

# Starhill REIT

Most liquid but lacking aggressive growth strategy relative to peers

- **Initiate with OW:** We initiate coverage on Starhill REIT with an OW rating and a Dec-07 price target of M\$1.30. With an asset size of M\$1.28B, Starhill REIT consists of 4 properties in the Golden Triangle—Starhill Gallery, Lot 10 (both retail malls), the JW Marriott Hotel, and ‘The Residences’ service apartments.
- **Share price drivers:** (1) As the most liquid proxy to the sector (market cap is 2.6x the next biggest M-REIT), Starhill will benefit from any withholding tax cuts on dividends. (2) Slight upward rental rate revision in FY08 is expected as sub-leases, which account for 67% of Starhill Gallery’s total NLA, initially signed with Autodome are novated back to the REIT. (3) The group’s unique/niche mid- to high-end retail malls will benefit from rising tourist arrivals and consumption spending, as well as potential long-term upside in turnover rents (1% of revenue currently) as rentals for more new tenancies are being fixed based on a base rent plus profit share.
- **PT, risks:** The stock is trading at a 17% discount to our DDM-based Dec-07 PT of M\$1.30 (implying a 4.2% FY08E yield vs. the 10-year government bond yield of 3.6%). Key risks to our PT: unexpected fluctuations in interest rates which could significantly affect cost of capital, and unexpected deterioration in Malaysia’s retail/hospitality sector environment.

Reuters: SRHL.KL; Bloomberg: STRH MK

M\$ in millions, year-end June	FY06*	FY07E	FY08E	FY09E
Revenues	81.2	95.0	108.0	113.2
Net profit	57.4	69.3	81.7	86.9
EPU (M\$)	5.52	6.56	6.93	7.37
DPU (M\$)	5.52	6.56	6.93	7.35
Net cash (debt)	-82.0	-49.2	-35.3	-29.7
Debt (% of total assets)	18%	15%	15%	14%
Revenue growth (%)	N/A	17.0	13.7	4.7
EPU growth (%)	N/A	18.7	5.7	6.3
DPU growth (%)	N/A	18.7	5.7	6.3
ROE (%)	5.6	6.3	6.8	6.9
P/E (x)	19.6	16.5	15.6	14.7
Prem/(Disc) to NAV (%)	4.7	2.3	-0.5	-5.4
Dividend yield (pre-tax) (%)	5.1	6.1	6.4	6.8
Dividend yield (post-tax) (%)	4.1	4.9	5.1	5.4
Dividend payout ratio (%)	N/A	100	100	100
	4Q06	1Q07	2Q07	3Q07
Sales	23.5	24.1	23.8	24.9
EPS (sen)	1.64	1.70	1.66	1.77

Source: Company reports, JPMorgan estimates. \*Note: 2006 numbers are annualized as only 7.5 months are reported.

Initiation  
Overweight

**M\$1.08**

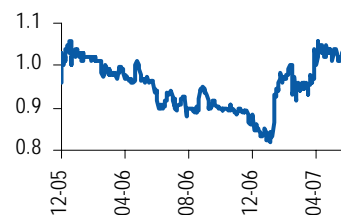
19 June 2007  
Price Target: M\$1.30

Malaysia  
REITs

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## Seedlings

Starhill REIT: Price performance chart



Source: Bloomberg.

### Performance

	1M	3M	12M
Absolute (%)	1.9	11.0	17.8
Relative (%)	0.2	-3.0	-24.0

### Company data

52-week range (M\$)	0.82-1.08
Mkt cap. (M\$ MM)	1,250
Mkt cap. (US\$ MM)	364
Shares O/S (MM)	1,179
Free float (%)	38%
Avg daily value (M\$MM)	1.24
Avg daily value (US\$MM)	0.36
Avg. daily volume	1.32
Exchange rate (M\$/US\$)	3.43
Index	1376.79
Year-end	June

Source: Bloomberg.

