Singapore Industry Focus

Keppel Limited & KDC REIT

Refer to important disclosures at the end of this report

DBS Group Research . Equity — 31 May 2024

Striking a win-win outcome

- A swap out of KDC Guangdong DC for a c.23% stake in sponsor's Genting Lane DC (in SG) a win-win strategy.
- Keppel can demonstrate its strength as an operator to sort out operational issues at the Guangdong DC, which should be resolved with time.
- KDCREIT could re-rate by 30% towards historical mean valuations, putting it back on the path of virtuous accretive growth
- Keppel should reap benefits as a "supportive" sponsor as it sparks its datacenter REIT platform back to life

A potential asset swap could showcase Keppel's fund management expertise. We believe a possible asset swap involving KDCREIT's Guangdong Datacenter ("GDC") properties worth c.SGD275m and a c.23% stake in Keppel Limited's Genting Lane datacenter (in Singapore) could effectively demonstrate to investors the strength of Keppel's fund management and operational capability ecosystem. GDC's issues are largely "tenant-related" rather than "asset-related", suggesting that time for reworking and reletting is necessary to fully optimise returns. Sponsor Keppel has this luxury, but KDCREIT, due to expectations of consistent returns, has less flexibility.

An asset swap is value accretive in both immediate and long-term for Keppel. In addition to the immediate financial benefits to Keppel from a 20% stake in KDCREIT through higher dividends and share prices, the asset swap enables Keppel to monetise the value of the recently completed Genting Lane DC. At the same time, it enables investment in GDC, which would serve as a pipeline for KDCREIT once it has stabilised. Other non-intrinsic benefits include raising Keppel's profile as a committed and supportive sponsor to its REITs, as well as cementing its foothold in Guangdong, the gateway to South China. The swap also helps to fulfill Keppel's desire to grow its presence in the fast-growing China DC market, while simultaneously generating attractive returns of up to an estimated IRR of 8-11% over a relatively short gestation period.

KDCREIT could repair its cost of capital. A successful asset swap would immediately lift the overhang on KDCREIT, boosting unitholder confidence on the back of stronger earnings and quality. We see potential upside of around 30% to KDCREIT's share price (to mean valuation) if a transaction materialises, returning the REIT to a path of sustained growth. With a c.23% stake in Genting Lane DC at c.6.5% yield, we see 4-5% uplift to DPUs in FY24-25F, bringing the REIT closer to its historical DPU highs.

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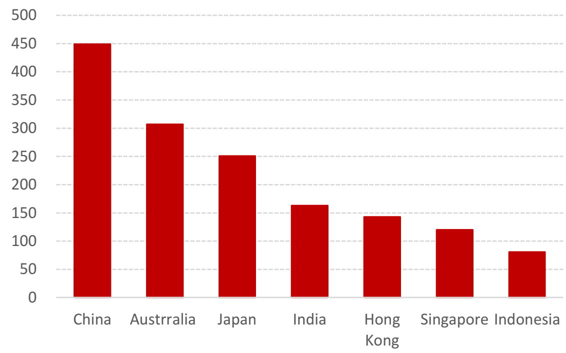
STOCKS

	Price SGD	Mkt Cap USDm	12-mth Target Price SGD	Performance (%) 3 mth	Performance (%) 12 mth	Rating
Keppel DC REIT	1.79	2,281	2.20	5.3	(14.8)	BUY
Keppel Limited	6.72	8,975	9.00	(7.2)	6.7	BUY

Source: DBS, Bloomberg
Closing price as of 30 May 2024

China has the largest number of DCs in Asia Pacific



Source: Statista

ed: JS/ sa: SM, PY, CS

Tenant trouble at Guangdong Datacenter "GDC" an overhang for Keppel DC REIT

Concerns surrounding GDC first came to light in mid-2023. In mid-2023, the financial health of Neo Telemedia, listed on the Hong Kong Stock Exchange, was called into question following consecutive quarters of losses. This was partly due to rising interest rates, which increased the cost of capital and possibly operational expenses, and a decline in utilisation rates at the data centres they were managing. Bluesea, Neo Telemedia's subsidiary, serves as the master-tenant of the Guangdong data centres (GDC), which the REIT had acquired in phases from July 2021, with a 15-year master lease for each of the three data centres.

Neo Telemedia's financial struggles led to a substantial correction of its share price, which also dragged on Keppel DC REIT's ("KDCREIT") share price since October 2023 as Bluesea is one of KDCREIT's largest tenants, with GDC contributing c.10% to the REIT's revenues.

