DIVING INTO REITs

BY **KUEK SER KWANG ZHE**

Datuk Stewart LaBrooy has played a pivotal role in the development of the local real estate investment trust (REIT) industry. He led the country's first REIT — Axis REIT — to a listing in 2005.

Today, he continues to be involved in the industry, where one of his roles is chairman of Alpha REIT Managers Sdn Bhd. Alpha REIT, the country's only unlisted REIT, focuses on the education sector and has plans to be publicly listed in the near future.

LaBrooy began his career in the 1990s as an engineer who designed home appliances such as refrigerators and air conditioners. He was general manager of Kee Huat Industries Bhd, a manufacturer of electrical appliances, before joining Jotun Powder Coatings Sdn Bhd as its general manager.

"Datuk [Abas] Carl Gunnar [Abdullah], managing director of Jotun (formerly known as Corro-Coat (M) Sdn Bhd), wanted to venture into the property sector and I got involved in it. With other partners, he came up with one of the first build-to-lease strategies in the 1990s and built a factory next to where Carlsberg is today. The factory was leased to a company for 15 years," says LaBrooy.

"It was a hugely bankable business and we started to buy tracts of land in Petaling Jaya. These included the land on which Crystal Plaza and Menara Axis are sitting on. We bought another tract next to Crystal Plaza, but had to sell it when the 1997/98 Asian financial crisis hit. We also built the first industrial park in Shah Alam. I was part of the team and was in charge of building up the real estate."

With Crystal Plaza, Menara Axis, Axis Plaza, Axis Business Park and Infinite Centre under their portfolio, Abas and his partners decided to list Axis REIT on the local bourse in 2005 to monetise the assets. LaBrooy became executive director of Axis REIT Managers Bhd, the manager of the REIT.

LaBrooy was appointed CEO of Axis REIT Managers three years later. Under his leadership, its total assets grew from about RM726 million to more than RM2.14 billion, with 34 properties in its portfolio, when he retired as CEO in 2015.

An investor who bought shares in the REIT during this period and reinvested all of his dividends would have enjoyed a total return of 195%, according to Bloomberg. During his tenure as CEO, the REIT was the first in the industry to be shariah-compliant.

LaBrooy earned a good reputation among industry observers for his ability to manage and grow Axis REIT. "He is one of the most knowledgeable people in the country when it comes to REITs," says an investment analyst who wishes to remain anonymous.

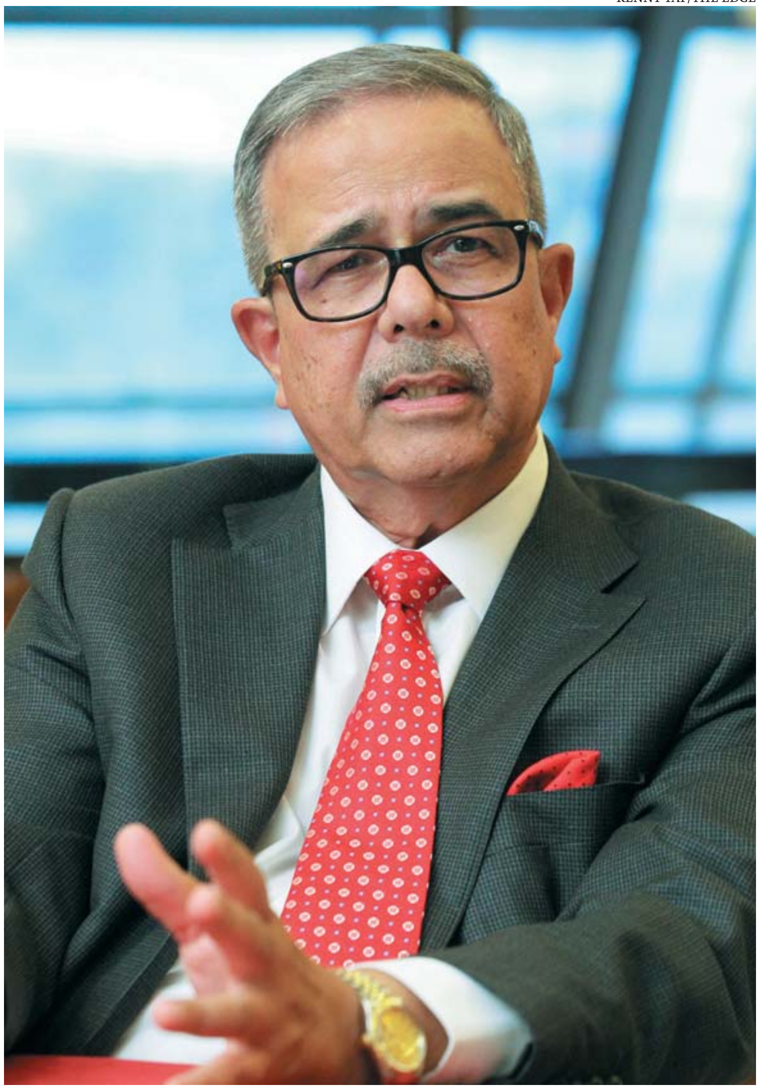
A fund manager agrees. "He used to chair analyst presentations for Axis REIT and was fully capable of taking difficult questions," he says.

