

Real Estate

Sector update

- Embassy Office Parks REIT (BUY)
- Mindspace Business Parks REIT (BUY)
- Brookfield India REIT (ADD)
- DLF (ADD)

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INDIA

Real Estate

REITs: On the cusp of a rebound

Indian REITs saw strong rental collections of over 99% in Q1FY22 and were able to achieve healthy re-leasing spreads along with contractual escalations. However, overall portfolio vacancy levels increased by another 100-200bps QoQ owing to continued Work-from-Home and second Covid wave leading to deferment of leasing decisions by occupiers. While vacancy levels may rise further in Q2FY22, we expect this trend to reverse from H2FY22E assuming that the pick-up in vaccinations is accompanied by a gradual return to offices. Factoring in incremental vacancy levels rising by 200-300bps in H1FY22 and building in a recovery towards the end of Q3FY22 (Dec'21), we expect the three REITs (Embassy/Mindspace/Brookfield) to offer distribution yields of 6-9% over FY22-24E along with 12-18% capital appreciation as per current Isec target prices. While a rise in global interest rates is the key risk, cumulative potential returns of 20-24% provides adequate valuation cushion, in our view.

- ▶ **Vacancy levels rise further by 100-200bps in Q1FY22:** Post the onset of the first Covid wave in India from Mar'20 (Q1CY20), pan-India Grade A vacancy levels across India's top 7 cities have risen by over 300bps till June'21 (Q1FY22) to 16.6%. In line with industry trends, portfolio vacancy levels had risen by 400-600bps on same-store basis for Embassy REIT, Mindspace REIT and DLF in FY21 while Brookfield REIT retained flattish occupancy levels in H2FY21. This was owing to exits by tenants for scheduled expiries and early exits as well. In Q1FY22, overall portfolio vacancy levels increased further by 100-200bps QoQ on same-store basis for Brookfield REIT, Mindspace REIT and DLF, while Embassy REIT retained flattish occupancy levels.
- ▶ **Recovery on the cards from H2FY22:** While the second Covid wave may lead to further rise in vacancy levels in Q2FY22, we expect this trend to reverse from H2FY22E assuming that vaccinations pick up accompanied by a gradual return to offices and possible pick up in international travel. Commentary from REIT managers and other large office developers indicate that leasing discussions which were on hold owing to the second Covid wave have now been revived again with existing occupiers talking about potential expansion and tenants who were looking to surrender space earlier looking to retain and possibly expand space.
- ▶ **REITs offer attractive yields of 6-9% over FY22-24E:** We have factored in a fall in occupancy levels of 200-300bps for the REITs in FY22E but expect the same to reverse by the end of Q3FY22 (Dec'21) with a full-fledged recovery from FY23E. We expect the three REITs to offer distribution yields of 6-9% over FY22-24E along with 12-18% capital appreciation as per current target prices. While a rise in global interest rates is the key risk, cumulative potential returns of 20-24% provides adequate valuation cushion, in our view.
- ▶ **Conversion of ZCBs to coupon bearing debt to optimally impact Embassy REIT yields:** The Embassy REIT had issued zero-coupon bonds (ZCBs) of Rs36.5bn in May'19 at an annual coupon of 9.3%. While these ZCBs were due for maturity in Jun'22 and the REIT manager's earlier intent was to refinance these as a ZCB on maturity (amortized cost of Rs47bn), the REIT manager has now indicated its intent to convert these ZCBs into a coupon bearing debt in Nov'21 at ~7% annual coupon. While our revenue/NOI/SPV NDCF estimates remain unchanged, the conversion of Rs45bn of ZCBs (fully amortized cost) to a coupon bearing bond will result in lower REIT NDCF distribution of Rs1.4bn in FY22E (Rs1.5/unit) and Rs3.2bn each in FY23E and FY24E (Rs3.3/unit).

Table 1: Brookfield, Mindspace and Embassy REIT Qualitative Comparison

| Details (as of June 2021) | Brookfield India REIT | Embassy REIT | Mindspace REIT |
|---|-----------------------|---------------|----------------|
| Completed Area (msf) | 10.3 | 32.3 | 23.8 |
| Total Area (msf) | 14.0 | 42.4 | 31.2 |
| Committed Occupancy (%) | 89.0% | 88.8% | 84.4% |
| Top 10 Tenants as % of Rentals | 75.0% | 38.0% | 38.6% |
| Geographic Presence (as % of overall area) | | | |
| Mumbai Metropolitan Region | 11.0% | 4.7% | 41.0% |
| Bengaluru | 0.0% | 63.7% | 0.0% |
| Hyderabad | 0.0% | 0.0% | 40.4% |
| Pune | 0.0% | 20.8% | 16.0% |
| NCR | 49.0% | 0.0% | 0.0% |
| Kolkata | 40.0% | 0.0% | 0.0% |
| Others | 0.0% | 10.8% | 2.6% |
| Total | 100.0% | 100.0% | 100.0% |
| In-place Portfolio Rentals (Rs/psf/month) | 65.0 | 71.0 | 57.1 |
| Weighted Average Lease Expiry (WALE) in years | 6.3 | 6.9 | 6.6 |
| Call option/ROFO Assets from Sponsor (msf) | 15.0* | 34.0 | 8.6 |

