

Regional REIT

Trading update

Positive trading and dividend increase

In a trading update Regional REIT (RGL) says that the regional office and light industrial markets in which it operates remain robust, with strong occupier demand for its assets, and that it is trading in line with management expectations for the year. These expectations include a return to full dividend cover, and the company has declared a Q119 DPS of 1.90p per share, a 3% increase, maintaining its position as one of the highest yielding stocks in the sector.

Year end	Net rental income (£m)	Adjusted EPS* (p)	EPRA NAV/ share (p)	DPS (p)	P/EPRA NAV (x)	Yield (%)
12/17	45.8	8.6	105.9	7.85	1.03	7.2%
12/18	54.4	7.5	115.5	8.05	0.95	7.4%
12/19e	55.2	8.5	116.7	8.25	0.94	7.6%
12/20e	55.7	8.6	117.8	8.45	0.93	7.7%

Note: *Adjusted earnings exclude revaluation movements, gains/losses on disposal, and other non-recurring items, and unlike EPRA earnings also exclude performance fees.

Occupational demand remains robust

The trading statement provides reassurance about the continued strength of trading, amid heightened Brexit uncertainty. It also details the progress of asset management initiatives in the year to date, with several significant lettings at rents well above previous levels. In FY18, rents increased by an average 11.8% on lease renewals in the office portfolio and the trend is continuing. We make no changes to our forecasts, published after the full year results (see our [update note](#)), which look for the contribution from recently completed acquisitions, like-for-like occupancy improvement and rental growth, and lower funding costs to drive growth, with DPS further increased and fully covered by adjusted earnings. Not included in our estimates are the further earnings accretive acquisitions that RGL targets.

Further growth opportunities

Since listing in November 2015, RGL's portfolio value has almost doubled, to £741m, including several large portfolio transactions. In the process portfolio positioning has been optimised, diversification increased and scale added, supporting the fully integrated in-house asset management platform and improving access to capital markets. Acquisitions also reflect capital recycling, at the heart of RGL's strategy to opportunistically acquire attractively priced, income-producing assets that will benefit from active management. These may subsequently be sold to realise the value thereby created, as was the case in FY18. With a cooling in the investment market, RGL now has a large and diverse pipeline of investment opportunities and says it is considering an equity fund raise to enable it to take advantage of these.

Valuation: Strong returns with income focus

RGL shares have performed well over the past year, outperforming the broad UK property sector, the wider market and a narrow group of direct peers. Still, the prospective yield, approaching 8%, remains among the highest in the sector and we expect DPS to be fully covered by adjusted earnings in FY19.

Real estate

3 June 2019

Price 109.2p
Market cap £407m

Net debt (£m) at 31 March 2018	297.7
Net LTV at 31 March 2018	41.0%
Shares in issue	372.8m
Free float	97%
Code	RGL
Primary exchange	LSE
Secondary exchange	N/A

Share price performance



%	1m	3m	12m
Abs	2.3	6.3	9.1
Rel (local)	5.2	4.5	16.6
52-week high/low	109.6p	90.1p	

Business description

Regional REIT owns a highly diversified commercial property portfolio of predominantly offices and light industrial units located in the regional centres of the UK. It is actively managed and targets a total shareholder return of at least 10% with a strong focus on income.

Next events

Q210 DPS declared	29 August 2019
Interim results	10 September 2019

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Further details from the statement

RGL's portfolio is focused on income producing regional UK core and core plus office (76.7%) and industrial assets (15.0%). With a general lack of new development in the regions, both sectors continue to benefit from positive supply/demand dynamics in occupational markets. Meanwhile, as Brexit uncertainty has increased the investment market has shown some signs of cooling, with transaction volumes weaker than last year, and this is opening up potential investment opportunities.

Since end-FY18, has acquired Norfolk House, a c 120 sq ft freehold office property with retail units, well situated in central Birmingham, adjacent to New Street station, the Bullring shopping centre and close to the proposed new HS2 station, providing enhanced rail links to London and Manchester. The property is 98.75% occupied with an annual net income of £1.69m and the £20m consideration reflects a net initial yield of 7.92%. The main tenant for the office accommodation is HMRC, occupying 49% of the property. Despite substantial capital expenditure for refurbishment having been undertaken by the vendor, RGL believes that attractive value-enhancing asset management opportunities remain.

