Embassy REIT

Embassy Splendid TechZone Acquisition – Management Call

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CORPORATE PARTICIPANTS

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Sakshi Garg – Investor Relations Manager

MANAGEMENT DISCUSSION SECTION

Operator: Good evening everyone. A very warm welcome to all for Embassy REIT's management conference call. Currently, all participants are in a listen-only mode. Our speakers will address your questions at the end of the presentation during the question-and-answer session. As a reminder, this conference call is being recorded.

I would now like to introduce your host for today's conference – Ms. Sakshi Garg, Investor Relations Manager for Embassy REIT. Mam, you may begin.

Sakshi Garg

Investor Relations Manager

Thank you. Good evening everyone and thanks for joining us to discuss the transaction Embassy REIT announced on April 06, 2024.

You may wish to refer to the Acquisition Presentation, the Press Release and the Extraordinary Meeting Notice relating to the transaction announcement. We have placed these relevant documents in the Investors section of our website at www.embassyofficeparks.com.

As always, we'd like to inform you that management may make certain comments on this call that you could deem forward-looking statements. Please be advised that the REIT's actual results or actual outcome of the proposed acquisition may differ from these statements. Embassy REIT does not guarantee these statements or results and is not obligated to update them at any time.

Joining me today are Aravind Maiya, our CEO and Ritwik Bhattacharjee, our CIO. They will run you through the proposed acquisition and fundraising plan after which we will open the floor to questions.

Over to you, Aravind.

Aravind Maiya

Chief Executive Officer (CEO)

Thank you, Sakshi. Good evening and thank you all for joining us on the call today.

We recently celebrated our 5th year anniversary as a listed REIT. On this occasion, we are very excited to announce a strategic acquisition which will allow our entry into our 5th growth market, and increase our portfolio to over 50 msf, positioning us as one of the largest office REITs globally.

I want to highlight that Embassy REIT is at the cusp of delivering strong growth over the next few years. This will be led by an occupancy ramp-up in our existing portfolio of 35.8 msf as well as our 6.9 msf active developments, out of which we have already pre-leased 73% of the next 2 years' deliveries. With the continued business momentum and favourable market conditions, we believe this is the right time to raise additional capital to strengthen our balance sheet and give us the firepower and flexibility to finance our growth.

Last Saturday, the independent directors of our Investment and Audit Committees as well as the Board of the Manager to Embassy REIT approved the acquisition of Embassy Splendid TechZone ('ESTZ'), Chennai for an enterprise value of ₹1,269 crores and an institutional placement of up to ₹3,000 crores, subject to unitholder and other approvals.

Let me now hand over to Ritwik to take us through the transaction details.

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Ritwik Bhattacharjee

Chief Investment Officer (CIO)

Thank you, Aravind. Good evening everyone.

I will keep my comments brief because this acquisition and the accompanying fundraise is quite self-explanatory. We view this transaction as a very compelling opportunity for the following reasons:

- ESTZ is a great asset. It's a 5 msf campus-style office park spread over ~26 acres. The asset is located at Pallavaram-Thoraipakkam Road, 15 minutes from the Chennai International Airport. The 1.4 msf completed area is 95% leased to marquee multinational occupiers such as Wells Fargo and BNY Mellon, among others. Another 1.6 msf is currently under development and already 26% pre-leased. An additional 2 msf future development potential provides embedded growth.
- Chennai is one of the fastest growing office markets in India and recorded a gross absorption of 9.4 msf last year. Within Chennai, ESTZ is located in OMR 2, which is amongst the top-performing sub-markets in the city and accounts for over 20% of its gross absorption.
- The proposed transaction is accretive across all key financial metrics. We are buying the asset for an enterprise value of ₹1,269 crores. Priced at a discount of 6.7% to the average of two independent valuations, our price implies a stabilized NOI yield of 8.5% for the completed portion and 10% for the development portion. This compares favorably to our current trading yield of around 7.1%. The overall transaction is 2.9% NOI and DPU accretive, and will not significantly impact NAV.

