Regional REIT

Acquisitions and outlook

Progress with capital raise deployment

Real estate

4 November 2019

Regional REIT (RGL) has exchanged contracts for the £27.7m acquisition of a regional office portfolio, its second significant transaction since H119 and marking progress with deployment of £62.5m (gross) proceeds of the July capital raise. With a strong pipeline of investment opportunities, we expect full deployment by early 2020, which will enhance earnings and provide further opportunities for active asset management and value creation.

Year end	Net rental income (£m)	Adjusted earnings (£m)	Adjusted EPS* (p)	EPRA NAV*/ share (p)	DPS (p)	P/NAV (x)	Yield (%)
12/17	45.8	25.6	8.6	105.9	7.85	1.00	7.4
12/18	54.4	27.9	7.5	115.5	8.05	0.92	7.6
12/19e	53.8	30.3	7.6	114.2	8.25	0.93	7.8
12/20e	61.5	36.6	8.5	115.7	8.45	0.92	8.0

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

Progress with capital deployment

Capital recycling is an important element of RGL's strategy, so in FY18 while locking in the value created by mature asset management plans to reinvest in new opportunities, the company was also a net seller of assets. It tactically sold nearly half of its industrial portfolio into what management had identified as an overheating investment market, increasing its focus on regional offices where the risk-return balance appeared more favourable. With lingering Brexit uncertainty having a dampening impact on the investment market (while the office and industrial occupational markets remain robust), RGL has found an increasing number of investment opportunities that meet its return criteria. In July, RGL used recycled capital to acquire a six-asset regional office portfolio for £25.9m at an initial yield of 8.9%. It has now exchanged contracts on the acquisition of a four-asset regional office portfolio for £27.7m at an initial yield of 8.7% and we expect a swift full deployment of the proceeds from the July equity raise (£62.5m gross).

Organic and acquisition-led growth

With the estimated rental value (ERV) c 24% ahead of contracted rents in H119, the existing portfolio has a significant opportunity for value creation. We also assume a further c £33m of investment by early 2020, including cash resources and modest further debt drawing, keeping LTV below 40%. We have updated our forecasts for the H119 results and recent transactions and while there is a small timing-related deferral of income into FY20, the net initial yields on the announced transactions are ahead of our previous assumptions and we continue to expect further DPS growth in FY20, fully covered by adjusted earnings.

Valuation: Strong income focus

The annualised accounting total return since IPO in November 2015 is 10%, two-thirds of which has been paid as income. RGL's prospective yield, approaching 8%, remains among the highest in the sector. We forecast further DPS growth in FY20 and full cover by adjusted earnings as new equity is deployed.

Price	**106p**
Market cap	**£457m**

Net debt (£m) at 30 June 2019	287.8
Net LTV at 30 June 2019	39.9%
Shares in issue	431.5m
Free float	100%
Code	RGL
Primary exchange	LSE
Secondary exchange	N/A

Share price performance

%	1m	3m	12m
Abs	3.7	0.6	5.2
Rel (local)	4.1	3.3	2.2
52-week high/low		109.59p	89.92p

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 event

Q3 trading statement	14 November 2019

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Edison profile page

Regional REIT is a research client of Edison Investment Research Limited

Investment summary

Company description: Active management

In this note we review recent progress with RGL's active management of its existing portfolio as well as its deployment of the July 2019 equity raise. We also discuss RGL's delivery on the investment strategy that it laid out at the time of its IPO (November 2015) and on its long-term return targets. Capital recycling is an important element of RGL's active management strategy. In FY18, while locking in the value created by mature asset management plans to reinvest in new opportunities, RGL was also a net seller of assets. It tactically sold nearly half of its industrial portfolio into what management had identified as an overheating investment market and increased its focus on regional offices where the risk-return balance appeared more favourable. With lingering Brexit uncertainty having a dampening impact on the investment market (while the office and industrial occupational markets remain robust), RGL has found an increasing number of investment opportunities that meet its return criteria and we expect the company to swiftly complete the full deployment of the proceeds from the July equity raise.

Financials: Organic and acquisition-led growth opportunity

With H119 contracted rental income of £57.8m and an estimated rental value (ERV) at full occupancy of £71.4m there is a significant opportunity for active asset management to drive rental growth from the existing portfolio. Management has continued to report leasing progress at rents in excess of ERV. Our forecasts also allow for £90m of acquisitions between H119 and early 2020, of which c £56m has already been completed or agreed. Earnings will be further supported by significant refinancing in the past year, which has lowered the average cost of borrowing while extending maturity. We have slightly reduced our FY19 adjusted earnings forecast due to the timing of lease maturities at end-H119 and modestly slower acquisitions than we had assumed. However, the acquisition yields are ahead of our assumptions and our FY20 and FY21 forecasts increase a little. We continue to forecast ongoing DPS growth, with full cover by adjusted earnings in FY20.

Valuation: Attractive yield underpins return targets

RGL targets a total return of more than 10% pa, with a strong focus on income supported by the potential for additional capital growth. Since listing, RGL has generated an accounting total return (change in NAV plus DPS paid) of 41%, equivalent to a compound 9.8% pa, effectively meeting its target. Income returns (DPS paid) accounted for two-thirds of the total. We would view RGL's target return as a medium-term target that will be difficult to achieve in all market conditions and given our cautious assumptions for capital returns over the next couple of years, our forecasts imply a total accounting return over the FY19–21 period of 7.1%, effectively all generated by dividend payments. In the context of a continuing low return environment we think this is attractive, supported by a c 8% discount to H119 EPRA NAV per share.

Sensitivities: Portfolio diversification mitigates income risks

We discuss the sensitivities on page 12. In summary, the commercial property sector is cyclical; occupier demand is sensitive to economic growth, while valuation yield and capital values are affected by investment flows and monetary conditions. The diversity of RGL's portfolio and tenant base mitigate the cyclical income risks. Near-term interest rate risk is also well-managed, with all of RGL's debt either fixed or hedged with an average maturity of 7.8 years (at H119). Gearing has reduced to c 40%, in line with the company's target, from a peak of c 49% immediately after the Conygar asset purchase in 2017.

Active management of regional commercial property

Regional REIT (RGL) is a UK-based real estate investment trust (REIT) that aims to provide an attractive total return to shareholders, targeting a total return of more than 10% pa, with a strong focus on income supported by the potential for additional capital growth. The company's investment portfolio is comprised wholly of UK commercial property assets, predominantly offices and light industrial units located in the regional centres of the UK outside of the M25 motorway.

