Regional REIT

Trading update

Dividend up, vacancy down

Real estate

Regional REIT (RGL) issued a trading update on 25 May providing portfolio statistics and declared a dividend of 1.8p for Q117 and then announced a major new letting on 30 May. Management has continued to reduce tenant concentration and has further rebalanced the portfolio towards offices and away from Scotland, in line with the intentions stated when it listed in November 2015. Regional economies remain robust, supporting occupier demand, while investment in new buildings is still subdued, constraining supply. RGL offers an attractive dividend supported by a growing portfolio of high-yielding assets in markets that may be more resilient to macroeconomic headwinds than London real estate.

Year end	Net rental income (£m)	EPRA EPS* (p)	EPRA NAV/ share (p)	DPS (p)	P/EPRA NAV (x)	Yield (%)
12/15**	4.6	0.9	107.8	1.0	0.99	0.9
12/16	38.1	7.7	106.9	7.7	1.00	7.2
12/17e	45.8	8.2	109.3	7.9	0.97	7.4
12/18e	51.7	9.4	110.7	8.8	0.96	8.3

Note: *EPRA EPS is adjusted to include exceptional expenses related to listing and includes estimated performance fees. **56-day trading period only.

Robust occupier demand

The letting of the whole of the recently acquired Brennan House near Farnborough is the 27th new lease in the portfolio in FY17 and came only two months after the property was acquired, supporting management's indication that regional occupier markets are healthy. The deal takes occupancy in the Conygar portfolio to 89% and in the total portfolio to c 84%, management targets 90% by the end of FY17.

Active management bearing fruit

In the trading update, RGL announced that four other buildings had reached zero vacancy, in three cases after major refurbishment. At 9 Portland Street in Manchester, estimated rental value (ERV) increased 44% as a result of the work undertaken. A 33% ERV uplift was achieved at Donegal House in Bromley following renovation and fully letting the building, and we would expect gains at the other locations too. With yields remaining roughly flat, increases in rent should be accompanied by rises in capital values. Several buildings are currently undergoing refurbishment, and the favourable supply/demand balance suggests that RGL should be able to keep finding good tenants at attractive rents, helping increase both the income and capital value of the portfolio.

Valuation: Attractive dividend

RGL's prospective dividend yield of 7.4% remains among the highest of all UK REITs, and the portfolio's geographic spread, high yields and sectoral diversity may also reduce exposure to macroeconomic risks, which the London market might feel most keenly. As well as an attractive income stream, the portfolio provides opportunities to increase capital value through active asset management. Although the share price has appreciated in recent weeks, RGL remains in the middle of the pack on a price/EPRA NAV basis (c 0.98x vs an average of 0.99x) despite the high dividend yield. There may be scope for further gains.

5 June 2017

Price	**106.75p**
Market cap	**£322m**

Net debt (£m) at 31 March 2017	300.9
Shares in issue	300.5m
Free float	80%
Code	RGL
Primary exchange	LSE
Secondary exchange	N/A

Share price performance

%	1m	3m	12m
Abs	(0.9)	1.4	1.9
Rel (local)	(4.3)	(1.4)	(15.9)
52-week high/low		111p	88p

Business description

Regional REIT owns a 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 10-15% with a strong focus on income.

Next events

Q1 dividend paid	14 July 2017
Interim results	14 September 2017
Q317 trading update	16 November 2017

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Summary of trading update

Following the acquisition of the Conygar portfolio, covered in detail in our February note, and several small disposals, as of 31 March the portfolio comprised 1,115 units in 150 properties let to 833 tenants. It is valued at c £630m and has an annualised contracted rent roll of £54.3m. Having changed the reporting basis from area to ERV, occupancy was 82.8% at 31 March (31 December: 82.7%) on a like-for-like basis. Occupancy has since risen to c 84% with Brennan House on Farnborough Business Park being fully let to Fluor for annual rent of £0.76m. Brennan House was acquired on 24 March as part of the Conygar portfolio and had already been fully refurbished. At 31 March the largest tenant accounted for only 3.0% of gross rental income, down from 3.7% at 31 December, and the most valuable property comprised 5.1% of the portfolio's total value, down from 6.4%. The net loan-to-value ratio rose to c 48% at 31 March, from 41% at 31 December 2016, as a result of the Conygar acquisition; however, we expect this to fall partly as a result of valuation gains, particularly on refurbished and newly let properties.