Also in FY19 to date, the group has been active in asset management, and exchanged on 19 new leases, with both existing long-term tenants and new tenants, totalling 116,443 sq ft. When fully occupied these will provide c £0.8m of rental income.

Exhibit 1: Portfolio summary		
	31 March 2019	31 December 2018
	Q119	FY18
Valuation (£m)	741.0	718.4
Gross lettable area (million sq ft)		7.43
Number of properties	151	150
Number of property units	1,223	1,192
Number of tenants	884	874
Contracted rents (£m)	60.5	59.7
WAULT to first break (years)		3.4
Estimated rental value, ERV (£m)		70
EPRA occupancy	88.6%	89.4%
Net initial yield		6.5%
Reversionary yield		8.8%
Source: Regional REIT		

Further growth opportunities

RGL came to market in November 2015 with an established portfolio of 128 properties valued at £386m. The portfolio has almost doubled in size since with acquisitions, including several large portfolio transactions, making a strong contribution. At the same time, the company has delivered on its aims to reposition towards faster growing regions such as the south-east and south-west of England and away from Scotland. Non-core investments outside of regional offices and light industrial assets have also been materially reduced.

Acquisitions have supported this portfolio repositioning and the further diversification of the portfolio, and have enabled RGL to build scale, to support its fully integrated in-house asset management platform and improve its access to capital, including improved debt financing terms. But acquisitions also reflect the capital recycling that is at the heart of RGL's strategy whereby it seeks to opportunistically acquire attractively priced, income-producing assets that will benefit from active management and may subsequently be sold to realise the value thereby created. Following significant acquisition activity in 2017, RGL took advantage of good investment demand in the earlier months of FY18 to dispose of properties where its asset management plans were complete.

and, in some cases, where plans were yet to reach maturity but where it had identified that a better risk-adjusted return was available by selling at prevailing market prices, well above valuations. With the investment market cooling slightly, RGL says that during Q119 it saw no shortage of opportunities for making further earnings accretive acquisitions. It says that the potential deal pipeline is both considerable and diverse and that it is considering an equity fund raise to enable it to take advantage of opportunities.

Financials and valuation

No changes to estimates

We have made no changes to our existing estimates that look for the contribution from recently completed acquisitions, like-for-like occupancy improvement and rental growth, and lower funding costs to drive growth, with DPS further increased and fully covered by adjusted earnings. As noted above, RGL targets further earnings accretive acquisitions that are not included in our estimates. Depending on the mix of funding (equity and debt) applied to any acquisitions, and the price that any equity is issued at, we would expect some modest near-term dilution of EPRA NAV. This would be the case in respect of share issuance below the current NAV per share and any acquisition related costs. However, given RGL's investment targets we would expect it to be targeting asset management driven post-acquisition improvements in capital values as well as income, such that any dilution of NAV should only be short term.

Active management delivering total return target

RGL targets a medium-term annual total return of more than 10% and the strong 16.6% EPRA NAV total return in FY18 took the total return generated since IPO in November 2015 to 37.5%, or a compound average annual return of 10.6%. The strong income focus is clear, with growing dividends per share contributing 59% of the total return over the period.

Exhibit 2: NAV total return

	2015*	2016	2017	2018	Since IPO
Opening EPRA NAV per share (p)	100.0	107.8	106.9	105.9	100.0
Closing EPRA NAV per share (p)	107.8	106.9	105.9	115.5	115.5
Dividends per share paid (p)	0.00	6.25	7.80	8.00	22.05
NAV total return (%)	7.8%	5.0%	6.4%	16.6%	37.5%
Compound return (%)					10.6%

Source: Regional REIT. Note: *55-day period from 6 November 2015.

RGL's high dividend yield continues to be at the very top end of the broad UK property sector. For FY19 we forecast the DPS to be both higher and fully covered by adjusted earnings, representing a prospective yield approaching 8%.

In Exhibit 3 we show a comparison with a narrow group of peers that are similarly focused on regional commercial property. To ease comparison, this data is based on 12-month trailing DPS declared and last published NAV. Compared with this narrower group, RGL's yield is also well above the average. Its c 5% share price discount to the end-FY18 EPRA NAV per share is lower than the average for the narrower group of peers and is lower than the average for the broad UK property market (we estimate a c 10% discount). Within the group, those companies with an income focus, like RGL, and covered dividends tend to have the higher P/NAV ratings.