Since listing on the Main Market of the London Stock Exchange (LSE) in November 2015, RGL has been committed to an opportunistic acquisitive growth strategy, seeking to generate operational and financial economies through increased scale and further diversifying the portfolio to mitigate cyclical and tenant-specific risks to income. The portfolio value has almost doubled since the IPO with a diversification by region, property and tenants. In addition to the focus on regional property assets, the managers seek under-managed properties where there are opportunities to create additional value through lease renewals and rent increases, minimising voids through effective marketing of vacant space, enhancing the tenant mix and covenant strength, and through refurbishment, extension, or change of use. When properties have met their return objectives they are assessed for sale (or to hold if their income and capital growth outlook looks strong), allowing the recycling of resources into new value-creating opportunities.

At 30 June 2019 (H119) the investment portfolio was valued at £721.7m with a gross rental income of £57.8m reflected in a net initial yield (NIY) of 6.5%. An ERV of £71.4m, reflected in a reversionary yield of 9.0%, represented a significant opportunity to grow income from the existing portfolio through void reduction (EPRA occupancy was 87.5% at H119) and other lease events. The company is also targeting accretive acquisitions through further deployment of the £62.5m (gross) proceeds of its July 2019 equity raise.

Experienced and well-resourced external management

Ahead of its listing, RGL was formed by the combination of two UK commercial property investment funds previously created by the external asset and investment managers. London & Scottish Property Investment Management (LSPIM) is the asset manager, responsible for the day to day management of the asset and debt portfolios. Toscafund Management (Toscafund) is the investment manager, responsible for management functions of the company.

LSPIM is a privately-owned co-investing asset management and property development business with assets under management of more than £1bn, of which c £750m relates to RGL, based in Glasgow with offices in Leeds, Manchester and London. The senior management team has worked together for a long time and has experience of managing portfolios for cash in down cycles.

Both the asset and investment management contracts initially run for five years from launch, at which point 12 months' notice could be given; beyond five years the contract has a three-year term subject to 12 months' notice being given at any point. The management fee is set at 1.1% of net assets up to £500m and 0.9% above £500m, split equally between LSPIM and Tosca. In addition, a property management fee of 4% of annual gross rental income is payable to LSI. An additional incentive is provided to the managers by way of a performance fee, set at 15% of total EPRA NAV per share return (EPRA NAV growth plus dividends declared) above an 8% hurdle, subject to a high-water mark (the greater of the highest year-end NAV per share in prior periods or the IPO price of 100p).

After an initial three-year performance fee calculation period, from the beginning of FY19 the performance fee is calculated annually and is expected to be paid one-third in cash and two-thirds in shares.

After the initial five-year term of the asset and investment management contracts, subject to EPRA net assets having reached £750m, the board and managers may decide to internalise the management of Regional REIT, subject to approval by independent shareholders.

Regional REIT has a six-member board and is chaired by Kevin McGrath (biography on page 15). There are five non-executive directors, three of whom RGL considers independent (William Eason, Daniel Taylor, and Frances Daley), plus Stephen Inglis (representing LSPIM) and Tim Bee (representing Toscafund).

Portfolio growth and repositioning since IPO

Since listing, RGL has significantly grown the scale of its portfolio, adding further diversification and repositioning its sector and geographic balance. At H119 RGL's portfolio comprised 149 properties valued at £722m compared with 128 properties valued at £386m at the time of the IPO. It has since completed the acquisition of a six-asset regional office portfolio for £25.9m. While growing the portfolio the company has also increased the share of assets in the more prosperous south-east and reduced the weighting to Scotland, while the focus on regional office and light industrial assets has been sharpened, both in line with the strategy expressed at the time of the IPO.

Exhibit 1: Portfolio summary

	30 June 2019		31 December 2018
	H119 reported	H119 pro forma*	FY18
Valuation (£m)	721.7	747.6	718.4
Number of properties	149	155	150
Number of property units	1,178		1,192
Number of tenants	828		874
Contracted rents (£m)	57.8		59.7
WAULT to first break (years)	3.5		3.4
Estimated rental value, ERV (£m)	71.4		70.0
EPRA occupancy	87.5%		89.4%
Net initial yield	6.1%		6.5%
Reversionary yield	9.0%		8.8%

Source: RGL data, Edison Investment Research. Note: *Includes the six-office portfolio acquired since H119 for a consideration of £25.9m.

A summary of the overall portfolio is shown in Exhibit 1. There is a material gap between the H119 annualised contracted rent of £57.8m and the ERV at full occupancy of £71.4m, representing the income growth opportunity from the existing portfolio. We estimate that c £9m of this potential relates to void reduction (primarily in the office portfolio) and the balance from moving rents towards market levels. The progress that RGL continues to make with leasing is not always apparent from published occupancy figures as properties are likely to be sold, and capital recycled, when successful asset management plans are complete. End-H119 occupancy of 87.5% (EPRA basis) was lower than at the end of FY18 due to the timing of lease maturities, but was consistent with the reported trend since IPO.

The rental growth that RGL has achieved over the past 18 months continued in H119. It undertook 39 new lettings over c 240k sq ft, achieving rental income of c £1.6m and reflecting an uplift of 5.2% over ERV. Additionally, 18 leases were renewed over c 70k sq ft, achieving rental income of c £0.6m, a 19.5% uplift from previous rents and 12% above ERV.

In August, RGL announced a string of successful lettings amounting to £1.3m pa, which represented a significant uplift to income as it mostly related to previously vacant properties.

Further progress was reported in October with leases representing an annualised c £850k of income renewed at an average c 10.9% uplift to ERV.

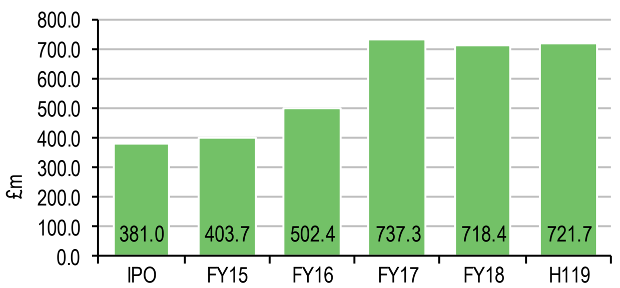
A proven track record in sourcing acquisitions

RGL has demonstrated its ability to source and execute on 'value add' acquisitions since IPO, growing the portfolio through a string of portfolio acquisitions, primarily off-market, funded by new equity issuance, borrowings and capital recycling. The most significant portfolio acquisitions have been:

- **2016.** A five-asset mixed regional office/industrial portfolio from La Salle Investment management for £37.5m (before costs) at a net initial yield of 8.25% and a 12-asset mixed regional office/industrial portfolio from Northwood Investors (the Rainbow portfolio) for £80m at a net initial yield of 8.2%.
- **2017**. A 31-asset mixed regional office/industrial/retail distribution portfolio valued at £129m, reflecting a net initial yield of 7.0%, from Conygar and two further portfolios, together comprising 20 office properties valued at £88.3m and reflecting a blended net initial yield of 8.6%.
- **2018.** A six-asset predominantly office portfolio from Kildare Partners for £35.2m at a net initial yield of 8.4% and an eight-asset regional office portfolio for £31.4m at a net initial yield of 8.7%.

