EDISON

Regional REIT

Capital raised for accretive acquisitions

Equity issue completed

Real estate

Regional REIT (RGL) recently completed a £62.5m equity raise, the proceeds of which will be directed at a strong pipeline of investment opportunities. Once the proceeds are deployed RGL expects the acquired assets to be earnings accretive and provide further opportunities for active asset management and value creation. Increased scale and income diversity are also positive factors while trading liquidity may also benefit.

Year end	Net rental income (£m)	Adj. 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	0.99	7.5
12/18	54.4	27.9	7.5	115.5	8.05	0.91	7.7
12/19e	54.7	31.1	7.8	114.5	8.25	0.92	7.9
12/20e	61.4	36.5	8.5	116.2	8.45	0.90	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.

Growth, diversification and new opportunities

Since listing in November 2015, RGL's portfolio value has almost doubled including several large portfolio transactions. In the process, portfolio positioning has been optimised, diversification increased and scale added. Acquisitions also provide new opportunities to seek out and 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, and capital recycled. The strategy has generated strong returns since IPO with an EPRA NAV total return to end-FY18 of 10.5% pa, ahead of the company's long-term target of at least 10%. With a cooling in the investment market RGL now has a large and diverse pipeline (£500m+) of further acquisition opportunities which meet its investment criteria.

Growing DPS fully covered once proceeds deployed

The £62.5m (gross) proceeds raised exceeded the £50m target and was completed at 106.5p, a small 2% discount to the share price immediately ahead of the issue being launched. EPRA NAV per share is initially diluted by c 1% and the new shares will suppress EPS and DPS cover until the proceeds are invested. The company expects the new capital to be deployed fairly quickly, be accretive to earnings and restore full dividend cover. A target DPS of 8.25p (+2.5%) has been set for FY19. We assume £90m of investment by early 2020, including cash resources and modest further debt drawing, keeping LTV below 40% (we estimate around 30% following the capital raise). We forecast further DPS growth in FY20 and full cover.

Valuation: Strong income focus

RGL shares have outperformed the broad UK property sector, the wider market and a narrow group of direct peers over the past year. 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 FY20 as new equity is deployed.

9 August 2019

Price	**105p**
Market cap	**£453m**

Net debt (£m) at 31 March 2019	297.7
Net LTV at 31 March 2019	41.0
Shares in issue	431.5m
Free float	97%
Code	RGL
Primary exchange	LSE
Secondary exchange	N/A

Share price performance

%	1m	3m	12m
Abs	(2.8)	(2.6)	9.3
Rel (local)	0.5	(2.3)	17.0
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 events

Interim results	10 September 2019
Q319 trading update	14 November 2019

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Edison profile page

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Equity issue completed

RGL recently completed the capital raise announced in June 2019, issuing 58.7m new shares at 106.5p per share, raising gross proceeds of £62.5m. The new shares issued represent a 16% increase in share capital. The issue price represented a 2% discount to the share price immediately prior to the issue launch and an 8% discount to the 31 December 2018 (FY19) EPRA NAV per share of 115.5p. We estimate that the issue initially dilutes the end-FY18 EPRA NAV per share by a little more than 1% to 113.8p. This allows for our estimate of £2.1m in share issue costs.

The proceeds will be directed towards continued growth and further diversification of RGL's portfolio. Although the newly issued shares will initially suppress EPS and dividend cover, the company expects investment of the proceeds to be earnings accretive and to provide new opportunities to apply its active asset management strategy and create additional value over time. Allowing for reported portfolio transactions year to date, we estimate that the net loan to value ratio (LTV) will have fallen to c 30% immediately following the issue and before the planned reinvestment. Our revised forecasts include assumed acquisitions of £90m funded by the equity issue proceeds, existing cash resources and modest drawing from debt facilities.

Background to the issue

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 and improve its access to capital, including improved debt financing terms. But acquisitions also provide new opportunities 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 and recycle capital. 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.

