

Regional REIT

Operational progress supports DPS

Regional REIT's (RGL) Q322 DPS declared of 1.65p is in line with its target of 6.6p for the year (+3%). Despite a deteriorating economic environment, Q322 operational progress included strong leasing activity, good tenant retention, an increase in occupancy and continuing strong rent collection. With all debt fixed/hedged for almost five years, interest costs are unaffected by rising interest rates, although higher bond yields are having a negative impact on asset values across the broad UK market.

Year end	Net rental income (£m)	EPRA earnings* (£m)	EPRA EPS (p)	NAV**/ share (p)	DPS (p)	P/NAV (x)	Yield (%)
12/20	53.3	28.1	6.5	98.6	6.40	0.65	10.0
12/21	55.8	30.4	6.6	97.2	6.50	0.66	10.2
12/22e	62.3	33.5	6.5	88.4	6.60	0.72	10.3
12/23e	64.3	34.5	6.7	88.4	6.70	0.72	10.5

Note: *EPRA earnings exclude revaluation movements, gains/losses on disposal and other non-recurring items. **NAV is EPRA net tangible assets (NTA) per share.

Positive income indicators while asset values weaken

New leases agreed in Q322 will add £1.2m to rental income when fully occupied. The year-to-date total is now £3.8m, above the 2019 pre-pandemic level. On lease renewals, retention of existing tenants was also strong at 70%, including leases 'held over' pending agreement. Overall, the end-Q322 rent roll was £72.2m, up slightly from mid-year (£72.0m) and EPRA occupancy increased to 84.6% versus 83.8% at June. The Q322 portfolio value of £915m reflects the June valuation, adjusted for subsequent transactions/capex, but not revaluation moves. Valuation yields are softening across all sectors of the market, although we expect RGL's leasing progress and asset quality enhancement to soften the impact. However, while our EPRA earnings and DPS forecasts are unchanged, we have reduced forecast NAV and expect LTV to move up from the 43.1% reported for Q322 (details below).

Income-led strategy

The commercial property sector is cyclical, but income returns have historically been significantly more stable than volatile capital values and provide a more consistent measure of value. RGL has consistently targeted a higher-yield portfolio that would provide progressive, regular dividends with the potential for capital growth. Asset yields and quality have been supported by active asset management and capital recycling. The Q322 rent roll of £72.2m compares with a full occupancy estimated rental value (ERV) of £93.3m, demonstrating strong income potential, primarily from letting vacant space to support a continuing high level of income. Despite the challenging environment, RGL observes a continuing acceleration in the return to the office.

Valuation: High yield despite sustained distributions

RGL continues to offer one of the highest yields in the UK REIT sector, a combination of its consistent income-led strategy and the market valuation of its shares. Its FY22 target DPS of 6.6p reflects a yield of 10.3%, significantly above close peers, while the shares trade at a 28% discount to FY22e NAV.

Q3 trading update and DPS

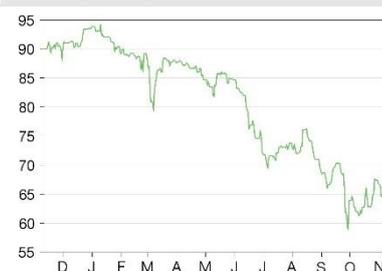
Real estate

11 November 2022

Price 64p
Market cap £330m

Net debt (£m) at 30 September 2022	394.3
Net LTV at 30 September 2022	43.1%
Shares in issue	515.7m
Free float	87.4%
Code	RGL
Primary exchange	LSE
Secondary exchange	N/A

Share price performance



%	1m	3m	12m
Abs	4.4	(12.6)	(27.7)
Rel (local)	(2.4)	(10.5)	(25.3)
52-week high/low		95p	59p

Business description

Regional REIT is focused on office assets located in the regional centres of the UK, highly diversified by property, tenants and the underlying industry exposure of those tenants. It is actively managed with a strong focus on income and targets a total shareholder return of at least 10% over the longer term.

Next events

Q322 DPS paid	12 January 2023
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Details of estimate changes

Continued leasing progress provides additional comfort to our EPRA earnings forecasts and RGL's ability to meet its FY22 DPS target.

However, across all main sectors of the UK commercial property market, general economic and political challenges, and uncertainties, including the war in Ukraine, are weighing on asset valuations. The 10-year UK gilt yield has increased from below 1% at the beginning of the year to c 3.5%, having recently been as high as 4.5%. Adding to asset pricing uncertainty, institutional investment demand for commercial real estate has fallen sharply from high levels at the start of the year. The open-ended property retail funds sector is again under pressure to raise liquidity and even the pension fund sector has been forced to reappraise sector weightings.