The enterprise value of ₹1,269 crores includes 61% economic interest in the lease revenues and 100% interest in the property management business of the asset. We propose to raise external debt of ₹400 crores and unit capital of ₹2,500 crores through an institutional placement, subject to requisite approvals. We will use the total proceeds of ₹2,900 crores in the following manner:

Acquisition-specific Proceeds

- To pay down around ₹800 crores of the existing debt;
- To refinance ₹400 crores of the existing debt; and
- To pay ₹43 crores to the Embassy Sponsor, which is in relation to the rental support.

REIT De-leveraging Proceeds

- The balance c.1,650 crores will primarily be used to de-lever the REIT's existing balance sheet.

The de-leveraging exercise will reduce our leverage from the current 30% to 27% and provides us the flexibility for our future growth.

In summary, ESTZ adds over ₹89 crores of NOI and ₹69 crores of NDCF on a proforma basis. We will achieve interest cost savings of over ₹130 crores through external debt repayment. Together, this will result in proforma NDCF of over ₹200 crores to the REIT.

2 other points. There is income support of ₹43 crores to Embassy Sponsor which is included in the consideration. We believe we have full visibility into this lease; however there is a valuation adjustment should the binding lease agreement not get executed prior to the acquisition completion; there will be a reduced consideration of ₹1,185 crores without the rental support.

Lastly, given this acquisition qualifies as a Related Party Transaction under SEBI's regulations, we have followed applicable related party safeguards. Also, while the acquisition does not exceed the thresholds requiring unitholder approval for related party transactions under the REIT regulations, we are seeking unitholder approval for the acquisition and institutional placement through an Extraordinary Meeting scheduled for April 29, 2024.

Let's move to Q&A please. Abhishek Agrawal, our CFO, and Amit Shetty, our leasing co-head, will join us as well.

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QUESTION & ANSWERS SESSION

(Note: The Q&A has been edited for clarity)

Moderator: Thank you. We will now begin the question-and-answer session. We have the first question from the line of Shrish Vaje from Money Life. Please go ahead.

Shrish Vaje: Thank you for the opportunity. My question pertains to the institutional placement that Embassy would be doing. So...

Management: I'm sorry, we lost you.

Moderator: The line for the participant in the queue seems to have dropped. We will take the next question from the line of Kunal Tayal. Please go ahead.

Kunal Tayal: Just a couple of questions on the Chennai market from my side. One, if we just talk through your assumptions on the leasing outlook for the under construction pipeline that you have?

And second, if you could just refresh for us as to what are the headline drivers of Chennai leasing market that you foresee? Is it expected to be a GCC story or a different set of events that would be the drivers? I know that in the last one year, Chennai has really come through the ranks in terms of leasing momentum. So, which of these you would expect to continue and what are the new ones that could come along the way?

Aravind Maiya: Thanks, Kunal. Let me start on some of our assumptions and then I'll hand it over to Amit Shetty, our Leasing Co-head, to talk a bit on the market. From our point of view, it's, as we said, 1.4 msf completed and 95% leased. And then there's 0.4 msf, which is today under construction, but that is fully pre-leased. So, in terms of the balance, there are around six blocks. Largely, big picture, we've assumed that we will do a block each year, which we believe is very comfortable for us to lease over the next few years. That's what we have underwritten. But in terms of the overall market, why don't I hand it over to Amit right now?

Amit Shetty: Thanks, Aravind. So, Chennai has been a very strong performer on the leasing side. It has been the third largest city in the country from an absorption perspective last year, with gross absorption of about 9.4 msf. And from a micro-market perspective, we are positioned very well, because around 20% of all the leasing that has happened in Chennai is in the micro-market that we are currently present. So, we believe that it's truly a great story. And given the clientele and the ecosystem that we have in the park, I think it's truly exceptional to attract newer clientele as well.

Kunal Tayal: Got it. Thank you. Just one quick clarification. You're saying that the under construction is 0.4 msf and all of that is leased out? I don't know, maybe I'm mistaken, but I thought I read 0.4 of 1.6 msf is being leased out so far?