KDCREIT confirms rental arrears at GDC for the past four months. In December 2023, KDCREIT confirmed that Bluesea had been in rental arrears since September 2023. As a result, KDCREIT issued a letter of demand for SGD15.1mn. This demand included four months of rent, late payment interest, real estate taxes, and a top-up of the security deposit, which had already been fully drawn down and depleted. Due to the rent arrears from Bluesea, the non-payment significantly impacted KDCREIT's earnings for FY23. The rental arrears resulted in a reduction of KDCREIT's DPU for FY23 by 0.649Scts, or c.6.5%. As a result, KDCREIT's FY23 DPU fell short of consensus estimates, coming in c.6.2% below our projections.

KDCREIT's share price has corrected by more than 20% since October 2023 when concerns surrounding Bluesea's master lease at GDC emerged and remains anchored near historical low levels as the tenant arrears situation remains unresolved. On a price-to-book (P/B) multiple basis, KDCREIT is now trading at around 1.3x, a substantial drop from its average of c.1.6x, and is trading at an even steeper discount compared to its 5-year historical average of c.1.8x.

Key events impacting Keppel DC REIT's share price

Source: Bloomberg, DBS

Exploring avenues for Keppel DC REIT's next moves?

A sticky tenant situation rather than an asset. Considering the ongoing uncertainties surrounding Bluesea's master lease at GDC and that a recovery is likely some time away since the tenant remains in a tight financial situation, we believe KDCREIT will have to more thoroughly address this uncertainty. This is because the issue with Bluesea is dragging down KDCREIT's share price. In fact, since this is an issue with the tenant rather than the asset itself, we believe a lease restructuring and time could resolve the situation. However, KDCREIT, with expectations from its unitholders to pay sustainable dividends from its cash flows, may not have the flexibility for this approach.

Our asset swap scenario could be a win-win for both KDCREIT and its sponsor, Keppel. Among the various options, we have identified a potential asset swap with KDCREIT's sponsor as the most favourable course of action. This strategic move is viewed as advantageous for several reasons.

Time is on Keppel's side to actively manage the asset. Firstly, an asset swap with its sponsor offers an immediate resolution to the uncertainties surrounding KDCREIT and effectively lifts the overhang on its share price performance. Other than restoring investor confidence, this will significantly boost Keppel's reputation as a sponsor to the REIT. In addition, given the sponsor's operational expertise in data-centers globally, we believe there could be opportunity to warehouse the asset, "cure it of its ills" via investments, and divest it after restoring its cashflows to a more stabilised state.

Potential options available to KDCREIT

	Details	Pros for KDC REIT	Additional considerations:
Option 1: Repossess properties and manage it with Sponsor	• Repossess the property immediately, and take over existing leases • Manage the properties on their own or work with their Sponsor to manage it as a co-location property	• KDCREIT will have full control over the property and leases • Quickest solution among the various options	• Existing tenants may have the right to terminate their leases, or seek compensation if there is a change of operator • May lead to near term losses if the occupancy rates at the GDC properties have yet to reach the breakeven level
Option 2: Divest GDC properties to "cut loss"	• Repossess the property and put it on the market for sale to recoup as much as they can and pay off related liabilities	• Cut losses, which should help to remove overhang on KDCREIT • Proceeds can be redeployed into other income producing assets	• Given the depressed market in China, divestment at this time could lead to substantial losses
Option 3: Carry out asset swap with Sponsor	• Carry out an asset swap with its Sponsor; swapping GDC properties for a stake in Genting Lane DC	• Immediate removal of the overhang on KDCREIT, while improving the quality of its portfolio and increasing its stake in Singapore DCs • KDCREIT may have the opportunity to purchase the GDC properties again in future once it has stabilised • Does not require any additional capital outlay and will not impact capital management metrics	• Depending on the Sponsor's willingness to perform the asset swap and type of assets involved

Source: DBS

A value accretive scenario: Asset swap of Guangdong DC (KDC) with Genting Lane DC (Keppel)