Asset management activity has included signing 27 new leases for £1.36m of rent, and a number of regears achieving an average rental uplift of 2.8% on headline rent. Brennan House, Llansamlet Retail Park (Swansea), Hampshire House (Eastleigh), Donegal House (Bromley) and 9 Portland Street (Manchester) are now all fully let. The company has also undertaken a programme of refurbishment, spending £2.1m gross in H117, which is expected to rise to £16.0m for the full year, although the company expects to be able to recover c 40% of that in dilapidations and other recoveries. The work is concentrated on four properties: Aztec West in Bristol, the HBOS campus (known as the Blue Leanie) in Aylesbury, The Crescent in Solihull and Arena Point in Leeds. It is expected that the work will enhance ERVs and will make the spaces more attractive to occupiers.

Changes to estimates

The changes to our estimates are minimal. We have adjusted our FY17 dividend assumption in line with the announced 1.8p quarterly dividend; having previously assumed three 1.9p quarterly dividends topped up with 2.5p in Q4, we now assume three 1.8p dividends and a final 2.5p, which has the effect of raising NAV by a corresponding amount. We had previously assumed occupancy would rise slightly sooner, but maintain our previous long-term run rate of 90% and expect that to be reached by year-end. We have also changed our model to measure this on an ERV basis, with no material effect on our figures. The changes in rental income reflect a slightly slower pace of occupancy increase to start with, picking up later in 2017.

Exhibit 1: Estimate changes

	Net rental income (£m)			EPRA EPS* (p)			EPRA NAV/share (p)			DPS (p)		
	New	Old	% chg.	New	Old	% chg.	New	Old	% chg.	New	Old	% chg.
12/17e	45.8	46.8	(2)	8.2	8.7	(5)	109.3	109.5	(0)	7.9	8.2	(4)
12/18e	51.7	51.5	0	9.4	9.5	(1)	110.7	111.6	(1)	8.8	8.8	0

Source: Edison Investment Research

Valuation

As discussed in previous notes, RGL's price to EPRA NAV ratio is roughly central in the peer group, although it has risen since our last note from c 0.94x to 0.98x, as might be expected given its high prospective yield (the second highest of all UK REITs on consensus estimates, see Exhibits 2 and 3). The diverse and high-yielding portfolio continues to offer attractive and stable income, as well as potential capital growth from asset management opportunities. The strategy of regional investment, as well as the relatively high yields of the assets, may also afford some protection from changes in the economic cycle and other macroeconomic factors, which would likely be felt more strongly in the London market.

Exhibit 2: UK REITs by prospective dividend yield

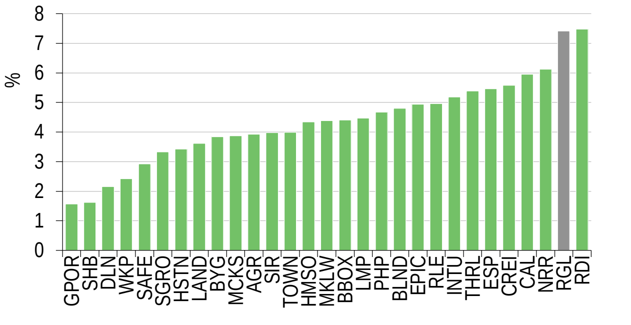
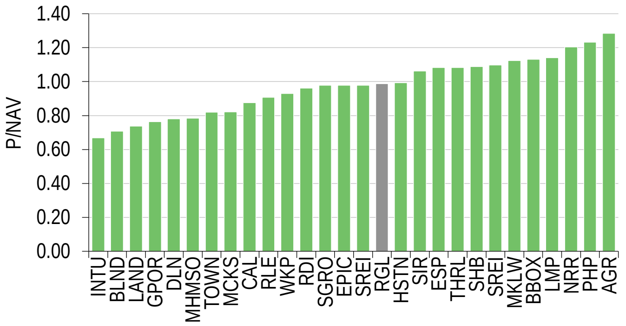