Exhibit 3: Peer comparison

	Price (p)	Market cap (£m)	P/NAV (x)	Yield (%)	Share price performance			
					One month	Three months	12 months	From 12m high
Circle Property	204	58	0.74	2.9	4%	11%	5%	-20%
Custodian	119	483	1.10	5.5	4%	4%	-1%	-3%
Picton	96	516	1.03	3.7	3%	7%	7%	-4%
Real Est Inv	55	102	0.79	6.5	-2%	7%	1%	-12%
Schroder REIT	57	297	0.83	4.5	-1%	-2%	-6%	-15%
Palace Capital	270	124	0.64	7.0	-4%	-10%	-24%	-26%
UK Commercial Property Trust	91	1188	0.97	4.0	3%	6%	6%	-2%
BMO Commercial Property Trust	120	961	0.87	5.0	0%	-1%	-17%	-22%
BMO Real Estate Investments	94	227	0.89	5.3	0%	5%	-7%	-9%
Average			0.88	4.9	1%	3%	-4%	-13%
Regional REIT	109	407	0.95	7.4	3%	7%	14%	-1%
UK property index	1,664			4.0	-3%	-4%	-10%	-11%
FTSE All-Share Index	3,924			4.7	-3%	0%	-7%	-9%

Source: Regional REIT data, Edison Investment Research. Note: *Last reported EPRA NAV per share and trailing 12-month DPS declared. Prices as at 31 May 2019.

Over the past year RGL shares have performed more strongly than the narrow peer group, the broad UK property sector and the FTSE All-Share Index. We attribute this to its ability to demonstrate strong asset management returns, commitment to a progressive dividend policy and reduced LTV. Given the high prospective yield, the prospect of a return to fully covered dividends in FY19 has the potential to support a further re-rating of the shares.