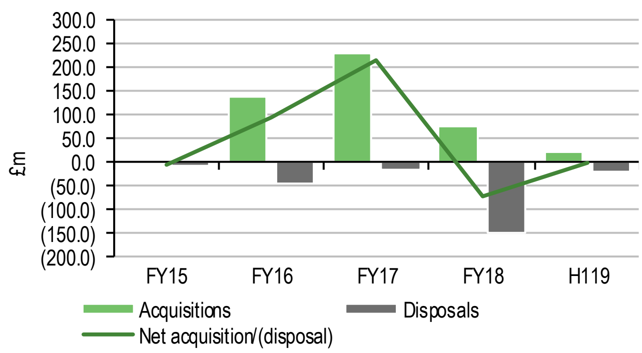
Not reflected in Exhibit 2, in August RGL completed the £25.9m acquisition (before costs) of a portfolio of six office assets located in Birmingham, Bristol, Cardiff, Chester, Glasgow and Manchester. The assets total c 172k sq ft of gross lettable space and are expected to provide a net income of c £2.36m per annum, equating to a net initial yield of 8.9% and an anticipated reversionary yield of 9.5%. The 27 tenants are diversified by industry type and geography, with no crossover to the existing tenant base. Also not included is the four-asset office portfolio acquisition on which the exchange of contracts was announced on 18 October 2019. The portfolio comprises multi-let offices in Redhill, Harefield, Bristol and High Wycombe with an aggregate c 131k sq ft of space, let to 24 tenants and which are expected to provide net income of c £2.6m pa. The agreed consideration of £27.7m (before costs) reflects a net initial yield of 8.7% and an anticipated reversionary yield of 9.7%.

Exhibit 2: Strong net portfolio growth since IPO



Source: RGL data, Edison Investment Research

Exhibit 3: But also significant capital recycling



Source: RGL data, Edison Investment Research

Opportunistic acquisition activity, net of disposals, significantly drove portfolio growth during FY16 and FY17, enabling RGL to benefit from strong tenant demand and growing rents. To fund these transactions, gearing was allowed to increase, reaching a high of c 49% post the Conygar transaction in 2017.

Subsequently, acquisitions and disposals have been more evenly balanced with RGL taking advantage of the strong investment market in 2018, especially for industrial assets, to dispose of properties where its asset management plans were complete or where plans were yet to reach maturity but where the managers had identified a better risk-adjusted return by selling at the prevailing market prices, well above valuations. This included the strategic decision to sell almost half of the industrial portfolio during FY18 into what the company appears to have correctly identified as an overheating investment market at the time.

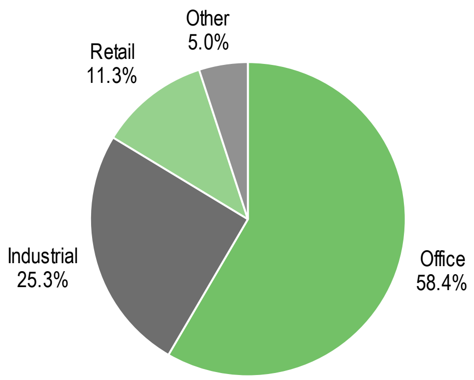
In H119 RGL continued to recycle capital, realising value from mature asset management plans and opening new opportunities, reflected in a continuing positive yield arbitrage. Two properties were sold for £19.7m (after costs), reflecting a blended net initial yield of c 6.7%, and generating a £1.7m uplift over the end-FY18 valuation. Norfolk House, an office property in central Birmingham, was acquired for £20m at a net initial yield of 7.9%.

Looking forward, capital recycling will continue to be at the heart of RGL's strategy to invest in, actively manage, and dispose of properties where asset management plans are mature. Additionally, now that the investment market has cooled (see page 7) while the occupier market for regional office and light industrial assets remains robust, RGL is finding an increasing number of acquisition opportunities that meet its investment criteria. It recently identified a broad pipeline of identified opportunities amounting to c £500m and in this context we expect the proceeds of the July 2019 equity raise to be swiftly deployed.

Focus on regional office and light industrial property

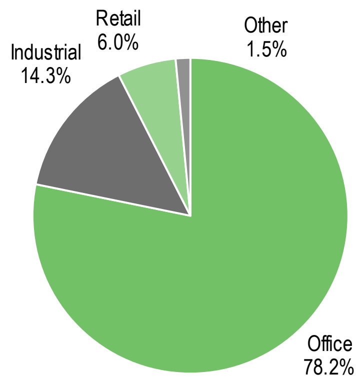
RGL's sector strategy since its IPO has been to focus on regional office and light industrial property and to reduce legacy retail and other exposures. Office and industrial assets represented 92.5% of the total at H119, up from 83.7% at the time of its IPO. With the industrial weighting being significantly reduced in the last year, the office weighting at H119 had reached 78.2%. Given continuing solid occupier fundamentals we would view the industrial weighting as more tactical in nature and would not be surprised to see some reversal if the investment market for industrial assets continues to cool.

Exhibit 4: Sector split by valuation at IPO



Source: RGL

Exhibit 5: Sector split by valuation at H119

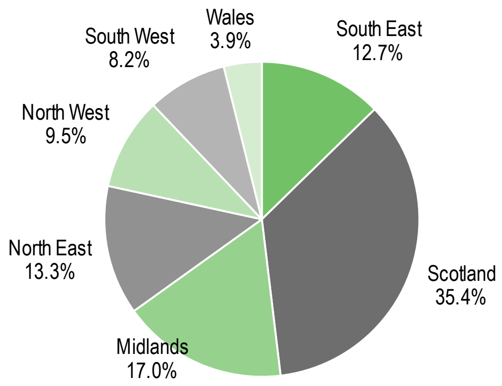


Source: RGL

Geographical optimisation

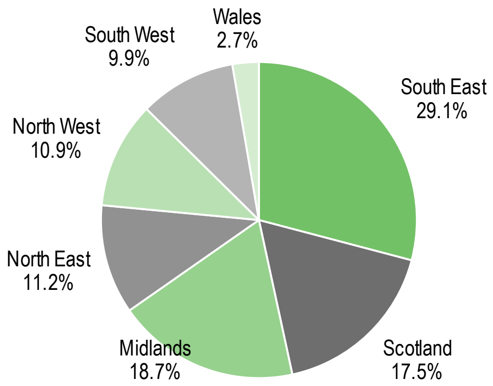
The shift in geographic positioning since IPO can be seen in Exhibits 6 and 7 with the main changes being the planned reduction in the relatively large historical weighting towards Scotland and increased exposure to the more affluent south-east of the UK. The Scottish weighting has halved to 17.5% since IPO towards a long-term target of c 15%. Exposure to the south-east has more than doubled to 29.1%.