Continued investment opportunities emerging

The UK economy has weakened in recent months, in part reflecting ongoing and heightened Brexit uncertainty but also a more general global trend. Against this background the UK commercial real estate market has showed signs of cooling and the retail and leisure sector has shown clear signs of stress, with rents and capital values falling. The regional office and light industrial sectors in which RGL invests have remained firm, supported by continued occupational demand, relatively low rental levels and a general lack of new supply. RGL has continued to report strong leasing progress and good results from its active asset management programmes and with the investment market cooling, it has continued to identify substantial and diverse opportunities for further investment.

The company says that it has an identified pipeline of assets in excess of £500m in value that meets its investment criteria and which can be acquired in a relatively short period of time. This includes a portfolio of six office assets, in respect of which RGL has entered an exclusivity agreement, and which the company expects to be both earnings accretive and enhance the characteristics of the portfolio.

Financials

Recently completed property transactions

Since end-FY18 RGL has reported three significant transactions, investing c £20m at a net initial yield (NIY) of 7.9% and selling two properties where asset management plans were mature for a similar amount, at a blended NIY of 6.8%.

- In February RGL 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 was 99% occupied at acquisition with an annual net income of £1.69m and the £20m consideration reflects a net initial yield of 7.9%. 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.
- An office property in Sheffield (**Aspect Court**, Pond Hill) was sold in June for £8.8m or 24.8% above the end-FY18 valuation and c 40% above the price at which it was acquired in 2016, reflecting a net initial yield of 6.6%. Asset management initiatives since acquisition have re-geared leases and taken back and re-let several floors resulting in increased lease length and a c 18% increase in annualised rental income to £620k.
- Also in June, RGL announced that it had contracted to sell **Tokenspire Business Park** in Beverley for £11.1m, reflecting a net initial yield of 7.0%. The sale price was similar to the end-FY18 valuation but represents an uplift of 30.6% to the March 2016 acquisition price of £8.5m. The five-year post-acquisition business plan, including improvements to the park's infrastructure to retain existing tenants, attract new tenants and reduce voids was completed ahead of schedule with occupancy increasing from 73.8% to 94.3% and rental income increasing by 24% to c £829k pa.

New equity and debt deployment

The changes to our forecasts are primarily driven by our assumptions for the deployment of the newly raised equity, along with cash resources and some additional debt capital, while maintaining a c 40% LTV which would be in line with RGL's medium-term targets. Specifically for acquisitions we assume:

- £70m of acquisitions during H219 and £20m at the beginning of FY20.
- A NIY of 8.5% on all acquisitions and a 4% cost of acquisition to reflect the expectation of a significant corporate acquisition element within the total. The net initial yield that we have assumed is slightly below the average 8.7% NIY on the c £73m (before costs) of acquisitions completed in FY18. We believe the lower 7.9% yield on Norfolk House reflects the quality of the asset and its high level of occupancy at acquisition.

The assumed FY19 acquisitions make a full year contribution in FY20, offsetting the initial dilutive effect of the equity raise. 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.

Exhibit 1: Estimate revisions

	Net rental income (£m)			Adj. earnings* (£m)			Adjusted EPS* (p)			EPRA NAV* (p)			DPS (p)		
	New	Old	% chg.	New	Old	% chg.	New	Old	% chg.	New	Old	% chg.	New	Old	% chg.
12/19e	54.7	55.2	-1%	31.1	31.7	-2%	7.8	8.5	-9%	114.5	116.7	-2%	8.25	8.25	0%
12/20e	61.4	55.7	10%	36.5	32.1	14%	8.5	8.6	-2%	116.2	117.8	-1%	8.45	8.45	0%
12/21e	62.9	N/A	N/A	38.0	N/A	N/A	8.8	N/A	N/A	118.2	N/A	N/A	8.65	N/A	N/A

Source: Edison Investment Research. Note: *Adjusted EPRA earnings excludes the investment manager performance fee accrual. EPS and NAV are fully diluted.

