Foreign-based trusts and complex structures: An under-appreciated risk?

In last year's report, we included a review of the sector and one of the areas we flagged was the complex structure common in many trusts, especially for trusts with mainly foreign assets for which additional entities often have to be created to comply with legal and tax requirements.

In June 2021, one trust announced that it was applying to list one of its wholly-owned subsidiaries in a UK stock exchange, which will then become a listed UK REIT. The subsidiary will remain wholly-owned after listing. This "technical" listing was undertaken to obtain preferential tax treatment under the tax laws of the UK, where the properties of the trust are located.

Another trust has faced tax and legal problems related to its complex structure, and has spent years in the courtroom with no resolution in sight.

Adverse events relating to foreign assets may also not be fully disclosed or disclosed in a timely manner.

In December 2021, Digital Core REIT listed on the SGX. It was one of the two newly-listed trusts not covered in GIFT this year. Touted as a "pure-play data centre REIT", its sponsor and manager, Digital Realty Trust, is described in the prospectus as the sixth largest publicly traded US REIT. This is a unique case where, and for the first time, a SGX-listed REIT has a sponsor and manager which is another (listed) REIT.

It is interesting that the sponsor carved out assets and listed Digital Core on SGX. It perhaps would not make sense to do so on NYSE where the sponsor REIT itself is listed and which is a far larger listing venue for REITs. Unlike its sponsor REIT which is internally managed, as is the common practice in the US, Digital Core is externally managed.

Digital Core's prospectus touts that it is to benefit from the sponsor's "best-in-class" ESG leadership. On the "Social" aspect of ESG, it said that Digital Realty has amended its corporate governance guidelines "to clarify that director candidate pools must include candidates with diversity of race, ethnicity and gender". Digital Realty's 11-member board does indeed have three women. In contrast, Digital Core has a five-member all male board, with two Singaporeans. One of the two Singapore independent directors spent 30 years with DBS Bank until his retirement in 2019 and was responsible for the bank's equity markets business in Singapore. DBS Bank is one of three issue managers, bookrunners and underwriters for Digital Core's listing.

4. KEY FINDINGS (CONT'D)

Digital Core's initial portfolio comprises 10 freehold data centres in key markets of the US and Canada with a valuation of US$1.46 billion and a net rentable area of 1.2 million square feet (111,484 square metres). Its parent, sponsor and manager, Digital Realty, has a global data centre footprint that stretches across 290 facilities in 50 metropolitan areas of 26 countries. One question is how the 10 data centres in the initial portfolio for Digital Core are selected and valued.

The media release by Digital Realty dated 6 December 2021 said that the listing of Digital Core "is ideally positioned to help Digital Realty create value by providing a perpetual capital partner for core assets, while acting as an extension of our global platform and enabling customers to continue to rely on Digital Realty's track record of operational excellence". It also spells out "key strategic and financial benefits for Digital Realty". While the benefits of the listing to Digital Realty are clearly spelt out, the same cannot be said about the benefits of the listing to the unitholders of Digital Core.

Bankruptcy of major customer

On 21 April 2022, Digital Core provided a first quarter business and operational update. In the market and portfolio update, it mentioned that its fifth largest customer, which it did not name, had filed for Chapter 11 bankruptcy on 11 April 2022. The customer occupies 2.7MW of capacity in Toronto and represents approximately US$5 million of annualised revenue or around 7.1% of Digital Core REIT's total revenue.

This happened just three years after the customer had come out of a prior bankruptcy. Digital Core did not announce the default as a standalone announcement on SGXNET. The first quarter business update was about 10 days after the default.

It further stated that the manager is confident of back-filling the capacity should the customer rejects its leases due to the "tight market conditions in Toronto". The manager also said that it has reached an in-principle agreement with the sponsor, Digital Realty, to guarantee the cash flow to Digital Core REIT in the event of a near-term cash flow shortfall due to the customer bankruptcy. The REIT stated in bold, underlined font that "**This customer event is not expected to impact DPU**".

The April announcement was followed by an announcement on 28 July 2022 titled "Cash flow support agreement" in which Digital Core REIT informed unitholders that the REIT's fifth largest customer has filed for bankruptcy protection. The customer was said to be current on its rental obligations under its lease through the month of July 2022. As a result of the bankruptcy, the sponsor has entered into a "cash flow support agreement" with the REIT manager, under which the Sponsor Entity will provide cash flow support to Digital Core REIT of no more than once per calendar quarter, calculated based on a formula set out. The total amount provided by the Sponsor Entity pursuant to the Cash Flow Support Agreement will not exceed US$7.5 million.

Digital Core REIT will repay the Sponsor Entity the aggregate amount received pursuant to the Cash Flow Support Agreement. Based on the first quarter update in April, unitholders may get the impression that the sponsor is covering any shortfall from the bankruptcy of a major customer but the subsequent announcement in July made it clear that the sponsor is only providing temporary cash flow support which will be paid back by the REITs in cash or units. Is it really the case that the “customer event is not expected to impact DPU” as the announced earlier in April 2022?

Further diversification

On 22 September 2022, Digital Core REIT Manager, the manager of Digital Core, announced the proposed acquisition of a 25% interest in a data centre in Frankfurt, Germany, and an 89.9% interest in another data centre in Dallas, United States. The latter acquisition is conditional on equity fund raising taking place. The acquisition of the data centre in Germany means that it is diversifying out of the US and Canada, where its initial assets are located.

Missed forecasts

Since its listing, Digital Core has missed its forecasts of distributable income to unitholders for the first three quarters ended 30 September 2022, with the US$34.4 million in distributable income being 3.4 percent lower than its forecast of US$35.6 million.

Digital Core has seen its unit price increased to US$1.20 from its listing price of US$0.88. Since early April, and along with poorer market sentiments, the unit price of Digital Core has fallen to as low as US$0.50 by 31 October 2022, a fall of 58% from its 52-week high.

Digital Core REIT has a financially strong sponsor listed on the largest stock exchange in the world. However, the sponsor has its own unitholders to account to, and the interests of those unitholders may not necessarily be the same as the unitholders of Digital Core REIT here.