Exhibit 6: Geographic split by valuation at IPO



Source: RGL

Exhibit 7: Geographic split by valuation at H119

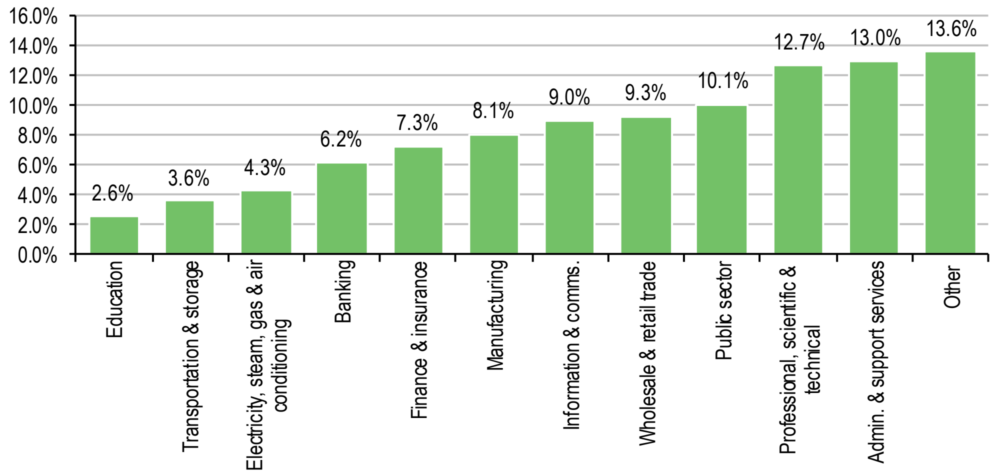


Source: RGL

Highly diversified tenant exposure

A large tenant base (more than 800 individual tenants), that can fairly be said to be representative of the UK economy as a whole, supports a highly diversified income stream. The largest tenant at H119 represented 2.8% of gross rent roll and the top 15 tenants represented just 27.1%. RGL closely monitors the industry exposure of its tenants (and prospective tenants when assessing acquisitions) not just at the broad sector level but using detailed analysis based on Standard Industrial Classification (SIC) codes.

Exhibit 8: Tenants by SIC code as a percentage of gross rent



Source: RGL

Regional office and light industrial occupier demand has remained robust

In the regional office and light industrial markets that are the focus of the RGL portfolio, occupier demand appears to have remained robust despite the continuing uncertainty of the Brexit process and some weakening in overall economic growth prospects. In the investment market, UK-wide commercial real estate investment volumes weakened in H119, although there are some signs that the impact in the regions was more muted than for London. Overall UK volumes fell by 29% compared with H118 and were 26% below the half-yearly average. Although it is difficult to be certain, most commentators believe that the slowdown in investment activity reflects a delay in decision making that may reverse when the Brexit outcome becomes clearer.

Research by Avison Young indicates that take-up of office space across the big nine regional office markets continued to be above the long-term average through Q219 and that against a backdrop of limited supply this has continued to put upward pressure on rents.

Occupier demand in the industrial market appears to have softened slightly but remains positive. Cushman and Wakefield estimate that occupier take-up in the industrial market was lower in H119 than in the same period of 2018, but that it remains slightly above the 10-year average. Similarly, rental growth appears to be continuing but at a slightly slower pace.

Looking forwards, the most recent quarterly market forecasts by the Investment Property Forum (IPF, canvassing a group of fund managers and surveyors under the IPF Research Programme) were published in September and point to an expectation of positive total returns in the industrial and office sectors through to 2023. In the past quarter, the expectation for both rental and capital growth in the office sector has increased, while the expectation for industrial rent growth has weakened very slightly with a more noticeable dip in the capital growth expectation for 2019.

Exhibit 9: Summary of IPF market consensus

	Rental growth value (%)				Capital value growth (%)				Total return (%)			
	2019	2020	2021	2019/23	2019	2020	2021	2019/23	2019	2020	2021	2019/23
Office	0.8	0.6	1.3	1.3	(1.1)	(1.1)	0.5	0.2	2.9	3.1	4.9	4.6
Industrial	3.0	2.0	1.7	2.0	2.1	1.1	1.5	1.5	6.6	5.7	6.1	6.1
Standard retail	(3.1)	(2.1)	(0.9)	(1.2)	(8.1)	(4.4)	(1.4)	(2.7)	(3.9)	0.1	3.3	1.9
Shopping centre	(4.7)	(3.3)	(1.8)	(2.3)	(13.8)	(7.2)	(3.7)	(5.7)	(8.8)	(1.5)	2.3	0.0
Retail warehouse	(3.8)	(2.5)	(1.0)	(1.5)	(10.8)	(5.7)	(1.9)	(3.9)	(5.2)	0.5	4.6	2.4
All property	**(0.2)**	**0.1**	**0.6**	**0.5**	**(3.6)**	**(1.8)**	**(0.2)**	**(0.8)**	**0.9**	**2.9**	**4.7**	**4.0**
Change since spring forecast												
	Rental growth value (%)				Capital value growth (%)				Total return (%)			
	2019	2020	2021	2019/23	2019	2020	2021	2019/23	2019	2020	2021	2019/23
Office	0.4	0.3	0.2	0.2	0.6	0.2	0.6	0.5	0.5	0.0	0.6	0.5
Industrial	0.0	(0.2)	(0.1)	(0.1)	(0.5)	0.1	1.0	0.5	(0.6)	0.0	0.9	0.4
Standard retail	(0.3)	(0.4)	(0.3)	(0.4)	(0.7)	0.1	(0.1)	(0.2)	(0.7)	0.1	(0.1)	(0.2)
Shopping centre	(0.8)	(0.7)	(0.5)	(0.6)	(3.1)	(1.0)	(0.6)	(1.1)	(3.0)	(0.8)	(0.4)	(1.0)
Retail warehouse	(0.7)	(0.4)	(0.1)	(0.5)	(1.9)	(0.8)	0.1	(0.7)	(2.0)	(0.7)	0.2	**(0.6)**
All property	**0.0**	**0.0**	**0.0**	**(0.1)**	**(0.8)**	**(0.1)**	**0.3**	**0.0**	**(0.9)**	**(0.2)**	**0.3**	**0.0**

Source: Investment Property Forum (IPF) UK consensus forecasts

We present the market consensus data as a guide to expected overall market direction and returns but would caution against a direct read across to RGL's, or any other, portfolio. The market consensus is formed of a wide range of differing expectations and at the individual portfolio level much depends on the performance of individual assets as well as the timing and effectiveness of asset management initiatives.