More broadly, our key forecasting assumptions are:

- In addition to including assumed acquisitions of £90m we have also factored in the disposals of Aspect Court and Tokenspire Business Park. The acquisition of Norfolk House was already reflected in our previous forecasts.
- We have assumed a continuing reduction in voids, with like-for-like portfolio occupancy (by value) increasing to 88.0% by end-FY19, 89.0% by end-FY20 and 90.0% by end-FY21 (end-FY18: 87.3%). Reported occupancy will be affected by portfolio transactions. We also allow for c 0.75% pa like-for-like rental growth. RGL has provided a number of updates on continued strong leasing activity in the FY19 year to date. Most recently, in June, it reported on lettings to new and existing tenants representing annualised headline rent of c £546k. Of this, a little more than £100k represented lettings of previously vacant properties, while the balance of lettings produced an average uplift in headline rent of 11.6%.
- Our assumption for gross revaluation gains reflects an unchanged c 6.5% net initial yield across the portfolio. This captures the positive impact of like-for-like occupancy and rental growth on the existing portfolio as well some post-acquisition asset management-driven upside from the acquired assets. Gross revaluation gains are equivalent to 1.1–1.2% of the opening portfolio value during the FY19–FY21 period and contribute c 2p pa to NAV. This is partly offset by acquisition costs. We estimate that a 0.25% increase/decrease in NIY would reduce/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.

Borrowings

At 31 December 2018 (end-FY18) RGL had fully drawn debt facilities of c £380m (including unamortised debt arrangement costs). Allowing for c £105m of cash, net debt was c £275m and the loan to value ratio (LTV) was 38.3%. 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 £66m and the term was extended from November 2022 to June 2029. The RBS facility was increased by c £28m to £55m and the term was extended from December 2021 to 19 June 2024. At the same time, a small £19m facility with HSBC was repaid. Immediately following this refinancing activity the average cost of borrowing, including hedging, was 3.5%, with the unexpired term extended from 6.7 years to 7.9 years. Current debt facilities amount to c £370m and our forecasts allow for c £356m of this to be drawn during the forecast period, taking LTV to just under 40%, compared with the c 30% that we estimate immediately following the equity issue.

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Valuation

Active management delivering attractive total return

RGL targets a medium-term annual total return of more than 10% and we estimate a compound average annual EPRA NAV total return of 10.6% since IPO in November 2015 to the end of FY18. The FY18 return was particularly strong at 16.6%. The group's 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.

Our forecasts for the years FY19–FY21 reflect a relatively cautious view towards rental growth and valuations compared with recent years. Our forecast FY19 total return of 6.2% includes equity issuance costs, modest initial dilution of EPRA NAV, and acquisition costs related investment of the proceeds. For FY20 and FY21 we forecast total returns of c 9% pa which although lower than the group's medium-term target compares well with UK 10-year gilt yield that has recently fallen towards 0.5%. Our forecast returns may prove conservative as they capture little of the asset management potential that management targets with acquisitions.

Exhibit 3: Peer comparison

	Price (p)	Market cap (£m)	P/NAV (x)	Yield (%)	Share price performance			
					1 month	3 months	12 months	From 12M high
Circle Property	189	53	0.68	3.3	-2%	-4%	-8%	-12%
Custodian	116	475	1.09	5.6	-2%	2%	-4%	-5%
Picton	89	487	0.96	3.9	-7%	-4%	-2%	-11%
Real Estate Investors	56	103	0.80	6.5	0%	0%	0%	-10%
Schroder REIT	56	290	0.82	4.6	-2%	-3%	-10%	-17%
Palace Capital	290	134	0.69	6.6	-3%	2%	-12%	-14%
UK Commercial Property Trust	84	1089	0.89	4.4	-5%	-6%	-6%	-10%
BMO Commercial Property Trust	110	879	0.80	5.5	-5%	-10%	-25%	-27%
BMO Real Estate Investments	84	202	0.79	6.0	3%	-11%	-14%	-16%
Average			**0.83**	**5.2**	**-3%**	**-4%**	**-9%**	**-14%**
Regional REIT	105	451	0.91	7.7	-3%	-3%	10%	-5%
UK property index	1,582			4.3	-7%	-8%	-13%	-13%
FTSE All-Share Index	3,981			4.7	-3%	1%	-6%	-7%