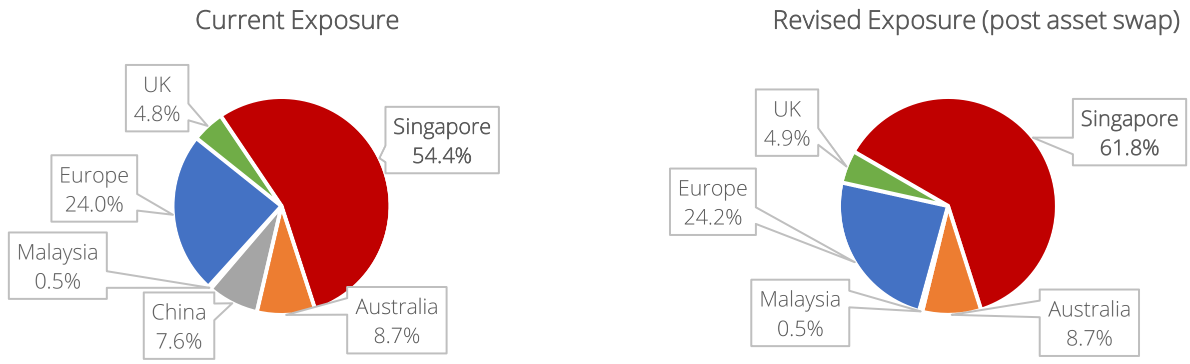
Preferred option: An asset swap with sponsor
In this proposed scenario, KDCREIT would exchange its interest in the GDC properties for a stake in its Sponsor's Genting Lane DC or Keppel Datacenter 7 and 8. Assuming the Genting Lane DC is valued at c.SGD1.2bn on a 100% basis with an estimated NPI yield of 6.5%, KDCREIT's current holdings in the GDC properties, valued at SGD274.3mn would translate to a c.23% stake in the Genting Lane DC, if swapped on a like-for-like basis.

The benefits of this asset swap for KDCREIT are significant and multifaceted. Firstly, it would immediately lift the overhang caused by income uncertainties surrounding the GDC properties, thereby improving investor confidence and potentially boosting the REIT's share price. Additionally, the asset swap would improve KDCREIT's asset mix by cementing its concentration in Singapore properties (from c.54% to c.62%), which could be advantageous for stability and growth prospects.

Furthermore, if KDCREIT eventually acquires the entire stake in Genting Lane DC worth SGD1.2bn, its Singapore portfolio exposure could rise even higher, reaching c.70%.

Overall, the asset swap presents a compelling opportunity for KDCREIT to enhance its asset mix and consolidate its position in the Singapore property market. By strategically reallocating its investments, the REIT could strengthen its competitive position, drive long-term value creation, and deliver sustainable returns to its stakeholders.

Consolidation of KDCREIT's foothold in the Singapore DC sector



Source: KDCREIT, DBS

A swap involving GDC and Genting Lane DC maybe value accretive for both Keppel DC REIT and Keppel Limited

Source: Company, DBS

Asset swap will fast track the recovery of KDCREIT's DPU back towards its previous highs. Based on our current estimates for FY24-26F, we have assumed that GDC properties will not contribute any income in FY24 and only 50% of the income in FY25. Our projections also assume that GDC will subsequently increase income contribution by an additional 10% per annum towards 100% starting from FY26 onwards.

However, using GDC as an asset swap for Genting Lane DC, its Sponsor, Keppel Limited, will see an immediate boost to DPU of up to 5% (assuming half year contribution or +10% annualised contribution) in FY24F and close to 3%-4% to our FY25-26F DPU estimates.

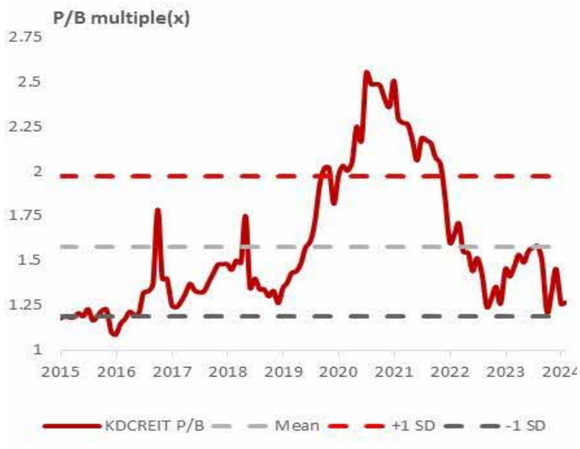
More importantly, the asset swap will pave the way for KDCREIT to get back on a fast track to DPU recovery, enabling DPU to return to levels seen prior to the rental defaults by Bluesea in FY23 and close to its peak earnings. Furthermore, the asset swap would immediately remove the overhang on KDCREIT, providing clarity and certainty and earnings quality for the REIT.