Source: Company, Isec research, includes identified + ROFO properties for Brookfield India REIT

Table 2: Brookfield, Mindspace and Embassy REIT Financial Metrics

| All figures in Rs mn Details | Brookfield REIT | | | | Embassy REIT | | | | Mindspace REIT | | | |
|-----------------------------------|-----------------|--------------|--------------|--------------|---------------|---------------|---------------|---------------|----------------|---------------|---------------|---------------|
| | FY21* | FY22E | FY23E | FY24E | FY21 | FY22E | FY23E | FY24E | FY21* | FY22E | FY23E | FY24E |
| Area Details: | | | | | | | | | | | | |
| Completed Area (msf) | 10.3 | 10.4 | 10.4 | 11.0 | 32.3 | 33.3 | 35.2 | 37.3 | 23.9 | 24.8 | 25.7 | 26.5 |
| Under Construction/Upcoming (msf) | 3.7 | 3.6 | 3.6 | 3.0 | 10.1 | 9.1 | 7.2 | 5.1 | 6.3 | 6.4 | 5.5 | 4.7 |
| Total Area (msf) | 14.0 | 14.0 | 14.0 | 14.0 | 42.4 | 42.4 | 42.4 | 42.4 | 30.2 | 31.2 | 31.2 | 31.2 |
| Financial Metrics: | | | | | | | | | | | | |
| Revenue | 8,628 | 9,267 | 11,022 | 11,359 | 23,603 | 27,264 | 32,512 | 39,216 | 16,293 | 17,106 | 20,662 | 24,131 |
| Net Operating Income (NOI) | 6,600 | 7,036 | 7,826 | 8,364 | 20,324 | 22,901 | 27,905 | 33,342 | 13,741 | 13,790 | 16,701 | 19,348 |
| EBITDA | 6,077 | 6,678 | 7,309 | 7,820 | 18,508 | 21,458 | 25,874 | 31,884 | NA | 12,564 | 15,164 | 17,467 |
| PAT | 3,912 | 4,207 | 4,659 | 5,011 | 6,984 | 6,523 | 8,103 | 12,810 | NA | 5,560 | 6,694 | 7,851 |
| Net debt/equity (x) | 0.2 | 0.2 | 0.3 | 0.3 | 0.4 | 0.4 | 0.5 | 0.6 | 0.2 | 0.3 | 0.3 | 0.4 |
| NDCF at REIT level | 4,914 | 6,030 | 6,873 | 7,171 | 18,364 | 20,303 | 20,621 | 22,980 | 5,687 | 10,463 | 11,621 | 12,389 |
| NDCF - Interest % | 94.3% | 73.1% | 60.8% | 54.5% | 34.0% | 32.7% | 33.2% | 30.4% | 9.4% | 8.5% | 7.5% | 14.2% |
| NDCF - Dividend % | 1.5% | 5.6% | 7.6% | 14.8% | 14.0% | 31.6% | 36.2% | 37.6% | 90.6% | 91.5% | 92.5% | 80.1% |
| NDCF - Principal repayment % | 4.2% | 30.2% | 31.5% | 30.6% | 52.0% | 35.7% | 30.6% | 32.0% | 0.0% | 0.0% | 0.0% | 5.7% |
| Distribution/Unit (Rs) | 16.2 | 19.9 | 22.7 | 23.7 | 21.5# | 21.4# | 21.8 | 24.2 | 9.6^ | 17.6 | 19.6 | 20.9 |
| CMP (Rs/Unit) | 261 | 261 | 261 | 261 | 347 | 347 | 347 | 347 | 293 | 293 | 293 | 293 |
| NDCF Yield (pre-tax) | 6.2% | 7.6% | 8.7% | 9.1% | 6.2% | 6.2% | 6.3% | 7.0% | 6.5% | 6.0% | 6.7% | 7.1% |
| Target Price/NAV (Rs/Unit) | 293 | | | | 415 | | | | 341 | | | |

