Multiple | 15x |
| Imp. Perpetuity Gr. Rt. | 3.33% |
| Imp. EV/EBITDA | 9.7x |
| Current EV/EBITDA | 17.5x |

*Source: Analyst Consensus, Bloomberg*

**Table 2**: WACC Analysis

| WACC Inputs | |
|---|---|
| Cost of Debt | 3.03% |
| Tax Rate | 3.27% |
| Risk Free Rate (BBB-) | 4.43% |
| STI Risk Premium | 6.00% |
| Levered Beta | 0.73 |
| Size Premium | 1.5% |
| **WACC** | **8.12%** |

*Source: Analyst Consensus, Bloomberg*

### Valuation Overview

A number of valuation methodologies were used in deriving a target price for Starhill. This includes a 10 year DCF, dividend discount model, relative multiples using P/E, P/B and EV/EBITDA. The valuations are summarized in the chart below.

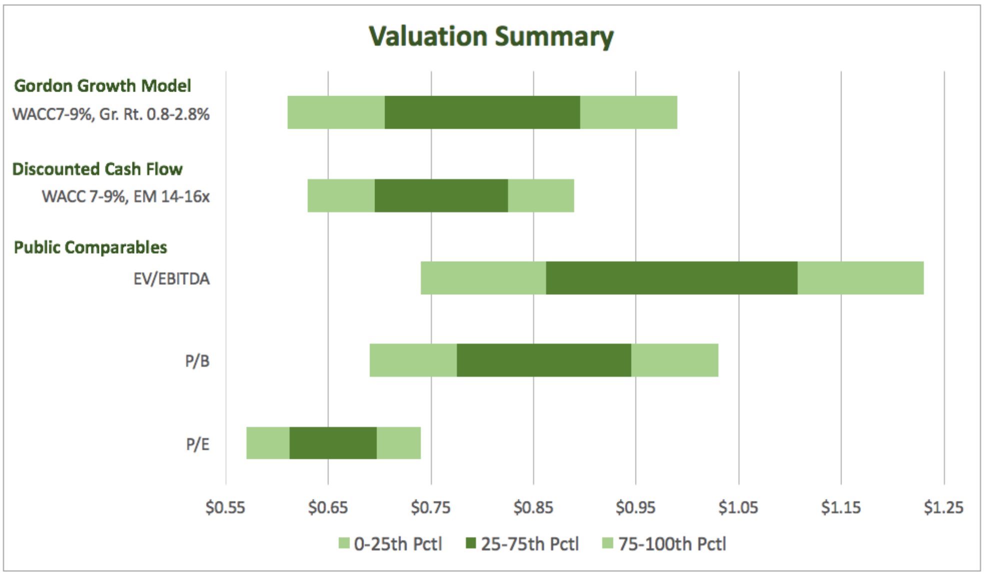



*Figure 11: Valuation Summary*

### Gordon Growth Model

As a property REIT, Starhill is required to pay a constant and high amount of its income to its unitholders. Therefore, it makes discounted dividend model a proper evaluation method to estimate Starhill's intrinsic value on top of the DCF model covered. Similarly with the DCF model, a 10 year forecast based on Y2013 is used to predict its annual DUP. Due to change in its internal accounting scheme; we chose not to use the current year's dividend value as the basis of our projection.

With an average of 96% of income distributed, and an average of 1% increase in its number of units held by investors, we believe that a 1.85% dividend growth rate is a reasonable, and a conservative, estimation of the future dividend prospect. The relatively lower growth rate than the CAGR of its income is due to the increase of total number of units. Eventually, using the DDM, we believe an intrinsic value of $0.80 is a good gauge.

### Discounted Cashflow Model

A 10 year discounted cashflow analysis was used to estimate the intrinsic value of the company due to predictability of cashflow in relation to growth and profitability by virtue of being a REIT. By referring to table 1, a WACC of 8.12% and an exit multiple of 15x yielded an output of $0.76, which is marginally higher than the current market price of $0.74. The DCF output implied a perpetuity growth rate of 3.33%, which is in line with industry's growth and overall economic growth in Asia. Additionally, the same inputs results in an implied EV/EBITDA of 9.7x which is significantly lower than the current EV/EBITDA of 17.5x. Overall, this gives us greater confidence in our DCF model output. That said, our team understands that DCF model is as much of an art as it is a science, hence key input variables such as WACC and exit multiple are sensitized to produce a range of outputs from $0.63 - $0.89.