Financials

Since we last updated our forecasts on 9 August 2019, RGL has:

- reported H119 results (10 September 2019);
- completed the acquisition of a six-asset regional office portfolio for £25.9m (before acquisition costs) at a net initial yield of 8.9% (21 August 2019);
- reported the exchange of contracts to acquire a four-asset regional office portfolio for £27.7m (before acquisition costs) at a net initial yield of 8.7% (18 October 2019); and
- provided further updates on lettings progress in H219.

Continued strong income generation in H119

The H119 results showed continued strong income generation, supporting RGL's target of declaring aggregate DPS for the year of 8.25p (+3% versus FY18), barring unforeseen circumstances.

Exhibit 10: Summary of H119 results

	H119			H118			H119/H118
£m unless stated otherwise	**IFRS**	**Adjustment**	**Adjusted earnings**	**IFRS**	**Adjustment**	**Adjusted. earnings**	**Adjusted earnings**
Rental income	35.4		35.4	36.7		36.7	-3.5%
Non-recoverable property costs	(9.4)		(9.4)	(9.8)		(9.8)	-4.1%
Net rental income	**26.0**		**26.0**	**26.9**		**26.9**	**-3.3%**
Administrative & other expenses	(5.4)		(5.4)	(5.1)		(5.1)	5.8%
Performance fee	0.0		0.0	(4.2)	4.2	0.0	
Operating profit before gains/(losses) on property	**20.6**	**0.0**	**20.6**	**17.6**	**4.2**	**21.8**	**-5.5%**
Gain on disposal of investment property	1.7	(1.7)	0.0	7.2	(7.2)	0.0	
Change in fair value of investment property	(2.9)	2.9	0.0	27.9	(27.9)	0.0	
Amortisation of right of use asset	(0.1)		(0.1)				
Operating profit	**19.2**	**1.2**	**20.5**	**52.8**	**(31.0)**	**21.8**	**-6.0%**
Net finance expense	(6.8)	0.5	(6.3)	(7.6)	0.0	(7.6)	-16.5%
Impairment of goodwill/change in fair value of derivatives	(1.7)	1.7	0.0	0.0	(0.1)	(0.0)	
Profit before tax	**10.7**	**3.4**	**14.2**	**45.3**	**(31.1)**	**14.2**	**-0.1%**
Tax	(0.0)	0.0	(0.0)	(0.4)	0.2	(0.2)	
Net profit	**10.7**	**3.5**	**14.2**	**44.9**	**(30.9)**	**14.0**	**1.0%**
Basic IFRS EPS (p)			2.88			12.05	
Diluted EPRA EPS (p)			3.80			2.60	
Diluted adjusted EPS (p)			**3.80**			**3.76**	**1.0%**
DPS (p)			**3.80**			**3.70**	**2.7%**
Diluted EPRA NAV (p)			**114.3**			**113.6**	**0.6%**
Investment properties			721.7			758.7	-4.9%
Net LTV			39.9%			41.2%	

Source: Regional REIT

H119 net rental income was slightly lower than in H118, primarily reflecting the timing of purchases and sales and a lower investment property portfolio in the period. At the adjusted earnings level there was no change, with the lower net rental income and higher admin costs offset by lower financing costs (lower average debt and reduced average cost of debt). Gross contracted rent and occupancy at end-H119 were both a little lower than was reflected in our modelling as a result of the timing of lease expiries and planned asset management/refurbishment. As discussed below, this has a small impact on our H219 net rental income and adjusted earnings, but we expect this to be made up in future periods as the properties are re-let.

Although ahead of H118, EPRA NAV per share of 114.3p was lower than the 115.5p at end-FY18 with £3.9m of H119 asset management related capex yet to be reflected in the valuation

Progress with new equity deployment

RGL has made good progress with the deployment of the proceeds of the July equity raise (£62.5m gross). Our forecasts incorporate full deployment by early 2020, along with cash resources and some additional debt capital, while maintaining a c 40% LTV, in line with RGL's medium-term targets. For acquisitions we continue to forecast:

- £90m of acquisitions during H219 (£70m) and early FY20 (£20m). This includes the completed acquisition of the six-asset office portfolio for £25.9m, completion of the acquisition of the four-asset office portfolio for £27.7m and the £2.5m industrial acquisition in Kilmarnock.
- Positively, all the above are at net initial yields ahead of our 8.5% assumption (the office portfolios at a blended yield of 8.8% and the industrial asset at 15.2%).

- For the balance of the £33.9m of acquisitions yet to take place but included in our forecasts (£13.9m remaining for H219 and £20m for H120) we continue to assume a net initial yield of 8.5% although this may prove conservative.
- Overall, the assumed FY19 acquisitions make a slightly lower time-weighted contribution to FY19 but still make a full year contribution in FY20. The timing of lease expiries in H119 also meant that the gross contracted rental income brought into H219 was lower than we had expected. Taken together, these two effects slightly reduce FY19 net rental income and adjusted earnings compared with our last published forecast, but we expect this to be made up in FY20. We expect DPS to increase further in FY20 and to be fully covered by adjusted earnings. FY21 is the first year to reflect fully the total acquisition impact and we expect continuing DPS growth and increasing dividend cover. Our EPRA NAV forecasts are slightly reduced by our taking a more cautious view on capital returns in line with overall market conditions, although this is partly offset by our forecasts indicating that a performance fee will no longer be payable.

Exhibit 11: Forecast revisions

	Net rental income (£m)			Adjusted earnings* (£m)			Adjusted EPS* (p)			EPRA NAV (p)			DPS (p)			Net LTV		
	New	Old	% chg	New	Old	% chg	New	Old	% chg	New	Old	% chg	New	Old	% chg	New	Old	Diff.
12/19e	53.8	54.7	-1.7%	30.3	31.1	-2.6%	7.6	7.8	-2.6%	114.2	114.5	-0.2%	8.25	8.25	0.0%	38.1%	37.7%	0.4%
12/20e	61.5	61.4	0.2%	36.6	36.5	0.3%	8.5	8.5	0.3%	115.7	116.2	-0.5%	8.45	8.45	0.0%	39.7%	39.3%	0.4%
12/21e	63.1	62.9	0.2%	38.1	38.0	0.3%	8.8	8.8	0.3%	116.5	118.2	-1.4%	8.65	8.65	0.0%	39.7%	39.3%	0.4%

Source: Edison Investment Research. Note: *Adjusted EPRA earnings/EPS excludes investment manager performance fee accrual.