With a weaker demand-supply balance, rising bond yields and limited market transactions, there is much uncertainty about capital values, despite many sectors reporting good occupier demand and increasing rents.

Across the UK office sector, asset values to end-September were down 1.4%, which includes a 2.6% decline since July. The experience of those listed investors that have reported Q322 valuation changes is that the picture is very mixed, reflecting very diverse portfolios and asset management initiatives. For RGL, our revised forecasts now allow for a c 50bp softening in the valuation yield over FY22, equivalent to a c 5% reduction in our previously forecast portfolio value and a c 9% reduction in NAV/EPRA NTA per share. Assuming no management actions, we expect this to delay RGL's targeted reduction in net loan to value, or LTV, towards 40% and we forecast c 45% over the next two years.

It is worth noting that RGL continues to have strong rent collection¹ and good liquidity. Year to date, 97.4% rents have been collected compared to 94.8% for the equivalent period of FY21, and ultimately a fiscal collection rate of 99.2%. End-Q322 cash was £48m and there is a good level of headroom against borrowing covenants that require LTVs at the loan facility level of no more than c 60%. Group level interest cover was 3.0x at 30 June 2022.

Exhibit 1: Estimates – changes to NAV only

(£m)	New		Previous		Change			
	FY22e	FY23e	FY22e	FY23e	FY22e	FY23e	FY22e	FY23e
Rental & other property income	76.8	77.3	76.8	77.3	0.0	0.0	0.0%	0.0%
Non-recoverable property costs	(14.5)	(13.1)	(14.5)	(13.1)	0.0	0.0	0.0%	0.0%
Net rental income	62.3	64.3	62.3	64.3	0.0	0.0	0.0%	0.0%
Administrative expenses	(11.6)	(12.3)	(11.6)	(12.3)	0.0	0.0	0.0%	0.0%
Net finance expense	(17.2)	(17.5)	(17.2)	(17.5)	0.0	0.0	0.0%	0.0%
EPRA earnings	33.5	34.5	33.5	34.5	0.0	0.0	0.0%	0.0%
EPRA cost ratio (exc direct property costs)	34.0%	32.8%	34.0%	32.8%				
EPRA EPS (p)	6.5	6.7	6.5	6.7	0.0	0.0	0.0%	0.0%
DPS (p)	6.6	6.7	6.6	6.7	0.0	0.0	0.0%	0.0%
Dividend cover (x)	0.98	1.00	0.98	1.00				
EPRA NTA per share (p)	88.4	88.4	97.3	97.3	(8.9)	(8.9)	-9.1%	-9.2%
EPRA NTA total return	-2.2%	7.5%	6.9%	6.8%				
Gross borrowing	(442.9)	(442.9)	(442.9)	(442.9)				
Net LTV	45.2%	45.5%	42.9%	43.3%				
Shares outstanding (m)	515.7	515.7	515.7	515.7	0.0	0.0	0.0%	0.0%
Average number of shares (m)	515.7	515.7	515.7	515.7	0.0	0.0	0.0%	0.0%

Source: Edison Investment Research

¹ As at 3 November 2022, 94.7% of the rent due for Q322 had been collected, comprising rent received of 94.1%, monthly rents of 0.5% and agreed collection plans of 0.1%. From 1 January 2022 to 3 November 2022, 97.4% of rent had been collected, comprising of rent received of 97.2%, monthly rents of 0.2% and agreed collection plans of 0.0%.