LaBrooy founded the Malaysian REIT Managers Association (MRMA) in 2010 and served as its chairman for five years. The association serves as a platform for the local REIT industry to develop common standards and benchmarks against international best practices.

LaBrooy relinquished his position as chairman of MRMA in 2016, but he continues to remain active on the REIT scene.

He took on the role of chairman of Alpha REIT Managers in 2017. Alpha REIT, which was established in June that year, aims to grow aggressively and is on track for a listing, says Alpha REIT Managers CEO Shireen Iqbal, who was handpicked by LaBrooy to drive the REIT in October last year.

KENNY YAP/THE EDGE



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> > ***LaBrooy***

Alpha REIT currently owns the real estate assets that house the Sri KDU International School, International School @ Park City and Eaton International School. Its assets under management (AUM) stood at RM417 million as at Feb 26, representing a year-on-year growth of 18%, according to Shireen. The distribution per unit has grown about 17%.

Shireen says that while she is unable to disclose the actual rate of return, it is "very comparable" with the returns provided by public-listed REITs. "Revenue is about RM35 million now. We started with about RM6 million in 2017. We have a few projects in the pipeline and we will list Alpha REIT on the market when we have an AUM of at least RM1.5 billion."

When that happens, it will be the first public-listed education REIT in the country to provide investors with a defensive, long-term play amid an already defensive real estate industry. For now, only institutional investors can invest in Alpha REIT, says Shireen.

LaBrooy is also executive chairman of AREA Management Sdn Bhd. The firm is a subsidiary of AREA Advisors Pte Ltd, a regional real estate private equity and advisory firm incorporated in Singapore.

AREA Management undertakes management projects for the AREA Industrial Development Fund-1, a private equity fund. According to its website, the fund's mandate is to build industrial and logistics assets with a focus on Malaysia. The US$150 million fund was closed in July 2015. Its portfolio comprises industrial buildings and parks as well as built-to-sell and built-to-lease assets.

LaBrooy says the AREA Industrial Development Fund-1 has built the biggest e-commerce hub in Kuala Lumpur, known as AREA Logistics @ Ampang. According to its website, it is the country's first three-storey ramp-up inner-city mega distribution hub with a net lettable area.

"The e-commerce hub is unique and built for the future of e-commerce, not the past. We are now looking at other projects in the Klang Valley," he says.

DO NOT CHASE YIELDS

Having spent decades in the property industry, LaBrooy has held on to a few principles throughout his career which he believes could serve as a gentle reminder for real estate investors. His first principle? Do not chase yields.

"Do not buy for the sake of yield. You can end up buying really bad real estate when someone is willing to pay you an attractive rent just to sell it to you. Many people have fallen into this trap," says LaBrooy.

"Just like Warren Buffett's famous quote, you should buy an asset that you are happy to leave there for the next 10 years, instead of buying bad real estate."

Instead, he says, it is important that investors take a forward-looking stance to identify good real estate and be one of the "early movers". "It goes back to a quote [I cited in one of Axis' previous] annual reports: 'Do not wait to buy real estate, but buy and wait'. It means if you are convinced about your investment and you buy now and wait, the real estate value can go up a lot over time.

"But if you are unsure and are waiting for a better time to come, prices could have already become expensive. As an investor, do your research and jump in early."

LaBrooy says investors should buy smart and invest in assets that provide long-term value. He cites the example of how Axis REIT invested in the past. As a REIT manager, it tended to lock in tenants with long leases of typically 10 years to reduce investment risk and have a more stable stream of rental income. It also acquired strategic assets that the tenant would usually hang on to and not let go.

"For instance, we invested in warehouses in strategic locations. In the early days, warehouses were easily filled up and logistic companies would never give up them up unless they go bust due to bad management. It is a generic product and fits everybody's needs. You do not need to customise it that much," he says.