Source: Isec research estimates. * Brookfield and Mindspace FY21 financial metrics given for representation purposes only, ^For 6 months in FY21 from October 2020 to March 2021, #For Embassy REIT we have assumed conversion of Zero-Coupon Bond (ZCB) to coupon bearing bond from Q3FY22 and assumed number of shares prior to ETV acquisition which was done in Dec'20

Lease expiries the key monitorable in FY22E

Post the onset of the first Covid wave in India from Mar'20 (Q1CY20), Grade A vacancy levels across India's top 7 cities have risen by 3-8% till June'21 (Q1FY22). Among these, the Hyderabad market has seen the highest rise in vacancy levels from 5.5% in Q1CY20 to 14.0% in Q2CY20 as a combination of tenant exits and large completions/supply has contributed to this rise in vacancies.

In keeping with the industry trend of rising vacancies post onset of Covid, Indian REITs and large office developers such as DLF saw strong rental collections of over 98% in FY21 and were able to achieve double digit re-leasing spreads along with contractual escalations. A dampener was reduction in overall portfolio occupancy levels by 400-600bps on like-to-like basis for Embassy REIT, Mindspace REIT and DLF while Brookfield REIT retained flattish occupancy levels in H2FY21. This was owing to exits by tenants for scheduled expiries and early exits as well.

In Q1FY22, overall portfolio vacancy levels increased further by 100-200bps QoQ on like-to-like basis for Brookfield REIT, Mindspace REIT and DLF, while Embassy REIT retained flattish occupancy levels in Q1FY22. While the second Covid wave may lead to further rise in vacancy levels in Q2FY22, we expect this trend to reverse from H2FY22E assuming that vaccinations pick up accompanied by a gradual return to offices and possible pick up in international travel.

Commentary from REIT managers and other large office developers indicate that leasing discussions which were on hold owing to the second Covid wave have now been revived again with existing occupiers talking about potential expansion and tenants who were looking to surrender space earlier looking to retain and possibly expand space.

Table 3: Grade A vacancy levels across cities have risen since onset of Covid in Q1CY20

| City Vacancy | Q1CY20 | Q2CY20 | Q3CY20 | Q4CY20 | Q1CY21 | Q2CY21 |
|----------------|--------------|--------------|--------------|--------------|--------------|--------------|
| MMR | 19.8% | 18.8% | 19.8% | 20.9% | 21.1% | 22.1% |
| NCR | 23.1% | 24.0% | 24.0% | 25.1% | 26.4% | 26.6% |
| Bengaluru | 6.3% | 6.5% | 8.0% | 8.1% | 9.0% | 9.3% |
| Chennai | 9.4% | 9.3% | 9.1% | 11.7% | 11.4% | 11.4% |
| Hyderabad | 5.5% | 6.7% | 8.3% | 8.4% | 13.0% | 14.0% |
| Pune | 4.0% | 5.5% | 5.9% | 7.2% | 6.7% | 6.5% |
| Kolkata | 33.9% | 33.5% | 32.5% | 32.7% | 32.3% | 32.2% |
| Overall | 13.5% | 13.8% | 14.5% | 15.2% | 16.2% | 16.6% |

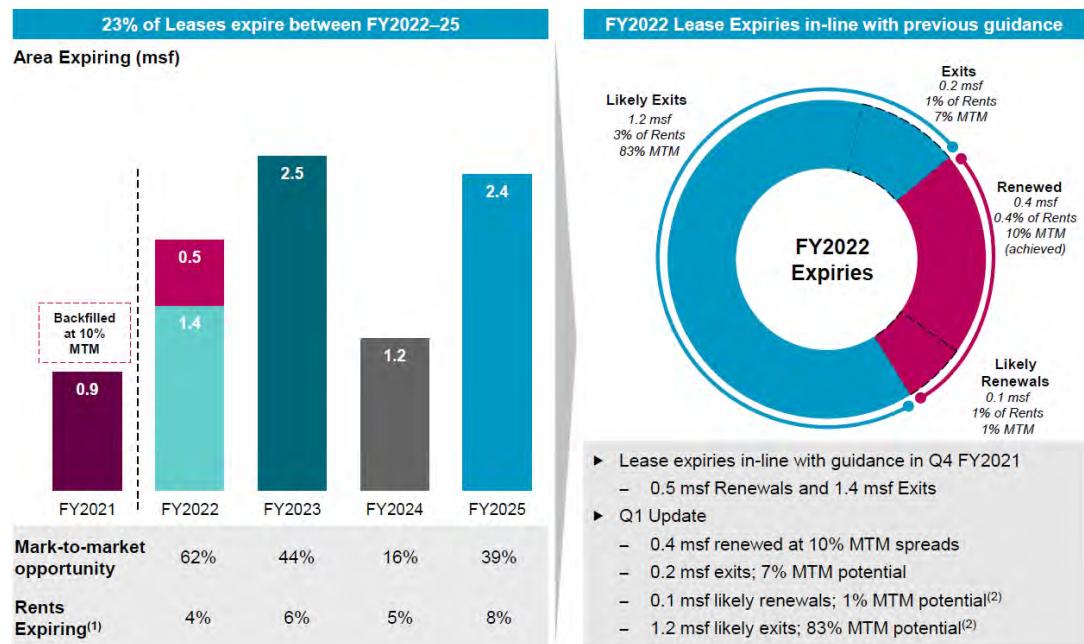
Source: Cushman & Wakefield, I-Sec Research