Exhibit 2: Financial summary

Year end 31 December (£m)	2019	2020	2021	2022e	2023e
INCOME STATEMENT	IFRS	IFRS	IFRS	IFRS	IFRS
Rental & other property income	64.4	62.1	65.8	76.8	77.3
Non-recoverable property costs	(9.4)	(8.8)	(9.9)	(14.5)	(13.1)
Net rental & related income	55.0	53.3	55.8	62.3	64.3
Administrative expenses	(10.9)	(11.3)	(10.6)	(11.6)	(12.3)
EBITDA	44.1	42.0	45.2	50.7	52.0
EPRA cost ratio	31.6%	32.4%	31.2%	34.0%	32.8%
Gain on disposal of investment properties	1.7	(1.1)	0.7	(3.3)	0.0
Change in fair value of investment properties	(3.5)	(54.8)	(8.3)	(41.1)	0.0
Change in fair value of right to use asset	(0.2)	(0.2)	(0.0)	(0.2)	(0.2)
Operating Profit (before amort. and except.)	42.0	(14.1)	37.6	6.1	51.8
Net finance expense	(13.7)	(14.0)	(14.9)	(17.2)	(17.5)
Fair value movement in interest rate derivatives & goodwill impairment	(2.0)	(3.1)	6.0	11.9	0.0
Profit Before Tax	26.3	(31.2)	28.8	0.7	34.2
Tax	0.3	0.2	0.0	0.0	0.0
Profit After Tax (FRS 3)	26.5	(31.0)	28.8	0.7	34.2
Adjusted for the following:					
Net gain/(loss) on revaluation/disposal of investment properties	1.9	55.9	7.6	44.4	0.0
Other EPRA adjustments	2.6	3.2	(6.0)	(11.6)	0.2
EPRA earnings	31.0	28.1	30.4	33.5	34.5
Period end number of shares (m)	431.5	431.5	515.7	515.7	515.7
Fully diluted average number of shares outstanding (m)	398.9	431.5	459.7	515.7	515.7
IFRS EPS - fully diluted (p)	6.6	(7.2)	6.3	0.1	6.6
EPRA EPS (p)	7.8	6.5	6.6	6.5	6.7
Dividend per share (p)	8.25	6.40	6.50	6.60	6.70
Dividend cover (x)	0.94	1.02	1.02	0.98	1.00
BALANCE SHEET					
Non-current assets	806.0	749.5	925.2	902.8	910.6
Investment properties	787.9	732.4	906.1	876.3	884.3
Other non-current assets	18.1	17.2	19.0	26.5	26.3
Current Assets	69.4	101.1	85.5	76.7	70.2
Other current assets	32.2	33.7	29.4	29.7	30.0
Cash and equivalents	37.2	67.4	56.1	47.0	40.2
Current Liabilities	(36.2)	(49.1)	(58.4)	(60.9)	(61.8)
Borrowings	0.0	0.0	0.0	0.0	0.0
Other current liabilities	(36.2)	(49.1)	(58.4)	(60.9)	(61.8)
Non-current liabilities	(355.5)	(380.9)	(449.9)	(449.7)	(450.3)
Borrowings	(287.9)	(310.7)	(383.5)	(387.5)	(388.6)
Other non-current liabilities	(67.6)	(70.3)	(66.4)	(62.2)	(61.7)
Net Assets	483.7	420.6	502.4	468.9	468.7
Derivative interest rate swaps & deferred tax liability	2.6	5.0	(1.0)	(12.9)	(12.9)
Goodwill	(0.6)	0.0	0.0	0.0	0.0
EPRA net tangible assets	485.7	425.6	501.4	456.0	455.8
IFRS NAV per share (p)	112.1	97.5	97.4	90.9	90.9
EPRA NTA per share (p)	112.6	98.6	97.2	88.4	88.4
EPRA NTA total return	4.9%	-5.8%	5.0%	-2.2%	7.5%
CASH FLOW					
Cash (used in)/generated from operations	26.0	48.0	56.9	52.8	52.5
Net finance expense	(12.2)	(12.5)	(13.1)	(15.4)	(16.1)
Tax paid	(0.8)	0.2	0.0	0.0	0.0
Net cash flow from operations	13.0	35.7	43.8	37.3	36.4
Net investment in investment properties	(25.6)	(0.3)	(98.3)	(14.5)	(8.0)
Acquisition of subsidiaries, net of cash acquired	(43.9)	0.0	0.0	0.0	0.0
Other investing activity	0.2	0.1	0.0	0.0	0.0
Net cash flow from investing activities	(69.4)	(0.2)	(98.2)	(14.5)	(8.0)
Equity dividends paid	(32.5)	(26.7)	(27.8)	(34.0)	(34.4)
Debt drawn/(repaid) - inc bonds and ZDP	3.5	22.2	73.8	3.0	0.0
Net equity issuance	60.5	0.0	(0.1)	0.0	0.0
Other financing activity	(42.7)	(0.8)	(2.7)	(0.9)	(0.8)
Net cash flow from financing activity	(11.2)	(5.3)	43.2	(31.9)	(35.3)
Net Cash Flow	(67.6)	30.1	(11.2)	(9.1)	(6.8)
Opening cash	104.8	37.2	67.4	56.1	47.0
Closing cash	37.2	67.4	56.1	47.0	40.2
Balance sheet debt	(337.1)	(360.1)	(433.1)	(437.2)	(438.5)
Unamortised debt costs	(6.9)	(6.0)	(6.9)	(5.6)	(4.4)
Closing net debt	(306.8)	(298.8)	(383.8)	(395.9)	(402.7)
LTV	38.9%	40.8%	42.4%	45.2%	45.5%

Source: company data, Edison Investment Research

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