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## Company description

With an asset size of M\$1.28B, Starhill REIT comprises four properties located within the Bintang Walk area in the Golden Triangle—two retail malls, namely, Starhill Gallery and Lot 10; the JW Marriott Hotel; and “The Residences” (a service apartment building).

The jewel in its crown, Starhill Gallery, caters to the high-end market segment and is home to some of the luxury brands in Malaysia, such as Asprey, Gucci and Louis Vuitton.

Lot 10, on the other hand, serves the mid- to high-end market while the JW Marriott Hotel and “The Residences” are popular among business travelers and high net worth individuals.

Table 1: Starhill REIT—Property data

	Starhill	Lot 10
NLA (sqft)	293,727	181,301
Occ. rate (%)	100	96
ARR (M\$ psf)*	8.3	10.7
Lease tenure (yrs)	3+3	3+3
% contribution to revenue	41%	27%

Source: Company. Note: Tenancies with JW Marriott and The Residences will expire in 2023 and 2031 respectively. Meanwhile JW Marriott and The Residences contribute 23% and 9% to revenue. \*Note ARR are based on JPM forecast for FY07E.

## Corporate governance metrics

Company dividend policy	Dividend track record
At least 90%	100% for 7.5 months in FY06
# Days to publish quarterly report	# Days to consolidated annual report
60	180
% Independent directors	Inter-company transactions
Trustee is independent of the REIT manager	Management fees paid to Pintar Project Sdn Bhd
History of share placement	Insider ownership (%)
138.9MM units for acquisition of “The Residences”	YTL Corp (direct & indirect)—66%

Source: Company data.

## Positive price drivers

**Starhill, as the most liquid proxy to the M-REIT market, will benefit from the strong possibility of withholding tax cuts on dividends in the upcoming Budget.** Starhill REIT’s market cap currently stands at US\$364 million versus the industry average of US\$121 million while its average daily trading value of US\$0.3 million is superior to the industry average of US\$0.1 million. If the government reduces withholding taxes for foreigners to 10% from 20% currently, Starhill REIT’s FY07E net dividend yield will be 5.8%, representing a 220bp spread over the risk free rate.

**Most contracts initially signed with Autodome will expire in November 2007; tenancies novated to Starhill REIT should boost rental rates.** About 67% of the total NLAs, which were based on sub-leases with Autodome (related party, which underwrote rentals for Starhill at cheaper rates during its IPO in 2005), will expire in November 2007. Now that the right tenant mix has been achieved and vacant lots filled, novation of these tenancy agreements to Starhill REIT will be at rates that are slightly higher.

**Unique properties, good brand name, and prime location for its retail malls (and hotels) to benefit from rising consumption spend and tourist arrivals.** All the four properties in the REIT are located within the Bintang Walk area in the Golden Triangle (which is also popular among tourists) and cater to their respective niche target markets. The jewel in its crown, Starhill Gallery, caters to the high-end, high net worth consumers, including tourists. Recent rental revisions for the group’s retail malls have seen rates rising by 10-15%. Moreover, increasingly, the group’s new tenancies are being fixed based on a base rent plus profit share. These turnover rents currently constitute 1% of the total rental revenue.

## Negative price drivers and risks to thesis

**Keener competition for Lot 10 with an upcoming 1.37 million sq ft The Pavillion by end-2007/early-2008.** *The Pavillion* retail mall (situated across the road from Starhill’s assets) may pose as a threat to Lot 10 given its size (NLA of 1.37 million sq ft versus Lot 10’s 0.17 million sq ft) and its similar mid- to high-end target market. *The Pavillion* is less likely to pose as competition to Starhill Gallery given the latter’s niche in the very high-end segment, in our view. Lot 10 accounts for 30% of the REIT’s rental revenue, while the remaining is accounted for by Starhill Gallery and the hotels.