Table 4: REITs and Developers' vacancy levels have also risen post Covid

| Developer Portfolio Vacancy | Q1CY20 | Q2CY20 | Q3CY20 | Q4CY20 | Q1CY21 | Q2CY21 |
|-----------------------------|--------|--------|--------|--------|--------|--------|
| Embassy REIT* | 7.2% | 7.8% | 8.3% | 9.4% | 11.1% | 11.2% |
| DLF** | 5.0% | 6.0% | 7.0% | 10.0% | 12.0% | 14.0% |
| Mindspace REIT | NA | NA | 12.9% | 14.7% | 18.2% | 19.7% |
| Brookfield India REIT# | NA | NA | 8.0% | NA | 9.0% | 11.0% |

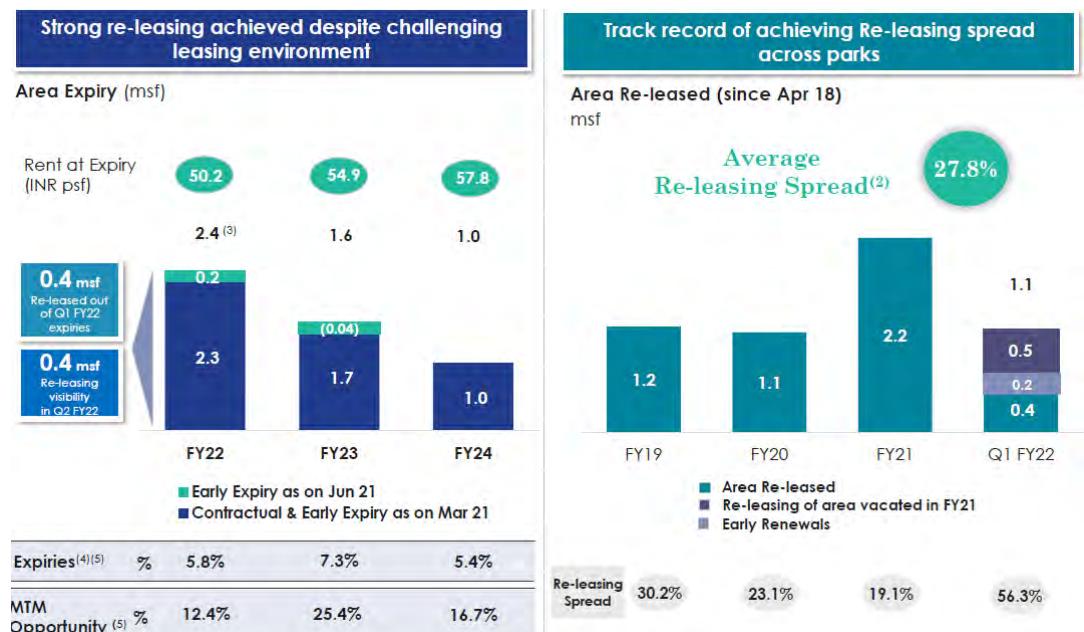
Source: Companies, I-Sec Research, *From Q4CY20 includes Embassy Tech Village asset, **Cyber Park & Chennai- Block 11 considered as Completed in FY21, #Same-store vacancy