KDCREIT to trade at an improved cost of capital. Moreover better earnings quality and visibility will likely drive KDCREIT back to its historical trading multiples of close to c.1.6x P/B, implying more than 30% upside from current levels.

In addition, the asset swap with Keppel opens the doors for KDCREIT to potentially increase its stake in Genting Lane DC in the future. This strategic move would not only further enhance the REIT's DPU but also align with its growth objectives, positioning KDCREIT for long-term success and value creation.

Overall, the asset swap presents a compelling opportunity for KDCREIT to mitigate the impact of the uncertainties surrounding the GDC properties, accelerate DPU recovery, and unlock potential growth avenues for the future.

Significant re-rating potential for KDCREIT



Source: Bloomberg, Refinitiv, DBS

Genting Lane DC to drive a quicker earnings recovery

DPU	FY22	FY23	FY24	FY25	FY26	Assumptions
Current estimates	10.21	9.38	8.80	9.50	9.84	Income contribution from GDC: FY24 – 0%, FY25 – 50%, FY26 – 60%, etc.
Without GDC	10.21	9.38	8.80	8.96	9.18	No income contribution from GDC, will still incurring interest expenses
With asset swap	10.21	9.38	9.21	9.79	10.03	Swap GDC for 22.9% stake in Genting Lane DC; asset swap is completed by end-2Q24
Revised DPU* vs. Current estimates	-	-	5.0%	3.8%	2.7%	* Revised DPU refers to the projected DPU with the asset swap
Revised DPU* as a % of FY22 DPU	-	-	91%	97%	99%	

Source: DBS

Sponsor Keppel Limited can grow its pipeline and enhance its reputation

Time is on Keppel's side as it can demonstrate its capability to fill and reposition datacenters to optimal use. Based on our analysis, we believe that an asset swap would also be beneficial for Keppel. Although the benefits may not be immediately apparent, such a strategic move could generate significant advantages for Keppel after re-working and re-letting the asset, putting it back into operational readiness in a relatively short gestation period. Unlike REITs, which are mandated to invest in income-producing assets and pay out regular dividends, Keppel can afford a gestation period for its investments, allowing for the potential of greater capital gains over time.

For Keppel, the asset swap would mean acquiring the GDC properties, which, while currently underperforming, have the potential for substantial value appreciation and income generation in the future once leased up and fully operational. This aligns with Keppel's investment strategy, which is not restricted by the same mandates as REITs.

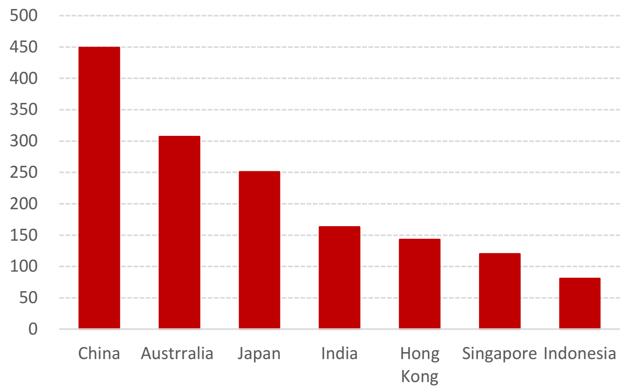
Reiterate strong sponsor support. In addition, this asset swap would allow Keppel to reiterate its support for KDCREIT, by alleviating its current challenges. By doing so, Keppel not only strengthens the REIT but also secures a more stable and potentially lucrative asset base that could serve as a future pipeline for KDCREIT. In summary, while the immediate benefits of an asset swap may seem skewed towards KDCREIT, Keppel stands to gain significantly over time by unlocking greater upside potential and achieving higher returns in the long run.

Keppel's strategic expansion into China's booming DC industry with local partners since 2018.
Keppel officially entered the fast-growing China's DC market in 2020, with Alpha Data Centre Fund's investment of RMB1.5bn (~SGD300mn) to develop a greenfield DC, Huizhou DC in Guangdong province. It partnered with a local data centre operator Shenzhen Huateng Smart Technology (a subsidiary of property developer Country Garden). Prior to this partnership, Keppel had also previously tied-up with three Chinese technology firms – i) tech giant Huawei, ii) data center equipment maker Xiangjiang Science & Technology, and iii) data centre operator Cloud Engine (Beijing) Network Technology to develop more efficient and robust DCs.