**Starhill REIT lacks an aggressive growth strategy.** This despite having the capacity to raise additional debt of up to M\$500 million for acquisitions, based on a maximum gearing ratio of 50% for REITs. Moreover, the low cost of debt of 5% should facilitate earnings accretive acquisitions. The REIT, however, has acquired only one asset post its listing, i.e., “The Residences” service apartments, a related party acquisition in late-2006, through the issuance of new units.

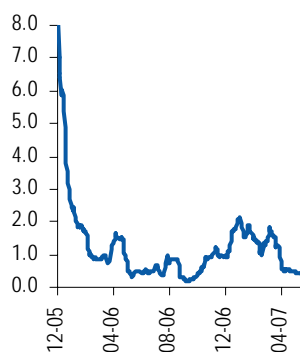
**The main risk to our thesis is unexpected fluctuations in interest rates.** While we expect Malaysian interest rates to remain stable, unexpected movements could result in volatility of the share price in the short term. A 1 percentage point rise in the risk-free rate (current assumption = 4%) will reduce our price target by 15% from M\$1.30 to M\$1.11.

Table 2: Starhill REIT—DCF-based valuation model assumptions

Risk free rate	4.00%
Beta	0.72
Index ratio	5.50%
Discount rate	7.96%
LT growth	3.00%
Terminal cap rate	4.96%

Source: JPMorgan estimates.

Figure 1: Average daily trading value M\$MM



Source: Bloomberg.

## Valuation and rating analysis

We set a Dec-07 price target of M\$1.30 for Starhill REIT, using a DDM model (assumptions: 4% risk free rate; 5.5% market risk premium; beta of 0.72, and long-term growth rate of 3%).

At our price target, Starhill's stock trades at an FY07E net dividend yield of 4.0% versus the 10-year bond yield of 3.6%. This compares to the M-REIT average of 5.4%, with the premium accorded to Starhill being backed largely by its size, liquidity, and decent assets. This also compares to 2.9% for Quill Capita, which has the lowest yield among M-REITs.

Table 3: M-REITs—FY07E net dividend yields

2007E	Assume 20% tax	Assume 10% tax
Atrium	6.5	6.7
Tower	6.1	6.8
AMFirst	5.9	6.7
KPJ	5.8	6.5
Hektar	5.7	6.4
UOA	5.4	6.1
A Raya	5.6	6.3
Axis	5.1	5.7
Starhill	4.9	5.5
Boustead	4.8	5.4
Quill	2.9	3.3

Source: Company, Bloomberg, JPMorgan estimates. Note that prospectus DPU were used for REITs not under our coverage.

Table 4: Sensitivity of Starhill's PT to the 10-year government bond yield changes

Change in 10-yr gov't. bond yield	Starhill's PT (M\$)	Change (%)
3.0%	1.64	26%
3.5%	1.46	12%
4.0%	1.30	
4.5%	1.20	-8%
5.0%	1.11	-15%

Source: JPMorgan estimates.

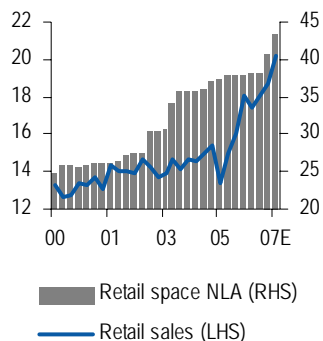
At our price target, Starhill's net yield spread (assuming 20% with-holding tax) over the 10-year government bond yield for FY07E and FY08E stands at 0bp and 20bp, respectively. For a 100bp increase in 10-year government bond yields, Starhill's price target will decrease by 15% to M\$1.11.