Chart 1: Embassy REIT Lease Expiry Profile



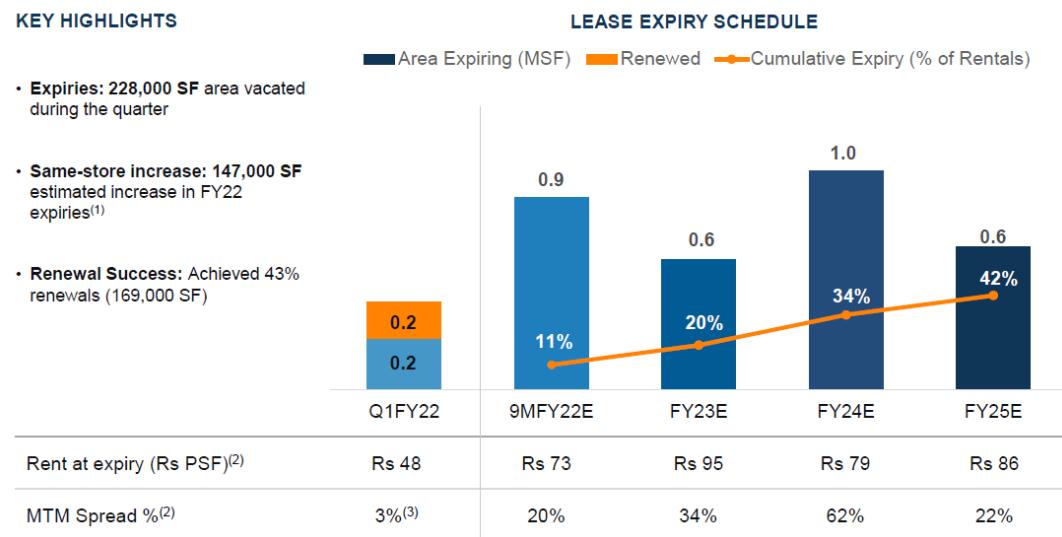
Source: Company, I-Sec research, (1) Refers to annualized rent obligations; (2) MTM potential for likely renewals and likely exits computed basis market rent per latest CBRE estimate and in-place rent for respective leases

Chart 2: MREIT REIT Lease Expiry Profile



Source: Company, I-Sec research, (1) Excluding 0.36msf area under re development at 1A and 1B; (2) Re-leasing spread includes spread on extensions and vacant area; (3) Excludes early re leasing of 175,000sf during the quarter; (4) Gross rent as % of total rent of Completed Area as of 30 Jun 21; (5) FY22 data pertains to 1.3 msf expiries between Q2 Q4 FY22

Chart 3: Brookfield REIT Lease Expiry Profile



Source: Company, I-Sec Research, (1) Based on on-going discussions with occupiers. BREIT will provide updated renewal guidance as and when it concludes its ongoing discussions, (2) Excludes amenity areas and area vacated in Q1FY22, (3) Re-leasing spread on renewed area, lower primarily due to large share being contributed by K1

Appendix: Indian office market scenario

Indian office market: Awaiting a recovery

The Indian Commercial Real Estate (CRE) office market saw record leasing in CY19 with 42msf of annual net absorption. The office market has been in a upcycle over CY14-19 with rising rentals, falling vacancies, consolidation among developers and emergence of REITs. At the beginning of CY20 (January 2020), the outlook was bright with healthy pre-leasing for upcoming supply. However, the evolving global situation owing to the Coronavirus (COVID-19) has led to CY20 net office absorption of 20msf in which is a 50% YoY decline. We look at the key areas of impact on demand and supply of offices in India:

- **Leasing may see an uptick towards the end of Q3CY21:** Until the global Covid-19 concerns reduce, corporates will relook at their space requirements in CY21E and expansion or consolidation plans will be put on the backburner. Given the fact that 30-40% of Indian office space demand originates from the USA, a prolonged economic slowdown in the USA will likely lead to reduced demand for offices in H1CY21. While CY20 was a weak year with 20msf of net absorption owing to Covid-19 impact, we expect net absorption to gradually improve and we build in net absorption of 21.7msf in CY21E and 28.3msf in CY22E. We expect leasing activity to pick up from Sep'21 as international travel may pick up again along with effective Covid-19 vaccines. We believe that cumulative net office absorption of 80msf over CY21-23E compares well with overall upcoming Grade A supply of 114msf over the same period of which 20-30% may be shelved as it is speculative supply, leading to effective supply of 80-85msf.
- **Demand for flexible office places to rise:** The COVID impact has led to companies having to shift to the Work from Home (WFH) model. Commentary from corporates increasingly indicates that they would try to replicate the WFH model over the long term, especially in the case of IT/ITeS companies that account for 40-50% of overall Indian office demand. However, the efficacy of WFH over an extended period of time vs. a traditional full-service office model is yet to be proven.
- **Limited number of developers capable of building quality rental assets:** Unlike the residential market which has relatively lower entry barriers in India, the Indian office and mall market is a capital-intensive business requiring developers to have adequate balance sheet strength. Further, the trend has now shifted to office campuses with larger plot layouts which require adequate planning. The few notable names are DLF, Embassy Office Parks REIT, Mindspace Business Parks REIT, Brookfield India REIT, Prestige Estates, Brigade Enterprises, RMZ Corp and The Phoenix Mills.
- **High quality talent pool and affordable rentals in India:** India leads in STEM (Science, Technology, Engineering, Mathematics) talent for technology assignments with over 2 million students graduating each year. Further, employees' costs in India would not be more than 20-25% of comparable cost for employees in the occupier's country of origin. India remains one of the more affordable office markets in the world, with average rentals for Grade A office markets in peripheral/suburban micro-markets hovering around 1 USD/psf/month or Rs70-75/psf/month. Further, with rental costs for MNC occupiers being just 2-