Source: Company data, Edison Investment Research. Note: *Last reported EPRA NAV per share and trailing 12-month DPS declared. Prices as at 8 August 2019.

Exhibit 3 shows a share price performance and valuation comparison between RGL and a peer group of companies similarly focused on regional commercial property. To ease comparison, the data is based on 12-month trailing DPS declared and last published NAV. Compared with this group, RGL's yield is also well above the average and it also compares favourably with the broader UK property sector. RGL's discount to NAV is narrower than the peer group average although within the group those companies with an income focus tend to have higher than average P/NAVs.

Over the past year RGL shares have performed noticeably more strongly than the peer average, the broad UK property sector and the FTSE All-Share Index. We attribute this to its ability to demonstrate strong asset management returns, its commitment to a progressive dividend policy and the reduction in LTV during FY18. The high prospective yield (FY19e of 7.9%) and the prospect of a return to fully covered dividends as the equity issue proceeds are invested represent scope for a further relative re-rating of the shares.

Exhibit 4: Financial summary

Year end 31 December (£000's)	2016	2017	2018	2019e	2020e	2021e
PROFIT & LOSS	IFRS	IFRS	IFRS	IFRS	IFRS	IFRS
Rental income	42,994	61,610	74,019	74,195	82,651	84,207
Property costs	(4,866)	(15,763)	(19,644)	(19,463)	(21,263)	(21,295)
Net rental income	38,128	45,847	54,375	54,732	61,388	62,912
Administrative expenses (excluding performance fees)	(7,968)	(7,819)	(10,540)	(10,486)	(11,325)	(11,511)
Performance fees	(249)	(1,610)	(7,046)	0	(925)	(1,148)
EBITDA	29,911	36,418	36,789	44,246	49,138	50,253
EPRA cost ratio	N/A	29.7%	40.1%	28.9%	29.2%	28.9%
EPRA cost ratio excluding performance fee	N/A	26.6%	28.6%	28.9%	27.8%	27.3%
Gain on disposal of investment properties	518	1,234	23,127	0	0	0
Change in fair value of investment properties	(6,751)	5,893	23,881	3,745	9,167	10,000
Operating profit before financing costs	23,678	43,545	83,797	47,991	58,305	60,253
Exceptional items	0	0	0	0	0	0
Net finance expense	(8,629)	(14,513)	(15,715)	(13,176)	(13,547)	(13,424)
Net movement in the fair value of derivative financial investments and impairment of goodwill	(1,654)	(340)	(142)	0	0	0
Profit Before Tax	13,395	28,692	67,940	34,815	44,758	46,829
Tax	23	(1,632)	(567)	0	0	0
Profit After Tax (FRS 3)	13,418	27,060	67,373	34,815	44,758	46,829
Adjusted for the following:						
Net gain/(loss) on revaluation/disposal of investment properties	6,233	(7,127)	(47,008)	(3,745)	(9,167)	(10,000)
Net movement in the fair value of derivative financial investments	865	(407)	(459)	0	0	0
Other EPRA adjustments including deferred tax adjustment	557	4,488	987	0	0	0
EPRA earnings	21,073	24,014	20,893	31,070	35,591	36,829
Performance fees & exceptional items	249	1,610	7,046	0	925	1,148
Adjusted earnings	21,322	25,624	27,939	31,070	36,516	37,977