Table 5: Sensitivity analysis—Starhill's PT to changes in Starhill Gallery's and Lot 10's occupancy rates

		Lot 10				
		75%	80%	85%	90%	96%
Starhill	85%	1.15	1.17	1.19	1.21	1.24
	90%	1.18	1.20	1.22	1.24	1.27
	95%	1.21	1.23	1.25	1.27	1.29
	100%	1.24	1.26	1.28	1.30	1.30

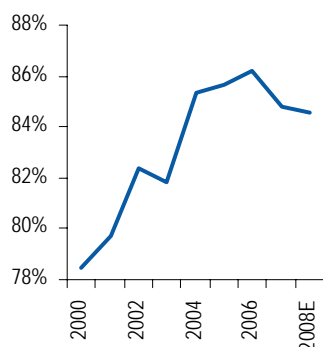
Source: JPMorgan estimates.

Figure 3: Retail sales (M\$B) vs. supply of retail space (MM sq ft)



Source: CEIC.

Figure 4: Retail property occupancy rates (Klang Valley)



Source: CEIC.

Table 5: Incoming supply of key retail space in Klang Valley

	Completion	NLA (MM sq ft)
The Pavillion	3Q07	1.37
Mid Valley City 2	Sep-07	0.80
Sunway Pyramid	3Q07	0.70
Suria KLCC	1Q09	0.16
Capsquare	2H07	0.12
Troika	2H07	0.60
Bagsar Shopping	2008/09	0.90
<b>Total</b>		<b>3.30</b>

Source: JPMorgan estimates

Table 6: Tourist arrivals and average room rates (ARR) for hotels

	05	06	07E
Tourist arrivals (MM)	16.4	17.5	20.0*
% growth		7%	14%

Source: CEIC, JPMorgan estimates. \*Represents target for Visit Malaysia Year 2007.

## Retail sales to grow strongly, but competition keen

**Starhill Gallery and Lot 10 to benefit from strong retail sales growth.** We expect it to continue growing strongly at 8% in 2007 despite achieving 8.4% in 2006 (the highest growth since 2001). The strong retail sales growth estimates by The Retail Group will be driven by favorable macro conditions such as low interest rates, buoyant capital market, rising tourist arrivals with ‘Visit Malaysia Year 2007’ and the overall ‘feel good’ factor arising from government pump-priming initiatives and positive policy changes.

**Upside to rental revenue for Starhill could come from ‘novation’ in some of the sub-leases from Autodome to Starhill REIT.** This can be possible now that the right tenant mix has been achieved and vacant lots have been filled. This accounts for 67% of Starhill’s NLA.

**Competition, however, will be keen.** With 7.9 million sq ft of incoming supply over the next 3-4 years (i.e., 19% of the existing stock), we estimate occupancy rates for retail space in the Klang Valley to edge down to 85% in 2008 from 86% in 2006. However, we believe that well-managed established retail malls such as Starhill Gallery should continue to fetch good occupancy rates given its niche in the very high-end segment. On the other hand, Lot 10 will compete more directly with *The Pavillion* (1.37 million sq ft of retail space across the road from Starhill’s assets), and, therefore, may face increased competition. In terms of NLA, about 68% of Starhill’s overall three-year tenancy lease will expire in 2008, and Lot 10 accounts for 30% of the group’s total rentals. We estimate that every 1 percentage point drop in occupancy rates and 1% drop in rentals for Lot 10 could reduce our NPV by 1%.

## Stable income from hotel properties

Both JW Marriott and “The Residences” pay a fixed annual rental income of M\$21 million and M\$8.4 million, respectively, to the REIT. This means that Starhill will not benefit from the current up-trend in occupancy rates and average room rates for KL hotels. Similarly, however, Starhill’s earnings from the hotel segment will be protected on the downside in the event of an economic downturn. The hotel segment contributes about 22% to the total group rental revenue for FY07E.

## Longer term strategy/plans

### Selling the Starhill Gallery brand name/concept overseas potentially for a fee:

The REIT’s parent company, YTL Corp, recently signed an agreement with UAE-based ETA Star Property Developers, to use the Starhill Gallery concept as part of its US\$410 million commercial-retail and hotel project in Dubai. For its services, Pintar Project (PP), a 70% subsidiary of YTL Corp and the current manager of Starhill REIT, will receive US\$1.5 million in licensing fee and 4% of the gross profit as a brand management fee when the project is completed in 2010.