More broadly, our key forecasting assumptions are:

- We have assumed a continuing reduction in voids, with like-for-like portfolio occupancy (on an EPRA basis) increasing to 89.5% by end-FY19 (H119: 87.5%), and 90.0% by end-FY20. The actual level of occupancy reported may well be lower, depending on the rate of occupancy on properties bought and sold as well as refurbishment activity. We also allow for c 1.0% pa like-for-like rental growth.
- Although our income forecasts for FY20 and FY21 are unchanged, we have slightly reduced our expectations for capital growth to better reflect the consensus expectation for capital growth noted above (page 8). We had previously assumed valuation changes in line with the blended rate of like-for-like rental growth but have now assumed capital growth rates independently of our rental growth assumption. We have assumed industrial capital growth of 2% in FY20 and 1% in FY21 with office capital growth of 1% in FY20 and 0.5% in FY21. Not material for RGL, we also assume a retail decline of 5% in FY20 and 2% in FY21. The blended rate of capital growth is now assumed to be 0.8% in FY20 and 0.4% in FY21, slightly below rental growth and implying a modest increase in NIY. For H219 we expect a larger 1.2% blended gain as some of the H119 capex is reflected in valuations. In H219 and H120, some of the assumed gross revaluation is offset by acquisition costs. We estimate that a 0.25% increase or decrease in NIY would reduce or increase our forecast FY19 EPRA NAV per share by c 7p.
- Our forecasts are consistent with RGL's expectation that dividend cover will be restored on an annualised basis once the proceeds of the equity issue are fully invested. RGL has given a DPS target of 8.25p (+2.5%) for the current year, barring unforeseen circumstances, and we forecast continued DPS growth in FY20 and FY21. In line with the company's expectation that full DPS cover will be restored once the proceeds of the equity issue are completed, we forecast full cover in FY20 with cover increasing in FY21, the first year in which our assumed acquisitions contribute fully.

Significant refinancing activity to enhance the debt portfolio

Significant refinancing activity, particularly over the past year, has increased the amount of available funding, while rationalising the number of facilities has increased average debt maturity and lowered the average cost. From a peak of c 49% in 2017 immediately after the Conygar acquisition, loan to value (LTV) has been steadily reduced in line with the group's medium-term target of c 40%.

At 30 June 2019 (H119), RGL had debt facilities of c £372m (including unamortised debt arrangement costs), of which c £342m was drawn and outstanding. Allowing for c £54m of cash, net debt was c £288m and the LTV was 39.9%. The weighted average term to maturity was 7.8 years.

In February 2019, £39.5m of 6.5% zero dividend preference shares were repaid at maturity and in June 2019 two of the existing bank facilities were extended and increased in size. Santander increased by £22m to c £66m and the term was extended from November 2022 to June 2029. The RBS facility was increased by c £28m to c £55m and the term was extended from December 2021 to June 2024. At the same time, a small £19m facility with HSBC was repaid.

The end-H119 weighted average interest rate payable was 3.4% and the average cost of debt including hedging costs was 3.5%. RGL has a target that at least 90% of the loan portfolio is hedged using fixed rate facilities or interest rate swaps, and at end-H119 the portfolio was more than 100% hedged.

Exhibit 12: Summary of debt portfolio at 30 June 2019

	Original facility (£m)	Outstanding (£m)*	Maturity	Gross loan to value	Interest terms
Royal Bank of Scotland	55.0	45.9	Jun-24	42.0%	Libor + 2.15%
Scottish Widows & Aviva	165.0	165.0	Dec-27	45.2%	3.28% fixed
Scottish Widows & Aviva	36.0	36.0	Dec-28	38.5%	3.37% fixed
Santander	65.9	44.7	Jun-29	27.1%	Libor + 2.20%
Total secured facilities	**321.9**	**291.6**			
Retail Eligible Bond	50.0	50.0	Aug-24	N/A	4.5% fixed
Total facilities	**371.9**	**341.6**			

Source: RGL. Note: *Outstanding debt includes unamortised loan arrangement fees.

Allowing for the unsecured Retail Eligible Bond debt, the LTV ratios on the secured debt facilities were all comfortable and the group indicated that at H119 it had c 25% headroom within the required debt service coverage ratios, implying an ability to withstand a reduction of about one-third in asset values.

Performance and valuation

Active management delivering total return target

RGL aims to provide an attractive total return to shareholders, targeting a total return of more than 10% pa, with a strong focus on income supported by the potential for additional capital growth. Up to end-H119 the cumulative accounting total return (the change in EPRA NAV per share plus dividends paid out) was 40.8% or a compound average annual return of 9.8%, very close to the target. Dividend payments have accounted for 65% of the total return over this period. Given our cautious assumptions for capital returns over the next couple of years, outlined above, our forecasts imply a total accounting return over the FY19–21 period of 7.1%, effectively all generated by dividend payments. Although lower than historical returns, and below the 10% target, we think this represents an attractive return in the context of generally low interest rates. By way of a risk-free benchmark, the 10-year gilt has recently been traded at a yield of c 0.75%. We would also view RGL's target return as a medium-term target, which will be difficult to achieve in all market conditions given the historical volatility of commercial property capital values.

Exhibit 13: NAV total return

	2015*	2016	2017	2018	H119	Since IPO	2019e	2020e	2021e	Cumulative 2019–21e
Opening EPRA NAV per share (p)	100.0	107.8	106.9	105.9	115.5	**100.0**	115.5	114.2	115.7	**115.5**
Closing EPRA NAV per share (p)	107.8	106.9	105.9	115.5	114.3	**114.3**	114.2	115.7	116.5	**116.5**
Dividends per share paid (p)	0.00	6.25	7.80	8.00	4.40	**26.45**	8.2	8.4	8.6	**25.2**
NAV total return (%)	7.8%	5.0%	6.4%	16.6%	2.8%	**40.8%**	6.0%	8.7%	8.2%	**22.7%**
Compound return (%)						**9.8%**				**7.1%**

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 the group has indicated that it will declare aggregate quarterly dividends of 8.25p per share, barring unforeseen circumstances, representing a prospective yield of 7.8%.

In Exhibit 14 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 8% share price discount to NAV is lower than the average for the peer group, within which those companies with an income focus, like RGL, tend to have the higher P/NAV ratings. This reflects the greater stability of income returns across the cycle and the recently increased level of uncertainty regarding future capital value movements.

Exhibit 14: Peer comparison

	Price (p)	Market cap (£m)	P/NAV (x)	Yield (%)	Share price performance			
					1 month	3 months	12 months	From 12-month high
Circle Property	202	57	0.73	3.1	5%	5%	2%	-1%
Custodian	116	476	1.11	5.7	-2%	0%	-3%	-4%
Picton	91	501	0.99	3.8	3%	1%	2%	-9%
Real Estate Investors	54	101	0.78	6.8	2%	-5%	-1%	-7%
Schroder REIT	57	296	0.83	4.5	6%	4%	-4%	-6%
Palace Capital	300	138	0.74	6.3	11%	3%	0%	-9%
UK Commercial Property Trust	87	1130	0.96	4.2	3%	8%	-1%	-6%
BMO Commercial Property Trust	118	943	0.88	5.1	2%	9%	-14%	-17%
BMO Real Estate Investments	87	210	0.84	5.7	6%	9%	-7%	-12%
Average			**0.87**	**5.0**	**4%**	**4%**	**-3%**	**-8%**
Regional REIT	**106**	**456**	**0.92**	**7.7**	**4%**	**1%**	**5%**	**-4%**
UK property index	1,824			3.7	6%	15%	6%	-3%
FTSE All-Share Index	4,038			4.7	3%	0%	3%	-4%

Source: Regional REIT data, Edison Investment Research. Note: *Last reported EPRA NAV per share and trailing 12-month DPS declared. Prices as at 1 November 2019.