One example is the logistics facility in Klang known as the Bukit Raja Distribution Centre. Axis REIT was able to acquire it during the 2008 global financial crisis, says LaBrooy.

"We were doing our due diligence on the warehouse in 2007 and wanted to buy it. Then, the crisis struck and all the bids were off. The deal was put on hold and we could not get it done.

"However, we went back to the owner a year later and asked if he was ready to sell the warehouse to us. The owner said it would be sold to an American investor, who would take 12 months to complete the deal. I said we could do it in 30 days as we did all our research the previous year. We managed to fulfil our promise.

"We made a nice profit on it. The real estate spanned 17 acres in the heart of Klang and the owner sold the property to us at a very good price. That gave us a yield of about 8%.

"This is what I mean. You have to buy smart and buy stuff that gives you long-term value."

NOT A FAN OF LEVERAGE AND PERPETUAL BONDS

The use of leverage is unavoidable in real estate investments. However, investors should always be prudent when doing so and not get addicted to it, says LaBrooy.

"Never listen to [American billionaire businessman and philanthropist] Sam Zell who says, 'Leverage is my favourite beverage'. You can have a low-yielding asset and borrow a lot of cheap money to fuel your business.

"For example, a fund buys a property for RM100 million that yields 7% (RM7 million) a year. The fund raises an interest-only debt for 80% (RM80 million) of the value of the property and puts in 20% equity, or RM20 million.

"Let's say the bank charges an interest rate of 4.5%. So, the bank requires payment of RM3.6 million (RM80 million x 4.5%) per annum. Under this interest-only loan, the fund gains RM3.4 million a year (RM7 million minus RM3.6 million). This equals to a very high return of 17% for the fund.

"That is what happened during the global financial crisis. Many companies had highly leveraged balance sheets with minimal equity. When the financial markets crashed in 2008, the banks called in their loans. The companies could not refinance their loans to pay the banks and the banks foreclosed on the assets. The investors lost all of their capital."

For the same reason, LaBrooy does not like perpetual bonds (also known as perps), which companies — including local REITs — can issue to raise funds from the market.

To put it simply, perps are bonds issued with no maturity date. This means the issuer can choose to pay coupons forever without the need to return the capital. The uncertainty of when investors will get back their principal means that these are usually offered at a higher yield. The no-maturity-date feature makes perps hybrid securities as they are debt securities with an equity-like feature.

In fact, perps are usually recognised as equity rather than debt under the International Financial Reporting Standards. This means perps allow companies that have already hit their debt ceiling (local REITs have a gearing limit of 50% of their total assets) to continue raising funds from the market without increasing their liabilities on their balance sheets.

"Based on how it works, it is basically a debt. But it is allowed to be shown as equity in the books because it does not have to be repaid yet. However, what it does carry is a trigger. Typically, every five years, there will be a step up in the interest rate. And unless you redeem the perps, you will face an ever-increasing financing cost," says LaBrooy.

"Also, the rate is fixed. When the market drops, you can borrow cheaper elsewhere. But you still have to keep serving those perps [at a high rate if you have not redeemed them].

"So, yes, it is a form of leverage. It makes your balance sheet look pretty with low gearing. But that is not the true picture. It allows you to blow your gearing limits and take on more debt.

"There is no control. If you are taking that kind of extreme view and borrow too much, you will be serving this monster debt one day and hopefully, you do not lose control."

Another thing that LaBrooy does not like about perps is that it would put the company's shareholders at a disadvantage. "Of all the income the company makes, bondholders get paid first. What is leftover is then distributed to the shareholders. And shareholders hate that," he says.

"In my philosophy of running any business, including REITs, unitholders [who are shareholders] are the people to look after first. They are my clients and customers who put their money on the line [with us]. They need to be treated with the most respect. We take care of them by making sure the investment returns we provide reflect their interest.

"A company can raise funds through equities in the market instead of perps. Yes, it is more expensive to do this and you have to work harder. But that should be the way going forward. You do not need perps."

LaBrooy recalls an incident that happened five years ago when an investment bank in Singapore approached him at Axis to issue a perp. "Not to be disrespectful to people who use perps, but this incident was five years ago. They gave us a presentation on perps and I told them that I would not touch this. [When the market goes down,] these can come and bite you in the ass."

THE IMPORTANCE OF SUCCESSION PLANNING

Another thing LaBrooy wants to share with investors is the importance of having a succession plan for the company's top management. This is an essential factor that will help the company grow in the long term and continue generating good returns for its investors.