We understand that the same licensing and Starhill brand management fee concept is being negotiated with other major destinations in the world. At this preliminary stage, the fees are attributable mainly to PP and not directly to the REIT. However, from our company visit, we understand that Starhill REIT may in some way benefit from the international roll-out of the Starhill Gallery concept as it materializes at a much more mature stage.

## SWOT analysis

<p><b>Strengths</b></p> <ul style="list-style-type: none"> <li>• <b>Strong brand-name/good management, where all four properties serve their respective niche markets.</b> Management has the ability to create a niche and strong brand name for its malls, mainly among the mid- to higher-end consumers.</li> <li>• <b>Properties are strategically located in the Bintang Walk area within the Golden Triangle:</b> This area is also very popular among tourists. This has translated into 10-15% rental rate hikes for Starhill Gallery and Lot 10 in the recent renewals.</li> <li>• <b>Stable income from its retail malls:</b> This is driven by high occupancy rates. Starhill Gallery and Lot 10 currently have occupancy rates of 100% and 96%, respectively.</li> </ul>	<p><b>Weaknesses</b></p> <ul style="list-style-type: none"> <li>• <b>Interest rate sensitivity:</b> While we expect Malaysian interest rates to remain stable, unexpected movements could result in volatility in the cost of capital, and hence the DDM-driven share price target in the short term.</li> <li>• <b>REIT will not benefit directly from rising occupancy and average room rates for hotels:</b> This is because both JW Marriott and “The Residences” pay a fixed annual rental rate to the REIT.</li> <li>• <b>Acquisition of retail malls for future growth is usually a more complex process</b> versus office space, in view of the size of the investment, more diverse tenancies, potential tenant re-mixing, and re-branding exercises.</li> <li>• <b>Starhill REIT lacks an aggressive growth strategy</b> despite having the capacity to raise additional debt of up to M\$500 million for acquisitions—based on a maximum gearing ratio of 50% for REITS.</li> </ul>
<p><b>Opportunities</b></p> <ul style="list-style-type: none"> <li>• <b>Turnover rent provisions in force:</b> Here turnover rental revenue comprises 1% of rental revenue, giving the REIT the opportunity to profit from higher consumer spending.</li> <li>• <b>Acquisition pipeline supported by sponsor:</b> Some of YTL Land’s green-field commercial projects, which are not intended for sale post the development, may be potentially injected into REIT. However, the prospect of this, if any, is much longer term, i.e., next 3-5 years.</li> <li>• <b>Selling the Starhill Gallery brand name and concept overseas is another potential source of stable income:</b> The Starhill Gallery concept is already being planned for launch in Dubai, upon completion of the mall project (as discussed earlier) by 2010. Although nothing is finalized as yet, the REIT could benefit in the form of a stable recurring project management fee once the project/concept materializes at a more mature stage.</li> </ul>	<p><b>Threats</b></p> <ul style="list-style-type: none"> <li>• <b>Increased competition from <i>The Pavillion</i>:</b> The opening of 1.37 million sq ft of retail space at <i>The Pavillion</i> across the road could pose a threat—if at all, we believe, the threat could mainly be for Lot 10 as it operates in the same mid- to high-end target markets (Lot 10 accounts for 30% of the group rental revenue).</li> <li>• <b>Rising capital values for commercial properties:</b> This means that acquisition of third party assets will become more challenging.</li> <li>• <b>Lower consumer confidence/economic activity:</b> Retail sales are quite sensitive to consumer confidence, level of economic activity, and spending power. Any downturn in economic activity will affect the retail properties. However, JPMorgan is expecting the economy to remain strong over the next two years, with annual GDP growth of 5.8% for 2007E and 5.6% for 2008E</li> </ul>

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