3% of their revenues, GICs may remain sticky tenants over the long term. Globally MNC occupiers typically enter into long-term tenancy contracts with office developers for 8-10-year periods with a contracted rental escalation of 15% every 36 months. They also invest at least Rs3,000-4,000/psf for fit-outs for their offices in addition to the contracted rentals keeping in mind the longer tenure of their leases.

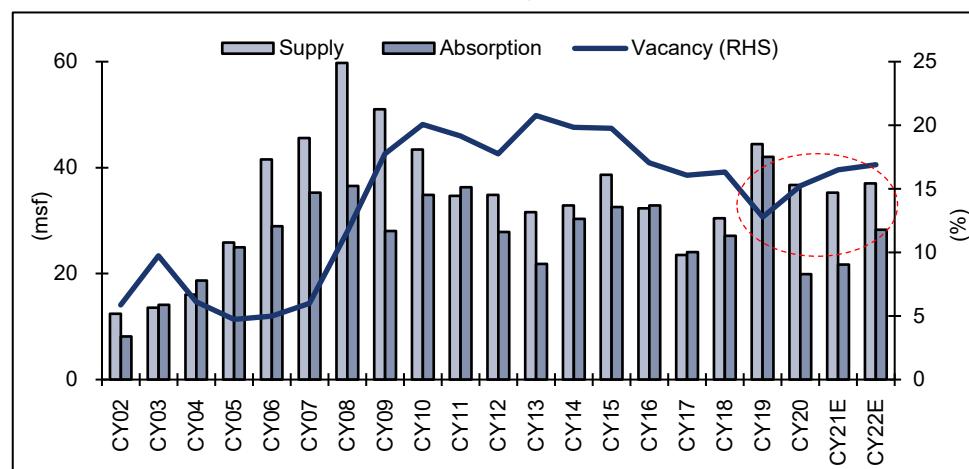
- **REITs have emerged as a potent asset monetisation tool:** With three REIT listings in India, the door has been opened for more potential REIT listings from FY22E onwards. With India having 491msf of occupied Grade A office stock as of March 2021 and global institutional investors continuing to invest in annuity assets, we expect more REIT listings over the next 2-3 years. Developers in our coverage universe such as DLF, Phoenix Mills and Oberoi Realty have already highlighted their medium-term plans to consider a REIT listing. Further, large annuity portfolio buyouts in FY21 such as Blackstone buying out Prestige Estates' office and mall assets and Brookfield's acquisition of RMZ's office portfolio points to consolidation in favour of institutional landlords for annuity assets.
- **DDT rollback a key positive:** In February 2020, the Government of India's (GoI) 2020 Union Budget had proposed to impose a Dividend Distribution tax (DDT) on REIT investors which had dampened sentiment for REIT investors. Although the proposed DDT had negligible near-term impact as the Embassy REIT has been paying out distributions mostly in the form of interest and capital return, numerous representations by industry stakeholders has prompted the GoI to rollback the proposed DDT on REITs in March 2020. However, this waiver is on the condition that REIT SPVs will not move to the new tax regime (of lower tax rate).

Net absorption/demand may pick up from H2CY21E

Until the global COVID-19 concerns reduce and international travel picks up again, the expansion or consolidation plans of corporates may be delayed by another 6 months. Given the fact that 30-40% of Indian office space demand originates from the USA, a prolonged economic slowdown in the USA may likely lead to reduced demand for offices in CY21E.

While CY20 was a weak year with 20msf of net absorption owing to Covid-19 impact, we expect net absorption to gradually improve and we build in net absorption of 21.7msf in CY21E and 28.3msf in CY22E. We believe that cumulative net office absorption of ~80msf over the next three years (CY21-23E) compares well with overall upcoming Grade A supply of 114msf over the same period of which 20-30% may be shelved as it is speculative supply, leading to effective supply of 80-85msf.