Aravind Maiya: Let me clarify. There's 1.4 msf completed, which is 95% leased. Then there is one tower called Block 10, which is 0.4 msf, which is under construction today, which is fully pre-leased, subject to a binding document which Ritwik spoke about. Then there is another 3.2 msf, which is at different stages of construction. Some where the structure has come, some where there's just podium, some where there is just land. So, all put together is around 3.2 msf.

Kunal Tayal: Got it. And this is where you're saying one tower or one block each year?

Aravind Maiya: Yes.

Kunal Tayal: Understood. Okay. Thank you so much.

Moderator: Thank you. We have the next question from the line of Murtuza Arsiwalla from Kotak Securities. Please go ahead.

Murtuza Arsiwalla: You talked about the 8.5% cap rate and 10% for the proposed development. Can you help break that up? When I see the ₹1,269 crores of enterprise value for this acquisition, can you give us the breakup of that value between the sub-categories? And the way I picked it up from the presentation is 1.4 msf completed, 1.6 msf under construction, and 2 msf future development. And also, if you could give us some flavor on the underlying NOI, how much is coming from rentals, how much is coming from the property management fee for the 8.5% cap rate and the 10% cap rate that you stated.

Aravind Maiya: Murtuza, hi. So, why don't I hand it over to Ritwik to give details on the valuation split? And then second question, I need a little bit more clarity from you, but I'll come to that. Ritwik, over to you.

Ritwik B: So, effectively, you should think about it in three different phases, Murtuza. First, 8.5% pertains effectively to blocks 2, 3, and 9. And also includes block 10 as well, right, with the rental support. And the 8.5% really is a number that we did not take lightly, simply because given where precedence and transaction comps have priced out in sort of the private markets and just overall, we wanted to make sure that there was full value further reflected in that.

The under construction portion of 10% really then pertains to doing this at effective Chennai rents and then obviously taking 61% of that for the rest of the assets on a blended basis. And then, assuming the full financing cost, the construction cost of that, because that's something that we have to bear the brunt on. So, that number comes in at that 10% range. But that's effectively the major areas. And we think about it from the perspective of 2, 3, 9, and 10 as the major blocks. And then obviously thinking about the rest of it under construction for the yield on cost.

Aravind Maiya: And just in terms of split of values, big picture, Murtuza, 2, 3, 9, 10 is around ₹910 crores. And the balance is around, say, ₹359 crores. That's broadly the split. On your second one, I didn't get your question fully, sorry, Murtuza.

Murtuza Arsiwalla: So, what I was trying to get a sense on was the NOI and the property management split. So when I look at the in-place rental of about ₹69, which is data points that you've given in your presentation, I get about ₹110 crores of rental revenue, which I understand only 61% belongs to us. So, when I look at 8.5% on roughly about ₹900 crores, that's roughly about ₹770 crores. So is the 8.5% on the ₹89 crores of NOI that you've given? Or is that on a more normalized number?

Aravind Maiya: Yes, okay, two things. One, it is on the ₹89 crores. The ₹89 crores includes 100% of the CAM. The only moving piece is there is balance cost to be spent on Block 10 that is reduced. And I gave you the number of ₹910 crores value.

Murtuza Arsiwalla: Okay. Thank you.

Moderator: Thank you. We have the next question from the line of Naishi Shah from ICICI Lombard. Please go ahead.

Naishi Shah: I just have a couple of questions. So based on my understanding, the currently constructed blocks are all SEZ properties. And the Block 10 that is under construction, that is also an SEZ, if I'm not wrong?

Aravind Maiya: Yes, that's correct.

Naishi Shah: Considering that there's a lot of denotification in process in the other cities that we have assets in, is there a specific reason why we're constructing these properties under SEZ? And is there demand for SEZ properties as of now, considering the occupancy rates have gone down in other cities?

Also, just wanted to understand a little more on the rental support of ₹42.9 crores. So is this something that the REIT will be paying to the Embassy group or how does it work?

Aravind Maiya: So in terms of the first question, the current 1.8 msf is fully SEZ. These are all new leases. It's a weighted average lease expiry of another 14 years. So we are comfortable with that. In terms of the balance 3.2 msf, we have assumed and underwritten the entire balance to be non-SEZ. So we have factored in the necessary GST costs in relation to the construction. So, we are assuming that every single lease henceforth will be in relation to a non-SEZ space. That's the way we've looked at it.