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	8.7	10.4	10.9
Adjusted EPS, fully diluted (p)	7.8	8.6	7.5	7.8	8.5	8.8
EPRA EPS, fully diluted (p)	7.7	8.1	5.6	7.8	8.2	8.5
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%	94.4%	100.1%	101.7%
BALANCE SHEET						
Non-current assets	506,401	740,928	720,886	808,835	844,835	860,835
Investment properties	502,425	737,330	718,375	806,324	842,324	858,324
Other non-current assets	3,976	3,598	2,511	2,511	2,511	2,511
Current Assets	27,574	66,587	126,986	55,362	45,563	39,368
Other current assets	11,375	21,947	22,163	18,966	20,758	21,150
Cash and equivalents	16,199	44,640	104,823	36,395	24,805	18,218
Current Liabilities	(23,285)	(42,644)	(83,685)	(35,566)	(38,641)	(39,334)
Bank and loan borrowings - current	0	(400)	(40,216)	0	0	0
Other current liabilities	(23,285)	(42,244)	(43,469)	(35,566)	(38,641)	(39,334)
Non-current liabilities	(218,955)	(371,972)	(334,672)	(335,612)	(351,152)	(351,692)
Bank and loan borrowings - non-current	(217,442)	(371,220)	(334,335)	(335,275)	(350,815)	(351,355)
Other non-current liabilities	(1,513)	(752)	(337)	(337)	(337)	(337)
Net Assets	291,735	392,899	429,515	493,019	500,606	509,177
Derivative interest rate swaps & deferred tax liability	1,513	2,802	971	971	971	971
EPRA net assets	293,248	395,701	430,486	493,990	501,577	510,148
IFRS NAV per share (p)	106.4	105.4	115.2	114.3	116.0	118.0
Fully diluted EPRA NAV per share (p)	106.9	105.9	115.5	114.5	116.2	118.2
CASH FLOW						
Cash (used in)/generated from operations	31,434	40,251	38,817	39,540	49,497	49,407
Net finance expense	(6,626)	(9,167)	(11,923)	(11,636)	(12,007)	(11,884)
Tax paid	(1,715)	(236)	(1,467)	0	0	0
Net cash flow from operations	23,093	30,848	25,427	27,903	37,489	37,523
Net investment in investment properties	(99,286)	(8,267)	100,601	(84,204)	(26,833)	(6,000)
Acquisition of subsidiaries, net of cash acquired	(5,573)	(51,866)	(32,629)	0	0	0
Other investing activity	60	25	220	0	0	0
Net cash flow from investing activities	(104,799)	(60,108)	68,192	(84,204)	(26,833)	(6,000)
Equity dividends paid	(15,723)	(23,321)	(29,429)	(31,686)	(36,247)	(37,110)
Debt drawn/(repaid) - inc bonds and ZDP	91,417	13,921	(547)	(39,816)	15,000	0
Net equity issuance	0	71,256	(1,190)	60,375	0	0
Other financing activity	(1,744)	(4,155)	(2,270)	(1,000)	(1,000)	(1,000)
Net cash flow from financing activity	73,950	57,701	(33,436)	(12,127)	(22,247)	(38,110)
Net Cash Flow	(7,756)	28,441	60,183	(68,428)	(11,590)	(6,587)
Opening cash	23,955	16,199	44,640	104,823	36,395	24,805
Closing cash	16,199	44,640	104,823	36,395	24,805	18,218
Balance sheet debt	(217,442)	(371,620)	(374,551)	(335,275)	(350,815)	(351,355)
Unamortised debt costs	(2,618)	(4,843)	(5,752)	(5,212)	(4,672)	(4,132)
Closing net debt	(203,861)	(331,823)	(275,480)	(304,092)	(330,682)	(337,269)
LTV	40.6%	45.0%	38.3%	37.7%	39.3%	39.3%

Source: Regional REIT accounts, Edison Investment Research

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