Across the broader UK commercial property sector, over the past 12 months share price performance has polarised between perceived low risk (most industrial focused companies and predominantly specialist sectors where assets are let on lease leases, often with inflation indexation of rents) and higher risk assets (of which the most notable casualty has been the retail sector). RGL has performed in line with the broader market and ahead of the narrow peer group shown in Exhibit 14. We attribute this positive performance to its attractive yield, commitment to a progressive dividend policy, reduced LTV, and ability to demonstrate asset management driven capital returns.

Sensitivities

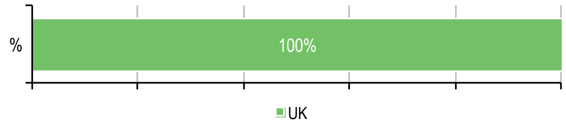
The commercial property market is cyclical, historically exhibiting substantial swings in valuation through cycles. Income returns are significantly more stable, but still fluctuate according to tenant demand and rent terms. The last major sector downturn came to an end in early 2009. From a sector viewpoint we also highlight the increased risks and uncertainties that attach to development activity, including planning consents, timing, construction risks and the long lead times to completion and eventual occupation. RGL is not a developer but is exposed to similar but lesser uncertainties as it actively invests in improvements to existing assets with the aim of enhancing long-term income growth and returns. We consider the main sensitivities to include:

- **Sector risk**: some of the inherent cyclical risk to vacancy in commercial property can be mitigated by portfolio diversification. As noted above, RGL's portfolio is highly diversified by geography, property and individual occupiers and the industries in which they operate. At end-H119 the largest tenant accounted for less than 3% of the total rent roll and the largest 15 tenants for less than 30%. The largest property accounted for less than 5% of the portfolio at the same date. The portfolio contains significant reversionary potential and management has identified several asset management opportunities, providing scope for counter-cyclical income growth and value creation.
- **Macro risk:**
  - The UK economy has lost momentum in recent months, in line with the global trend, and there are signs that Brexit-related uncertainty is contributing to increased volatility in economic data. GDP growth of 1.4% in 2018 was the slowest since 2012 and in March 2019 the Office of Budget Responsibility (OBR) revised down its 2019 GDP forecast to 1.2% from 1.6%, in part reflecting heightened Brexit uncertainty. The most recent preliminary monthly forecast, for August 2019, brought relief that the economy would avoid slipping into technical recession following a 0.2% decline in the three months to June 2019; although activity fell 0.1% in the month of August, on a rolling three-month basis growth was 0.3%. The labour market has remained resilient with further falls in unemployment (3.8% in May-July) and average earnings are rising at the fastest rate in more than 10 years.
  - Consumer price inflation has moderated and at 1.7% in August is now below the Bank of England target of 2%, indicating no pressure for interest rate increases while internationally, monetary policy has recently been loosened in many countries including the US. At its 18 September 2019 meeting the Bank of England Monetary Policy Committee voted unanimously to maintain the Bank Rate at 0.75%. On a longer-term basis, real interest rates are low and seem likely to increase. At H119, all of RGL's borrowing was fixed rate or hedged, significantly mitigating future interest rate risk. An increase in longer-term rates is likely to have a knock-on effect on NAV, through increased property yields.
- **Management risk**: RGL is externally managed, with both the asset management and investment management contracts in place for an initial five years from the November 2015 IPO, at which point 12 months' notice may be given. Although Stephen Inglis, Derek McDonald and Simon Marriot, respectively CEO, managing director and investment director of the asset manager, LSPIM, are significantly involved in the management of the RGL portfolio, we note that LSPIM is backed by an experienced and growing team.