The rent support is purely in relation to the 0.4 msf pertaining to one tenant where construction is going on. So what we've done is, because it's fully backed up by a tenant, we have valued this appropriately or accordingly in the valuation and to the extent of the rent from the date of purchase till the expected rent commencement date, which is expected to be around Nov'25. That is going to be paid back by Embassy Sponsor to us and all of this anyway will be done through an escrow arrangement.

Naishi Shah: All right, thank you so much. That's it for now.

Moderator: Thank you. We have the next question from the line of Pallav Garg from Star Health Insurance. Please go ahead.

Pallav Garg: I quickly wanted you to give us some sense on the rents and occupancy prevailing in other office-dominated areas in the Chennai market. Just trying to get a sense on how OMR 2 is placed compared to other office markets.

Aravind Maiya: Okay, I'll request Amit to take the question.

Amit Shetty: So, Pallav, essentially OMR 1 is the highest grossing in terms of rent. Rents are anywhere between ₹85 to about ₹100 psf there. The second most premium for the rent that we've seen is PTR Road, which is anywhere between ₹75 to about ₹85, ₹90. So, that's the rental spread. And OMR 2 broadly is slightly lower than the PTR Road market, which is closer to about ₹50, ₹55 to ₹60 rental range.

Pallav Garg: Okay, sure. So, when we see the valuation report here, on the page 52 on the filing which you have put up, which has a total of 230 pages, the current vacancy for peripheral southwest, the region where OMR 2 and our property belongs to, that comes out to be among the highest. But our property, per se, is sitting at a very handsome occupancy rate. So, our property is outstanding in the OMR 2 region? Is that understanding right?

Amit Shetty: Yes, if you see our strength, Pallav, is that we build business ecosystems and that's the ethos that this park has been built with as well. And that's why it has commanded much better than the other parks in and around the vicinity.

Ritwik B: Yes, look, not all supply and not all products are created equal. And I think one of the reasons why we have the names that we do in the park and the reason why we were moved to actually go out there, and I think this is important for everybody on this call and just for the market to understand, we are doing this for a very specific reason. There is clearly a GCC boom, there is a leasing boom, and Chennai as a market is growing. We are really looking to capitalize on this entire aspect by listening to what our tenants want. They're looking to lease more, they're looking to take up more space, and I think if we don't strike while the iron's hot, we'll lose out to competition. Again, the quality of our assets dictate the vacancy level, and 95% occupied for the completed is a sign of that.

Pallav Garg: Okay, yes, thanks. That is it for me.

Moderator: Thank you. We have the next question from the line of Girish Chaudhary from Avendus Spark. Please go ahead.

Girish Chaudhary: Thanks for the opportunity. So if you can just let us know a bit more about the need to de-leverage now, especially, if you look at the interest rate cycle, we are at peak levels. So why not go for growth, and also from a timing point of view, why the overall de-leveraging exercise currently?

Ritwik B: Yes, that's a very good question, and I think part of the entire fundraising strategy for us was predicated around this. If you look, the majority of the proceeds for the fundraising is going to be for de-levering, and the reason is quite simple. As a REIT in India, we're a new structure, and while I think we've done an exemplary job managing our cost of capital, the fact is that the debt markets are quite shallow. We've raised money at leading rates, but what we want to do is just create a little bit of headroom that allows us to manage the balance sheet. 30% leverage in a new market is still quite a lot, and I think if we have the opportunity to take advantage of a rising stock price and make sure that the balance sheet remains clean, it gives us the opportunity to continue having that ₹135 crores of interest savings. That allows us to just keep the development clean and funded appropriately.

That's why we just thought it would be a prudent way to do it. This is no different from what other REITs do worldwide or when companies actually take advantage of capital markets to de-lever, and there's no real science behind it. I think we just feel comfortable at slightly lower levels at this point, ingest the acquisition appropriately, and make it accretive, which dictates why we are out there in the market doing a placement at this point.