**Table 3**: Public Comps Summary

| Range | P/E | P/B | EV/EBITDA |
|---|---|---|---|
| **Min** | 11.3x | 0.75x | 10.8x |
| **Mean** | 12.9x | 0.89x | 13.2x |
| **Max** | 14.6x | 1.11x | 15.0x |

*Source: Company Annual Report*

**Table 4**: Final Target Price

| **Blended Median Price** | |
|---|---|
| Gordon Growth Model | 0.80 |
| Discounted Cashflow | 0.76 |
| **Absolute Valuation** | 0.78 |
| *Weightage* | *50%* |
| EV/EBITDA | 0.99 |
| P/B | 0.86 |
| P/E | 0.66 |
| **Relative Valuation** | 0.86 |
| *Weightage* | *50%* |
| **Final Price Target** | **S$0.82** |

*Source: Analyst Consensus*

## Weighted Average Cost of Capital (WACC) Analysis

Based on the annual report, the cost of debt is 3.03% based on a blended yield of debt instruments that the company owes. The tax rate was derived by averaging income tax payments as percentage of total returns over the past 3 years. Given that Starhill's credit rating is at BBB-, the risk free rate was based on BBB- bond yield. A relatively low size premium of 1.5% was given due to the implied stability of a REIT's earnings and low risk. This results in a WACC of 8.12% as seen in table 2. The target capital structure is 30% debt and 70% equity. Given that Starhill does not intend to change its capital structure in the foreseeable future, the same ratio was used to project over a period of 10 years. Due to the uncertainty and inaccuracy of WACC inputs and its correspondingly large impact on intrinsic value calculation, WACC was sensitized with a range of 7.12% to 9.12%.

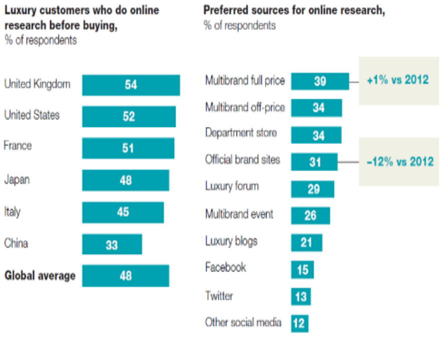
## Public Comparables

The companies used as peers for comparables are Suntec REIT (T82U) and CapitaLand Mall Trust (C38U). This two companies are selected to represent different characteristics of Starhill. Firstly, CapitaLand Mall Trust is a retail REIT but focuses on heartland malls instead. Next, Suntec is an office REIT that focuses on prime real estate. Despite the differences in business model, these two companies are the closest to Starhill REIT hence used as comparables. The metrics used for relative valuation are P/E, P/B and EV/EBITDA ratios. Overall, the average intrinsic value from relative valuation is $0.86.

## Valuation Final Target Price

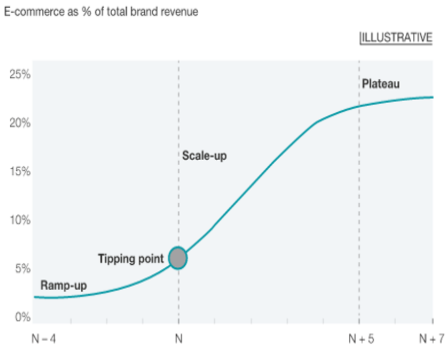
The final target price was derived by blending the median price for relative valuation and absolute valuation methods and assigning a 50% weightage respectively to derive a value of $0.82, as shown in table 4.

**Figure 10**: Frequency of consumer searching information about Luxury Product online




*Source: Pew Research Centre, McKinsey 2015*

**Figure 11**: Online Sales of luxury goods may triple in the next decade




*Source: McKinsey 2015*

## Key Investment Risks

### Threat from E-commerce.

Not only are the general products that are facing threats from the e-commerce platform, the luxury products having the same fate. When questioned during AGM 2015, on the impact of online platforms to Starhill's retail portfolio, the CEO replied that e-commerce is only supplementary as many of the Starhill's tenants are luxury brands, such as Louis Vuitton, Chanel, Hugo Boss, etc. He believed although customers are more inclined to search information Online, but they will prefer a tangible visit to the store for customized experience. The McKinsey's 2015 research confirmed this argument, however, it also pointed out Online sales for Luxury brands already reached a 'tipping point' of 7% of the brand revenue, and will scale up to double by 2020. Many of the merchants already started revamping their websites and actively react to any changes. E-commerce will indeed become the competing ground for the luxury products and pose a threat to the Offline stores.

### Currency Risk and Interest Rate Risk

Apart from the most recent acquisition of Myer Center Adelaide, Australia, the group is considering further enhance their portfolio in Australian commercial property market. Starhill believes that the weakening AUD/SGD proved beneficial in required acquisition capital outlay, in short, it is cheap to make purchase of any Australian asset. However, due to the effect of aforementioned long term down trend in AUD/SGD and MYD/SGD, this may translate into a smaller profit as the company's financials are based on SGD. Moreover, the increase in interest rate will divert the funds from investor to safer assets such as USD and Gold from REIT.

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