Chart 4: India annual absorption-supply of offices and forecast



Source: Cushman & Wakefield, I-Sec Research estimates

Bengaluru and Hyderabad remain the key markets

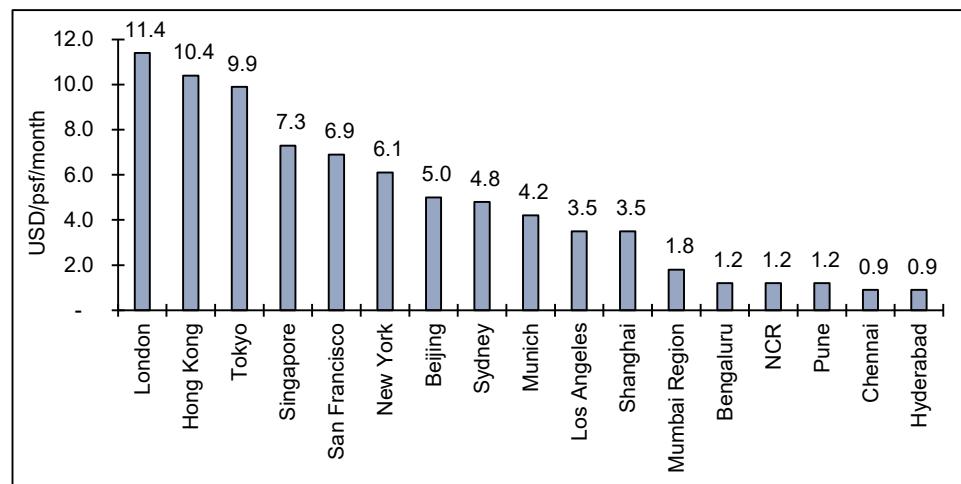
- Pre-COVID, Bengaluru had low Grade A vacancy of 5% and accounted for ~22% of net absorption of office space in CY19. We expect Bengaluru market to retain more than 25% of net absorption over CY21-22E.
- Pre-COVID, the Hyderabad market clocked record annual absorption of 4.9msf in CY17 and 6.0msf in CY18. Vacancy levels for Hyderabad also fell to 7% in CY18 from 18% in CY14. In CY19, Hyderabad has seen record net absorption of 9.3msf and is now on par with leasing levels seen in Bengaluru. However, with fresh supply infusion of 13.3msf over Q1CY20-Q2CY21 (Jan'20-Jun'21) and corresponding net absorption of 7.0msf, Grade A vacancy levels have risen to 14% in Jun'21 from 5.5% in Jan'20. Going forward, we expect the Hyderabad market to continue to clock annual net absorption of 5-6msf annually.
- Kolkata and non-CBD regions of Gurugram continue to suffer from supply glut where current vacant office space is expected to take at least 24-36 months to be absorbed.

Table 5: India Grade A office stock vs. vacancy

| City (Jun-21) | Stock (msf) | % share of stock | Vacancy (%) | Occupied space (msf) | % share of occupied stock |
|----------------|--------------|------------------|-------------|----------------------|---------------------------|
| MMR | 103.4 | 18% | 22% | 80.5 | 16% |
| NCR | 122.2 | 21% | 27% | 89.7 | 18% |
| Bengaluru | 158.2 | 27% | 9% | 143.5 | 29% |
| Chennai | 53.8 | 9% | 11% | 47.7 | 10% |
| Hyderabad | 69.9 | 12% | 14% | 60.1 | 12% |
| Pune | 55.0 | 9% | 7% | 51.4 | 10% |
| Kolkata | 26.2 | 4% | 32% | 17.8 | 4% |
| Overall | 588.7 | 100% | 17% | 490.8 | 100% |