Aravind Maiya: And just to add on, while Ritwik covered it, you are aware that we are developing close to 7 msf in our portfolio. The expected capex spend on that is almost close to ₹4,000 crores. Plus, we will develop further in Chennai, and all of this will come from debt. So, considering all of this, we thought it makes sense to de-lever a bit.

Ritwik B: And just one last point on this for the market to consider, we've always operated in an elevated funding environment, and if you look at the Fed, it doesn't seem to be in any real rush to cut at this point in time. So, if you think of an elevated rate cycle over the next year, and there's some refinancing risk, at least globally, that's going to hit commercial real estate, we just want to stay ahead of that and keep the balance sheet flexible.

Girish Chaudhary: Okay. And one more question. If I look at your NOI to NDCF walk for the transaction, the incremental NDCF is ₹203-odd crores. So there, I would just want to understand why the incremental tax is not factored in, for the interest cost savings.

Aravind Maiya: This is to introduce Abhishek, our CFO, Abhishek, go ahead please.

Abhishek Agrawal: This transaction will be tax neutral from the interest rate perspective, because we will lose the tax shield on the interest of outside debt, but we will get similar tax shield when the REIT infuses this amount to that SPV.

Aravind Maiya: So, there won't be additional tax expense, just to keep it short.

Girish Chaudhary: Okay, got it. Thank you.

Moderator: Thank you. The next question is from the line of Praveen Choudhary from Morgan Stanley. Please go ahead.

Praveen C: Thanks so much for taking my call, and congratulations for getting this deal done. Two quick questions from me. One is, when you mentioned on page number 22, the accretion of 2.9%, this assumes the entire placement on top of the deal, right? It's not just that you're assuming the deal is done with equity of ₹13 billion raising. Just wanted to confirm that.

And the second question is what is the maximum gearing that you're comfortable with? You said 30 going to 27, but what is that percentage where you are comfortable if tomorrow there is another deal that comes through, and you have to gear yourself? Is it 35? Is it 40? Thank you.

Aravind Maiya: Just taking the second question first, in terms of gearing. Praveen, anyway, we have a cap that we will not cross 35%, because that's the maximum number which is approved by the unitholders. So, that is anyway the cap we have, but we would probably be in the early side of 30s, then the latter side of 30s. That's broadly what I would say.

And in terms of accretion, you're right. The 2.9% accretion factors in both the Chennai asset acquisition and the necessary cash inflow and the full funding of ₹2,500 crores in form of equity and refinancing. But just big picture split, close to around 1% or 1.1% is pure accretion from the Chennai asset and the balance 1.8% accretion is coming from de-leveraging.

Praveen C: Understood. And for de-leveraging, you have assumed the debt to be refinanced at 8.3%, right? That's where the interest cost saving is happening. Would you be doing it immediately or is it just an assumption here?

Aravind Maiya: So, we have the necessary ability to do it immediately, in terms of the loan terms.

Praveen C: Okay. Very clear. Thank you so much for taking the time.

Moderator: Thank you. The next question is from the line of Kunal Lakhan from CLSA. Please go ahead.

Kunal Lakhan: Good evening. Just wanted to get some numbers there. In terms of balance capex on Block 4, 1, 5- 8, what would that amount be?

Aravind Maiya: So, all in, it'll be close to ₹1,600 crores, including master plan for all future blocks, including what is today under construction.

Kunal Lakhan: Including GST?

Aravind Maiya: Yes, including all costs.

Kunal Lakhan: This excludes Block 10?

Aravind Maiya: Includes Block 10.

Kunal Lakhan: But Block 10 would be very minimal of this, right?

Ritwik B: It's around ₹135 crores.

Kunal Lakhan: Okay. So, around ₹1,450-odd crores would be for Block 4, 1, and 5, and 8?

Ritwik B: No, it's 5, 6, 7, 8.

Aravind Maiya: Yes. So, there are four blocks between 5 and 8. So, including Block 10, there are seven blocks. If you were to exclude Block 10, there are six blocks, plus master plan.

Kunal Lakhan: Correct. And that's the portion which you have valued at ₹359 crores?

Aravind Maiya: That's correct.

Kunal Lakhan: Okay. So, just trying to get some numbers there. So, if I look at the completed portfolio valued at about ₹910 crores, that includes Block 10, I'm assuming, right?