Exhibit 4: Financial summary

Year end 31 December (£000s)	2015	2016	2017	2018	2019e	2020e
PROFIT & LOSS	IFRS	IFRS	IFRS	IFRS	IFRS	IFRS
Rental income	5,361	42,994	61,610	74,019	74,034	74,637
Property costs	(754)	(4,866)	(15,763)	(19,644)	(18,822)	(18,976)
Net rental income	4,608	38,128	45,847	54,375	55,212	55,662
Administrative expenses (excluding performance fees)	(1,353)	(7,968)	(7,819)	(10,540)	(10,309)	(10,385)
Performance fees	0	(249)	(1,610)	(7,046)	(36)	(344)
EBITDA	3,255	29,911	36,418	36,789	44,867	44,933
EPRA cost ratio	N/A	N/A	29.7%	40.1%	27.7%	28.2%
EPRA cost ratio excluding performance fee	N/A	N/A	26.6%	28.6%	27.7%	27.7%
Gain on disposal of investment properties	87	518	1,234	23,127	0	0
Change in fair value of investment properties	23,784	(6,751)	5,893	23,881	3,356	3,762
Operating profit before financing costs	27,126	23,678	43,545	83,797	48,224	48,695
Exceptional items	(5,296)	0	0	0	0	0
Net finance expense	(820)	(8,629)	(14,513)	(15,715)	(13,176)	(13,176)
Net movement in the fair value of derivative financial investments and impairment of goodwill	115	(1,654)	(340)	(142)	0	0
Profit Before Tax	21,124	13,395	28,692	67,940	35,048	35,519
Tax	0	23	(1,632)	(567)	0	0
Profit After Tax (FRS 3)	21,124	13,418	27,060	67,373	35,048	35,519
Adjusted for the following:						
Net gain/(loss) on revaluation/disposal of investment properties	(23,870)	6,233	(7,127)	(47,008)	(3,356)	(3,762)
Net movement in the fair value of derivative financial investments	(180)	865	(407)	(459)	0	0
Other EPRA adjustments including deferred tax adjustment	0	557	4,488	987	0	0
EPRA earnings	(2,926)	21,073	24,014	20,893	31,691	31,757
Performance fees & exceptional items	5,296	249	1,610	7,046	36	344
Adjusted earnings	2,371	21,322	25,624	27,939	31,727	32,100
Period end number of shares (m)	274.2	274.2	372.8	372.8	372.8	372.8
Fully diluted average number of shares outstanding (m)	274.2	274.3	297.7	372.8	372.8	372.8
IFRS EPS - fully diluted (p)	7.7	4.9	9.1	18.1	9.4	9.5
Adjusted EPS, fully diluted (p)	0.9	7.8	8.6	7.5	8.5	8.6
EPRA EPS, fully diluted (p)	(1.1)	7.7	8.1	5.6	8.5	8.5
Dividend per share, declared basis (p)	1.00	7.65	7.85	8.05	8.25	8.45
Dividend cover	N/A	101.6%	109.7%	93.1%	103.2%	101.9%
BALANCE SHEET						
Non-current assets	407,492	506,401	740,928	720,886	752,542	762,305
Investment properties	403,703	502,425	737,330	718,375	750,031	759,794
Other non-current assets	3,790	3,976	3,598	2,511	2,511	2,511
Current Assets	35,803	27,574	66,587	126,986	59,347	55,098
Other current assets	11,848	11,375	21,947	22,163	22,137	22,482
Cash and equivalents	23,954	16,199	44,640	104,823	37,210	32,616
Current Liabilities	(21,485)	(23,285)	(42,644)	(83,685)	(42,286)	(43,057)
Bank and loan borrowings - current	(200)	0	(400)	(40,216)	0	0
Other current liabilities	(21,285)	(23,285)	(42,244)	(43,469)	(42,286)	(43,057)
Non-current liabilities	(126,469)	(218,955)	(371,972)	(334,672)	(335,612)	(336,152)
Bank and loan borrowings - non-current	(126,469)	(217,442)	(371,220)	(334,335)	(335,275)	(335,815)
Other non-current liabilities	0	(1,513)	(752)	(337)	(337)	(337)
Net Assets	295,341	291,735	392,899	429,515	433,991	438,193
Derivative interest rate swaps & deferred tax liability	416	1,513	2,802	971	971	971
EPRA net assets	295,757	293,248	395,701	430,486	434,962	439,164
IFRS NAV per share (p)	107.7	106.4	105.4	115.2	116.4	117.5
Fully diluted EPRA NAV per share (p)	107.8	106.9	105.9	115.5	116.7	117.8
CASH FLOW						
Cash (used in)/generated from operations	(2,232)	31,434	40,251	38,817	43,711	45,358
Net finance expense	(424)	(6,626)	(9,167)	(11,923)	(11,636)	(11,636)
Tax paid	0	(1,715)	(236)	(1,467)	0	0
Net cash flow from operations	(2,656)	23,093	30,848	25,427	32,074	33,722
Net investment in investment properties	1,157	(99,286)	(8,267)	100,601	(28,300)	(6,000)
Acquisition of subsidiaries, net of cash acquired	26,659	(5,573)	(51,866)	(32,629)	0	0
Other investing activity	13	60	25	220	0	0
Net cash flow from investing activities	27,828	(104,799)	(60,108)	68,192	(28,300)	(6,000)
Equity dividends paid	0	(15,723)	(23,321)	(29,429)	(30,571)	(31,317)
Debt drawn/(repaid) - inc bonds and ZDP	(1,217)	91,417	13,921	(547)	(39,816)	0
Other financing activity	0	(1,744)	67,101	(3,460)	(1,000)	(1,000)
Net cash flow from financing activity	(1,217)	73,950	57,701	(33,436)	(71,387)	(32,317)
Net Cash Flow	23,955	(7,756)	28,441	60,183	(67,613)	(4,595)
Opening cash	0	23,955	16,199	44,640	104,823	37,210
Closing cash	23,955	16,199	44,640	104,823	37,210	32,616
Balance sheet debt	(126,669)	(217,442)	(371,620)	(374,551)	(335,275)	(335,815)
Unamortised debt costs	(1,875)	(2,618)	(4,843)	(5,752)	(5,212)	(4,672)
Closing net debt	(104,588)	(203,861)	(331,823)	(275,480)	(303,277)	(307,871)
LTV	25.9%	40.6%	45.0%	38.3%	40.4%	40.5%

Source: Regional REIT, Edison Investment Research

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