In 2022, Keppel made further inroads into the China DC market with a strategic partnership with Heying, a wholly-owned subsidiary of Tianjin Zhengxin Group Co. to jointly develop a greenfield DC in Greater Beijing, Huailai DC in Hebei, Keppel's sixth project in China.

in addition to KDCREIT's GDC properties, Keppel operates three other DCs strategically located in China's three largest data centre hubs – Guangdong, Shanghai, and Hebei.

China has the largest number of DCs in Asia Pacific



Source: Statista

China DC market sees healthy growth rate; fits Keppel's portfolio.
After an explosive growth of 44% during 2017-2023, China's DC market is expected to grow at a slower but still healthy growth rate of 10-15% in 2024 and gradually normalise to high single-digit growth rate in the next few years. During Keppel's 1Q24 business update call with investors, management expressed their intentions to redefine its playbook in China. We believe that China DCs align well with Keppel's portfolio and will be an important growth engine for the group, with China being the second largest DC market after US.

China further liberalising and opening up its DC market
In April 2024, China announced that it will remove foreign ownership restrictions on some value-added telecom services provided within domestic pilot areas. The pilot areas include the key DC hubs - Beijing's national comprehensive demonstration zone, Lingang, a new area of the Shanghai Pilot Free Trade Zone, Hainan Free Trade Port, and the Shenzhen pilot zone. The value-added telecom services, for the first time, will include internet DC and its sub-item, internet resource collaboration business, will be open to foreign capital, with no shareholding limits.

Keppel has a proven track record and early mover advantage in China
The major DC players are the Chinese Telcos (i.e.. China Telecom) and Tech companies (i.e. Tencent Cloud, Alibaba Cloud). Over the years, several foreign companies including Amazon Web Services (AWS), Equinix, Digital Realty, Princeton Digital, GLP and Keppel have also grown their presence and increased their prominence in China.

Leveraging on its strong customer relationships with global cloud service providers and internet enterprises as well as expertise in developing and operating innovative and sustainable DCs, Keppel is uniquely positioned to tap the fast-growing DC market throughout Asia Pacific and Europe.

KDCREIT remains as the only DC securitisation arm for Keppel. Keppel, as the Sponsor to KDCREIT, holds a 20% stake in the REIT which contributes to c.5% of the group's AUM. In the imminent term, Keppel has completed Keppel DC Singapore 7 and 8 (Genting Lane DC), which are expected to be injected into KDCREIT when the opportunity arises. KDCREIT also plays a crucial role in Keppel's overseas DC portfolio expansion plans. It is amongst a small handful of Asian players that has established a prominent presence in China. Hence, the sooner KDCREIT is able to return to its growth trajectory, the more beneficial it will be for Keppel to also grow its presence and foothold in the DC market.

Keppel's Data Centre footprint in China (Private funds and REITs)

Data Centres	Location	Status	COD**	Effective Group Interest	Lease	Rentable Area (sqm)
Private Funds						
Alpha DC Fund						
Huizhou DC, Guangdong	China	Operating	2022/24	65%	50-year	12,648
Keppel DC Fund II						
Huailai DC, Hebei	China	Operating	2022	41%	50-year	63,305
Greater Shanghai DC, Shanghai	China	Operating	1Q24	41%	50-year	29,801
Keppel DC REIT						
Guangdong DC 1, Guangdong	China	Operating	2019	20%*	50-year	20,596
Guangdong DC 2, Guangdong	China	Operating	2020	20%*	50-year	20,310
Guangdong DC 3, Guangdong	China	Construction	NA	20%*	50-year	20,610

**effective stake in Keppel DC REIT which owns 100% of the datacenter*
*** COD = commercial operation date.*
Source: Company, DBS

Potential attractive near term and medium gains for Keppel Limited

KDCREIT to trade at more favourable cost of capital, with the potential for additional stake injections over time. In the immediate term, an asset swap between KDCREIT and Keppel could re-rate KDCREIT and position the REIT to resume its growth plans.

Firstly, the recovery in KDCREIT's unit price would result in an increase in the valuation of Keppel's stake, and assuming KDCREIT trades back up to a P/B multiple of c.1.6x, equivalent to a unit price of SGD2.10, this would add c.SGD115.6mn to Keppel's stake in the REIT. Additionally, the recovery in KDCREIT's DPU would mean that Keppel stands to receive more dividends from its stake in KDCREIT, potentially up to SGD3.7mn more over the next three years. Based on our estimates, every 5% rise in KDCREIT's unit price would imply a c.SGD31mn uplift in the value of Keppel's 20% stake in the REIT.