Exhibit 3: UK REITs by P/NAV



Source: Bloomberg, data as at 26 May 2017

Exhibit 4: Financial summary

Year end 31 December	£'000s	2015	2016	2017e	2018e
PROFIT & LOSS		IFRS	IFRS	IFRS	IFRS
Gross rental income		5,361	42,994	51,736	58,347
Non-recoverable property costs		(754)	(4,866)	(5,898)	(6,652)
Revenue		4,608	38,128	45,838	51,695
Administrative expenses		(1,353)	(7,968)	(8,813)	(9,521)
EBITDA		3,255	30,160	37,025	42,174
Gain on disposal of investment properties		87	518	0	0
Change in fair value of investment properties		23,784	(6,751)	7,504	5,152
Operating profit before financing costs		27,126	23,927	44,528	47,326
Performance fees		0	(249)	(1,591)	(2,862)
Exceptional items		(5,296)	0	0	0
Finance income		177	193	240	109
Finance expense		(997)	(8,822)	(12,486)	(13,499)
Net movement in the fair value of derivative financial investments and impairment of goodwill		115	(1,654)	(557)	(557)
Profit Before Tax		21,124	13,395	30,133	30,517
Tax		0	23	0	0
Profit After Tax (FRS 3)		21,124	13,418	30,133	30,517
Adjusted for the following:					
Performance fees		0	249	1,591	2,862
Exceptional items		5,296	0	0	0
Net gain/(loss) on revaluation		(23,784)	6,751	(7,504)	(5,152)
Net movement in the fair value of derivative financial investments		(180)	1,097	0	0
Gain on disposal of investment properties		(87)	(518)	0	0
Profit before Tax (norm)		2,370	20,997	24,221	28,227
Period end number of shares (m)		274.2	274.2	300.5	300.5
Average Number of Shares Outstanding (m)		274.2	274.2	294.6	300.5
Fully diluted average number of shares outstanding (m)		274.2	274.2	294.6	300.5
EPS - fully diluted (p)		7.7	4.9	10.2	10.2
EPS - normalised (p)		0.9	7.7	8.2	9.4
EPRA EPS		0.9	7.7	8.2	9.4
Dividend per share (p)		1.0	7.7	7.9	8.8
Dividend cover		n.a.	100%	104%	107%
BALANCE SHEET					
Fixed Assets		407,492	506,401	649,371	661,196
Investment properties		403,703	502,425	646,928	660,080
Goodwill		2,786	2,229	1,672	1,114
Non-current receivables		1,004	1,747	771	1
Current Assets		35,803	27,574	33,797	30,294
Trade and other receivables		11,848	11,375	10,808	8,605
Cash and equivalents		23,954	16,199	22,989	21,689
Current Liabilities		(21,485)	(24,798)	(32,468)	(34,722)
Trade and other payables		(12,576)	(14,601)	(20,642)	(22,395)
Deferred income		(5,906)	(8,022)	(9,652)	(10,152)
Taxation		(2,387)	(662)	(662)	(662)
Bank and loan borrowings - current		(200)	0	0	0
Derivative financial instruments		(416)	(1,513)	(1,513)	(1,513)
Long Term Liabilities		(126,469)	(217,442)	(323,642)	(325,642)
Borrowings		(126,469)	(217,442)	(323,642)	(325,642)
Net Assets		295,341	291,735	327,057	331,126
Derivative interest rate swaps		416	1,513	1,513	1,513
EPRA net assets		295,757	293,248	328,570	332,639
IFRS NAV per share (p)		107.7	106.4	108.8	110.2
EPRA NAV per share (p)		107.8	106.9	109.3	110.7
LTV		25.4%	40.1%	46.5%	46.0%
CASH FLOW					
Operating Cash Flow		(2,232)	31,434	43,877	43,769
Net Interest & other financing charges		(411)	(24,064)	(34,312)	(39,093)
Tax		0	0	0	0
Purchase of investment properties		(4,191)	(144,143)	(129,000)	0
Sale of investment properties		5,348	44,857	0	0
Capex			0	(8,000)	(8,000)
Acquisition of subsidiaries, net of cash acquired		26,659	(5,573)	28,000	0
Net proceeds from issue of shares		0	0	0	0
Equity dividends paid		0	0	0	0
Other (including debt assumed on acquisition)		0	(1,040)	25	25
Net Cash Flow		25,172	(98,529)	(99,410)	(3,299)
Opening net (debt)/cash		(127,886)	(102,714)	(201,243)	(300,653)
Closing net (debt)/cash		(102,714)	(201,243)	(300,653)	(303,952)

Source: Company data, Edison Investment Research

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