Exhibit 15: Financial summary

Year end 31 December (£000s)	2016	2017	2018	2019e	2020e	2021e
PROFIT & LOSS	**IFRS**	**IFRS**	**IFRS**	**IFRS**	**IFRS**	**IFRS**
Rental income	42,994	61,610	74,019	72,881	82,350	83,614
Property costs	(4,866)	(15,763)	(19,644)	(19,084)	(20,866)	(20,549)
Net rental income	38,128	45,847	54,375	53,797	61,484	63,064
Administrative expenses (excluding performance fees)	(7,968)	(7,819)	(10,540)	(10,577)	(11,471)	(11,427)
Performance fees	(249)	(1,610)	(7,046)	0	0	0
EBITDA	29,911	36,418	36,789	43,219	50,012	51,638
EPRA cost ratio	N/A	29.7%	40.1%	29.2%	27.7%	26.4%
EPRA cost ratio excluding performance fee	N/A	26.6%	28.6%	29.2%	27.7%	26.4%
Gain on disposal of investment properties	518	1,234	23,127	1,653	0	0
Change in fair value of investment properties	(6,751)	5,893	23,881	1,999	5,420	3,460
Operating profit before financing costs	23,678	43,545	83,797	46,871	55,432	55,098
Exceptional items	0	0	0	0	0	0
Net finance expense	(8,629)	(14,513)	(15,715)	(13,289)	(13,393)	(13,528)
Net movement in the fair value of derivative financial investments and impairment of goodwill	(1,654)	(340)	(142)	(1,715)	0	0
Profit Before Tax	13,395	28,692	67,940	31,867	42,039	41,570
Tax	23	(1,632)	(567)	(49)	0	0
Profit After Tax (FRS 3)	13,418	27,060	67,373	31,818	42,039	41,570
Adjusted for the following:						
Net gain/(loss) on revaluation/disposal of investment properties	6,233	(7,127)	(47,008)	(3,652)	(5,420)	(3,460)
Net movement in the fair value of derivative financial investments	865	(407)	(459)	1,436	0	0
Other EPRA adjustments including deferred tax adjustment	557	4,488	987	651	0	0
EPRA earnings	21,073	24,014	20,893	30,253	36,619	38,110
Performance fees & exceptional items	249	1,610	7,046	0	0	0
Adjusted earnings	21,322	25,624	27,939	30,253	36,619	38,110
Period end number of shares (m)	274.2	372.8	372.8	431.5	431.5	431.5
Fully diluted average number of shares outstanding (m)	274.3	297.7	372.8	399.1	431.5	431.5
IFRS EPS - fully diluted (p)	4.9	9.1	18.1	8.0	9.7	9.6
Adjusted EPS, fully diluted (p)	7.8	8.6	7.5	7.6	8.5	8.8
EPRA EPS, fully diluted (p)	7.7	8.1	5.6	7.6	8.5	8.8
Dividend per share, declared basis (p)	7.65	7.85	8.05	8.25	8.45	8.65
Dividend cover	101.6%	109.7%	93.1%	91.9%	100.4%	102.1%
BALANCE SHEET						
Non-current assets	506,401	740,928	720,886	806,213	838,466	847,927
Investment properties	502,425	737,330	718,375	804,103	836,356	845,817
Other non-current assets	3,976	3,598	2,511	2,110	2,110	2,110
Current Assets	27,574	66,587	126,986	53,857	45,506	41,592
Other current assets	11,375	21,947	22,163	18,735	20,692	20,975
Cash and equivalents	16,199	44,640	104,823	35,122	24,814	20,617
Current Liabilities	(23,285)	(42,644)	(83,685)	(33,051)	(35,400)	(35,740)
Bank and loan borrowings - current	0	(400)	(40,216)	0	0	0
Other current liabilities	(23,285)	(42,244)	(43,469)	(33,051)	(35,400)	(35,740)
Non-current liabilities	(218,955)	(371,972)	(334,672)	(336,690)	(351,830)	(351,970)
Bank and loan borrowings - non-current	(217,442)	(371,220)	(334,335)	(334,917)	(350,057)	(350,197)
Other non-current liabilities	(1,513)	(752)	(337)	(1,773)	(1,773)	(1,773)
Net Assets	291,735	392,899	429,515	490,329	496,743	501,809
Derivative interest rate swaps & deferred tax liability	1,513	2,802	971	2,446	2,446	971
EPRA net assets	293,248	395,701	430,486	492,775	499,189	502,780
IFRS NAV per share (p)	106.4	105.4	115.2	113.6	115.1	116.3
Fully diluted EPRA NAV per share (p)	106.9	105.9	115.5	114.2	115.7	116.5
CASH FLOW						
Cash (used in)/generated from operations	31,434	40,251	38,817	30,263	50,404	51,694
Net finance expense	(6,626)	(9,167)	(11,923)	(11,977)	(11,887)	(12,022)
Tax paid	(1,715)	(236)	(1,467)	(844)	0	0
Net cash flow from operations	23,093	30,848	25,427	17,442	38,516	39,672
Net investment in investment properties	(99,286)	(8,267)	100,601	(62,096)	(26,833)	(6,000)
Acquisition of subsidiaries, net of cash acquired	(5,573)	(51,866)	(32,629)	(19,769)	0	0
Other investing activity	60	25	220	126	55	40
Net cash flow from investing activities	(104,799)	(60,108)	68,192	(81,739)	(26,778)	(5,960)
Equity dividends paid	(15,723)	(23,321)	(29,429)	(25,023)	(36,247)	(37,110)
Debt drawn/(repaid) - inc bonds and ZDP	91,417	13,921	(547)	(38,736)	15,000	0
Net equity issuance	0	71,256	(1,190)	60,375	0	0
Other financing activity	(1,744)	(4,155)	(2,270)	(2,020)	(800)	(800)
Net cash flow from financing activity	73,950	57,701	(33,436)	(5,404)	(22,047)	(37,910)
Net Cash Flow	(7,756)	28,441	60,183	(69,701)	(10,308)	(4,197)
Opening cash	23,955	16,199	44,640	104,823	35,122	24,814
Closing cash	16,199	44,640	104,823	35,122	24,814	20,617
Balance sheet debt	(217,442)	(371,620)	(374,551)	(334,917)	(350,057)	(350,197)
Unamortised debt costs	(2,618)	(4,843)	(5,752)	(6,713)	(6,573)	(6,433)
Closing net debt	(203,861)	(331,823)	(275,480)	(306,508)	(331,816)	(336,013)
LTV	40.6%	45.0%	38.3%	38.1%	39.7%	39.7%

Source: RGL historical data, Edison Investment Research forecasts

Contact details	Revenue by geography
Toscafund Asset Management LLP 7th Floor, 90 Long Acre London WC2E9RA +44 (0) 207 845 6100 www.regionalreit.com	

Key members of the leadership and management teams	
Chairman Regional REIT: Kevin McGrath	**Senior independent NED: William Eason**
Kevin McGrath is a chartered surveyor with 30 years of property experience. He is a member of the Royal Institute of Chartered Surveyors, the Investment Property Forum, the Worshipful Company of Chartered Surveyors, and he is a Freeman of the City of London. He is chairman of M&M Property Asset Management. Prior roles include managing director and senior adviser of F&C REIT Asset Management, founding equity partner in REIT Asset Management, and senior investment surveyor with Hermes Investment Management.	William ('Bill') Eason was previously head of charities with Quilter Cheviot and, before that, with Laing & Cruickshank. He had managed diversified high net worth portfolios since 1973 and became a member of the London Stock Exchange in 1976. He was chief investment officer at Laing & Cruickshank Investment Management and is a former chairman of Henderson High Income Trust plc. He is currently a director of Henderson International Income Trust and The European Investment Trust, an associate of the Society of Investment Professionals and a fellow of the Chartered Institute for Securities and Investment.
CEO London & Scottish Property Investment Management: Stephen Inglis	**MD London & Scottish Property Investment Management: Derek McDonald**
Stephen Inglis, group property director and CEO of London & Scottish Property Investment Management, the asset manager of RGL, serves as NED on the board of Regional REIT. He is a chartered surveyor with over 25 years' experience in the commercial property market most of which has been working in the investment and development sectors. As co-founder of London & Scottish Investments he was instrumental in establishing the Tosca Commercial Property Funds in 2013 and 2014 and subsequently combining these, undertaking the IPO and then listing as Regional REIT.	Derek McDonald is managing director of London & Scottish Property Investment Management (LSI), the asset manager of RGL. He joined LSI in June 2015 from REVCAP, which he joined as a partner in May 2014 having previously spent 27 years at Bank of Scotland/Lloyds Banking Group in a variety of senior roles in corporate banking, including time in the bank's corporate banking business in the US, the UK real estate joint ventures business, the European real estate business, the UK business support unit and the Irish business support unit, which both dealt with high-value real estate lending.

Principal shareholders (as stated in FY18 annual report)	(%)
Toscafund Asset Management LLP	7.3%
AXA Investment Managers	5.0%

Companies named in this report

Circle Property (CRC). Custodian REIT (CREI), Picton Property Income (PCTN), Real Estate Investors (RLE), Schroder REIT (SREI), Palace Capital (PCA), UK Commercial Property Trust (UKCM), BMO Commercial Property Trust (BCPT), BMO Real; Estate Investments (BREI)

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