Secondly, the asset swap would allow Keppel to unlock value from its development of the Genting Lane DC and monetise the upside from the project.

KDCREIT's rerating could generate an additional c.SGD119mn for Keppel's stake

	Implied unit price	P/B	KDCREIT mkt. cap.	Value of Keppel's stake	Dividends (FY24-26)
Current	SDG1.77	1.33x	SDG3.0bn	SDG615.2m	SDG98.4m
After asset swap	SGD2.10	1.58x	SDG3.6bn	SDG730.8m	SDG102.1m
Upside for Keppel	+ SGD$0.33	+ 0.25x	+ SDG0.6bn	+ SDG115.6m	+ SDG$3.7m
Remarks	*Implied unit price based on P/B multiple*	*Assumes KDCREIT trades back up to its P/B premium prior to when GDC concerns first surfaced in October 2023*	*Increased market cap with higher KDCREIT share price*	*Keppel's 20% stake in KDCREIT would be worth c.SGD116mn higher if KDCREIT trades back up to S$2.10 per unit*	*Keppel will receive c.SGD3.7mn more in dividends over the next 3 years*

Source: DBS

Every 5% increase in KDCREIT's unit price will lead to c.SGD31mn upside to Keppel's stake

KDCREIT unit price	Implied KDCREIT unit price (SGD)	KDCREIT mkt. cap. (SGDmn)	P/B (x)	Value of Keppel's stake (SGDmn)	Potential upside to Keppel's stake (SGDmn)
Current	1.77	3,032	1.33	615.2	-
5% increase	1.86	3,183	1.40	645.9	+ 30.8
10% increase	1.95	3,335	1.46	676.7	+ 61.5
15% increase	2.04	3,487	1.53	707.4	+ 92.3
20% increase	2.12	3,638	1.60	738.2	+ 123.0
25% increase	2.21	3,790	1.66	768.9	+ 153.8

Source: DBS

Attractive returns for Keppel post repositioning. The GDC properties would add significant depth and scale to Keppel's existing operations in China, tapping on their resources and operational expertise on the ground in China to manage and operate the DCs. The GDC properties would also become Keppel's second DC asset in Guangdong, complementing its other asset owned by Alpha DC Fund, Huizhou DC.

Furthermore, as the GDC properties achieve a stabilised occupancy rate, further value could be unlocked for Keppel by potentially positioning the asset as a future pipeline for KDCREIT. Given the ongoing structural tailwinds in the DC sector and continued growth in China, the GDC properties could command a higher price in the future once they achieve stabilised occupancy.

Depending on the entry and exit cap rates, Keppel could also potentially generate very attractive IRRs from investing in the GDC properties. Based on our estimates, GDC could potentially generate an IRR of between 8-12%.

GDC properties could potentially generate an IRR of between 8-12%

Assumed entry cap rate	Purchase price	EBITDA	Exit Cap	Exit Valuation	Estimated IRR
8.5%	SGD274.3mn	SGD23.3mn	7.0%	SGD333.1mn	8%
9.5%	SGD274.3mn	SGD 26.1mn	7.0%	SGD372.3mn	9%
10.5%	SGD274.3mn	SGD28.8mn	7.0%	SGD411.5mn	10%
11.5%	SGD274.3mn	SGD 31.5mn	7.0%	SGD450.6mn	12%

** Assumes Keppel invests a further SGD100mn to fully fit-out GDC 3; ** Assumes the GDC properties do not generate income in Year 1, and ramps up occupancy to 50% in Year 2.*
Source: DBS

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BUY (>15% total return over the next 12 months for small caps, >10% for large caps)
HOLD (-10% to +15% total return over the next 12 months for small caps, -10% to +10% for large caps)
FULLY VALUED (negative total return, i.e., > -10% over the next 12 months)
SELL (negative total return of > -20% over the next 3 months, with identifiable share price catalysts within this time frame)

**Share price appreciation + dividends*

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Sources for all charts and tables are DBS unless otherwise specified.

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Directorship/trustee interests:

8. Jimmy NG, a member of DBS Group Management Committee, is a Director of Keppel Ltd as of 02 May 2024.

9. Tham Sai Choy, a member of DBS Group Holdings Board of Directors, is a Director of Keppel Ltd as of 31 Mar 2024.

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