Aravind Maiya: Exactly. That's correct.

Kunal Lakhan: So, that's like 1.8 msf of portfolio valued at ₹910 crores, which essentially is a valuation of about ₹5,055 psf. And the ongoing and upcoming, you have valued at ₹359 crores. And if I add balance capex to this of ₹1,450 crores, the implied valuation for this would be about ₹5,653 crores. So, I'm just trying to reconcile some numbers there?

Aravind Maiya: Sorry, ₹5,653 crores you mean, or you mean per square feet?

Kunal Lakhan: ₹5,653 per square feet. Correct. So, ₹359 plus ₹1,450 is about ₹1800 crores, divided by 3.2 msf. It's about ₹5,653 psf. So, is that understanding correct?

Aravind Maiya: Let me put it this way. The completed blocks, all your numbers are right, but just remember that we have only 61% rights. So, when you factor for the 61% rights, it will come to around ₹9,000 psf.

Kunal Lakhan: Correct.

Aravind Maiya: Similarly, for the 3.2 msf, there are already some costs spent. Right? So, if I were to remove the cost spent and were to value only the rights which we have, that comes to around ₹1,200 psf.

Kunal Lakhan: How much is the cost spent?

Aravind Maiya: Cost spent is approximately around ₹120 crores.

Kunal Lakhan: Okay. But that would still value, it would not be very materially different, right, in terms of valuation.

Aravind Maiya: So, Kunal, I think, we don't understand the way you have done it. It's better to just take this one-on-one, where we can explain it to you better. Because we are not able to really see what you have done.

Kunal Lakhan: Fair enough. I'll take this offline. Thanks.

Moderator: Thank you. The next question is from the line of Satinder Singh Bedi from Eon Infotech Limited. Please go ahead.

Satinder S Bedi: Good evening. So, carrying on with this last question. So, this ₹910 crores, which is the cost attributed to 1.4 msf built-up and 0.4 msf partly built-up. So, what part of this 910 is attributable to the 1.4 msf already completed piece?

Aravind Maiya: It's around ₹770 crores.

Satinder S Bedi: Okay. So, ₹770 crores for 61% of 1.43 msf. That works out to about ₹8,800 psf. Is that a clear understanding?

Aravind Maiya: Yes, that's correct.

Satinder S Bedi: Okay. And regarding this interest cost, this was an original question I had, but I couldn't understand when it was answered by Abhishek. So, Abhishek, on this walkdown, NOI to NDCF, you said the interest cost savings have not been offset by the tax implication. So, why no tax implication of the interest cost savings, please? If you could kindly help understand.

Abhishek Agrawal: So, Satinder, what will happen is that there will be an interest saving on the external debt at the SPV level. There will also be additional debt which will come in because of the equity raise that we do, we will infuse that into the SPV, and the REIT will also charge interest on that. So, net-net, there will be no tax drag.

Satinder S Bedi: Okay. So, there will be no tax drag at all.

One more query I had was regarding your views on the cap rate of 8% for PTR, given that other leading companies, for example, Capital Land for Taramani would have typically been valued at 8.5%. So, is 8% kind of stiff?

Ritwik B: We're at 8.5% for the completed, Satinder. We're not at 8%. We're at 8.5%. So, I think it's very well in line with the market precedents. And I think, if anything, slightly wider given where markets have been. And we're not private capital, we obviously have a fiduciary duty to shareholders as well. So, if you look at precedent trades that have been done, that's significantly sort of inside us.

Aravind Maiya: Yes, Satinder. I think, honestly, some of the trades which have happened, the few ones in Chennai, are at a much tighter cap rate than 8.5%.

Satinder S Bedi: Okay. So, I think I stand corrected. The valuer has valued it at 8%. And because of the 6.7% discount, I think we will end up transacting at 8.5%. So, I think that's fine. Maybe a question or two more. I'll take it offline. Thank you very much.

Moderator: Thank you. Ladies and gentlemen, we will take that as the last question. On behalf of Embassy REIT, that concludes this conference. Thank you for joining us. You may now disconnect your lines.