Source: Cushman & Wakefield, I-Sec Research

Chart 5: Indian cities remain the most affordable for office rentals globally

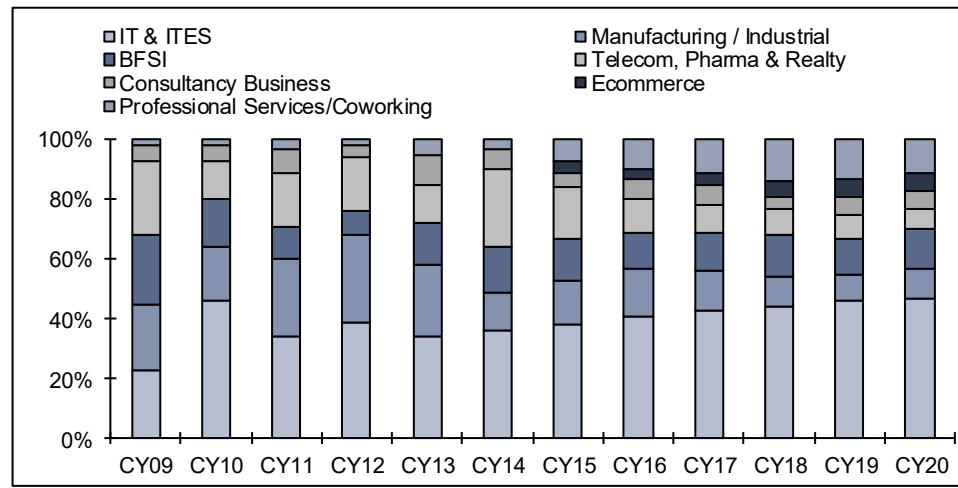


Source: Cushman & Wakefield, I-Sec Research

Two-third of India office demand driven by MNCs

IT-ITES sector has remained top-most in terms of share of office occupancy across major Indian cities. The sector maintains its lead with 35-40% share in office occupancy. While there has been a noticeable slowdown in absorption by E-Commerce companies, they only accounted for 3% of demand in CY17.

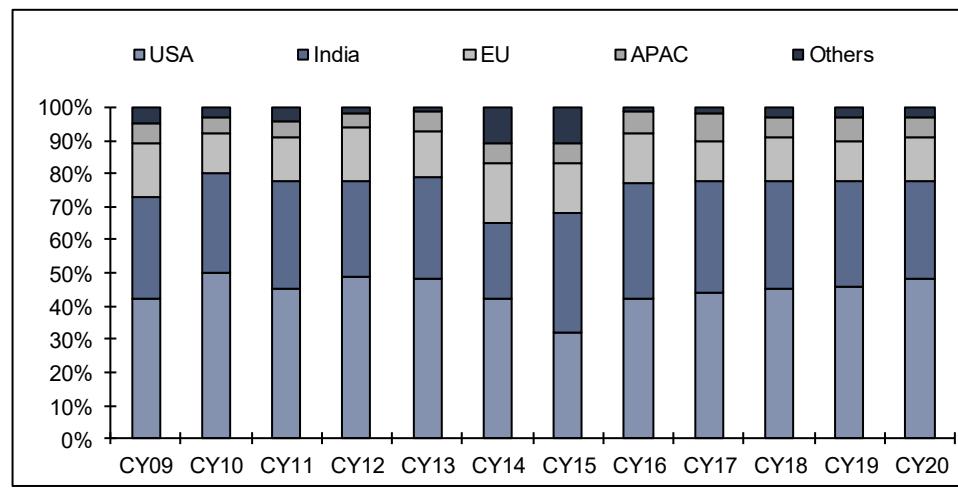
Chart 6: India office absorption by sector



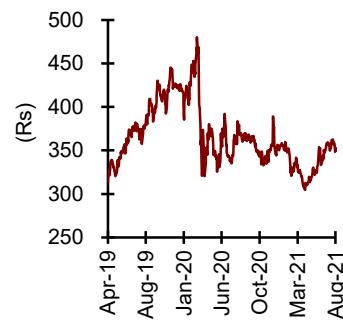
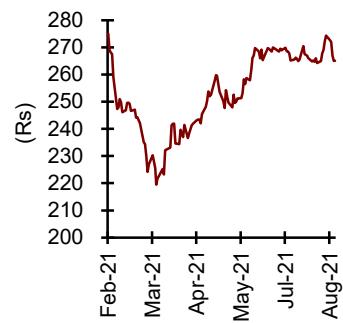
Source: JLL India, I-Sec Research

In CY16, share of leasing by US-based firms jumped up to 42% from 32% in CY15 led by expansion of companies such as Amazon, Microsoft, Google. Domestic firms continue to account for a third of demand. Incrementally, we expect this trend to continue as majority of office expansion, especially in the IT/ITES segment, is being driven by Global In-House Captives (GICs).

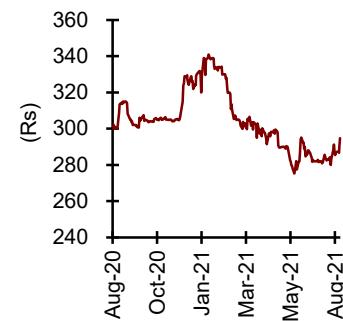
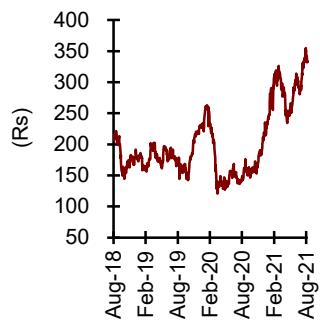
Chart 7: India office absorption by country of origin of the occupier



Source: JLL India, I-Sec Research

Price chart**Embassy REIT****Brookfield REIT**

Source: Bloomberg

Mindspace REIT**DLF**

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