One of the things LaBrooy is proud of during his tenure as CEO of Axis REIT Managers was identifying Leong Kit May as his replacement before stepping down in 2015. "Axis was listed a year before my retirement age. I was 54 years old. I was employed on a contract basis after that and had been on the lookout for a successor. That is something some companies do not do very well," he says.

"I started grooming my successor from my seventh year [as CEO]. If you do not groom them and they continue to stay longer and get better, they will become so good that someone else pinches them. Then, what will you get out of this? There will be a huge gap between you and the next generation of management."

LaBrooy is a huge believer in promoting from within, instead of "parachuting in" a CEO from the outside. He says this is particularly important in the REIT industry. "I am a huge believer in this. It is a very specialised industry and the people who work for you need to understand the dynamics of the industry. We should have a successor from the real estate or finance side to head the company.

"Kit May was very good at financing and she understands the real estate side of the industry. So, I told her very early on that I intend to leave. I wanted to go and do other things and that she would take over." E

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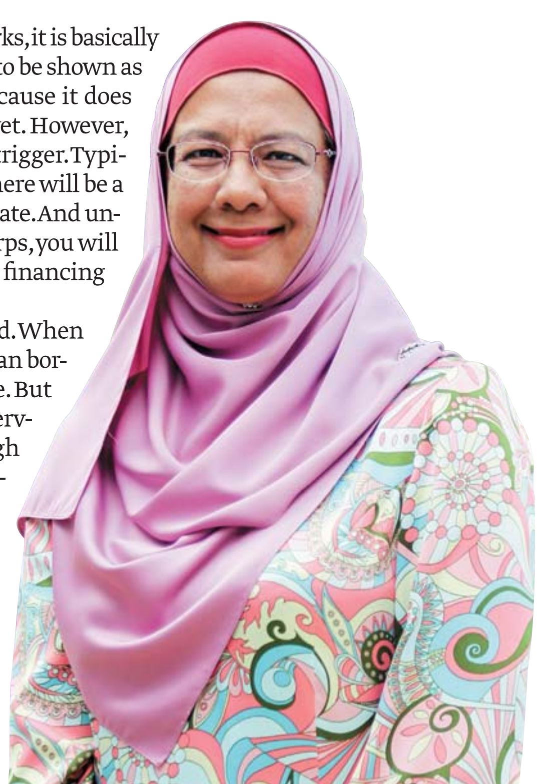

Market outlook

Datuk Stewart LaBrooy, chairman of Alpha REIT Managers Sdn Bhd and executive chairman of AREA Management Sdn Bhd, says 2020 is proving to be one of the most worrying years in more than a decade. Locally, political uncertainties have spooked investors while globally, supply chains are being disrupted due to the Covid-19 outbreak. "These factors have contributed to falling stock markets and things are pointing toward a global recession," he adds.

However, the good news is that real estate investment trusts (REITs) have continued to dish out dividends to investors. "REITs have thrived in such uncertainties as they have long leases and reliable cash flows. Investors rush to park their money in REITs when the profits of companies in other industries become uncertain. The high cash payouts of REITs are much sought after and their prices are driven up," says LaBrooy.

"Despite the local stock market falling over the past month, REIT prices have not been affected. Instead, they have bucked the trend and risen."

He points out that six REITs are currently traded at a premium to their net asset value. These are IGB REIT (82.9%), Axis REIT (33.3%), Pavilion REIT (31.5%), Sunway REIT (16.7%), KLCC Property Holdings Bhd (11.2%) and Al-'Aqar Healthcare REIT (7.2%).

The other 12 REITs are trading at a discount to their net asset value, he adds. "Many of these REITs have been performing at these levels for many years. [Regardless of their share price to net asset value], all of them share a common characteristic. They manage to maintain their dividend yields despite a rising share price, which means the total amount of dividends distributed to investors has been rising year on year."

LaBrooy expects a consolidation to take place in the REIT industry. "The REIT sector is a bipolar market. There are large-cap stocks that are doing well and can acquire assets. There are also those with high gearing ratios and are being traded at a huge discount to their net asset value, with unitholders demanding high yields," he says.

"In the case of the latter, it means that their ability to raise funds and buy assets is almost impossible. Their growth in assets and dividends has hit a brick wall and their performance will languish at the current levels. They also tend to have a small market capitalisation of less than RM500 million.

"The smaller-cap REITs should look at consolidating their portfolios through mergers. This is already happening in Singapore and it is a matter of time before it happens here. It will be positive for the market."