

Company Guide

MRCB-Quill REIT



Refer to important disclosures at the end of this report
Version 7 | Bloomberg: MQREIT MK | Reuters: MQRE.KL

AllianceDBS Research, Malaysia Equity

20 Nov 2017

HOLD

Last Traded Price (17 Nov 2017): RM1.27 (KLCI : 1,721.66)
Price Target 12-mth: RM1.38 (9% upside) (Prev RM1.34)

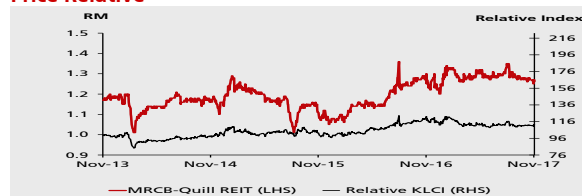
Analyst

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What's New

- 3QFY17 results were above expectations
- Higher income from Menara Shell
- Increase earnings by 3-4% for FY17F-19F
- Maintain HOLD with higher TP of RM1.38

Price Relative



Forecasts and Valuation

FY Dec (RMm)	2016A	2017F	2018F	2019F
Gross Revenue	132	181	186	191
Net Property Inc	102	146	149	153
Total Return	58.8	88.6	92.7	96.5
Distribution Inc	58.8	88.6	92.7	96.5
EPU (sen)	9.49	8.30	8.67	9.01
EPU Gth (%)	(7)	(13)	4	4
DPU (sen)	8.89	8.30	8.67	9.01
DPU Gth (%)	5	(7)	4	4
NAV per shr (sen)	137	125	125	125
PE (X)	13.4	15.3	14.7	14.1
Distribution Yield (%)	7.0	6.5	6.8	7.1
P/NAV (x)	0.9	1.0	1.0	1.0
Aggregate Leverage (%)	43.8	41.5	41.7	41.9
ROAE (%)	6.9	7.9	6.9	7.2

Distn. Inc Chng (%):	4	3	3
Consensus DPU (sen):	8.00	8.20	8.50
Other Broker Recs:	B: 4	S: 0	H: 4

Source of all data on this page: Company, AllianceDBS, Bloomberg Finance L.P

Steady income

Maintain HOLD with higher TP of RM1.38. We have raised our forecast by 4%/3%/3% for FY17F/18F/19F on lower property expense. MQREIT's appeal is the availability of an asset acquisition pipeline of completed investment properties from sponsor MRCB. The confirmation of injections at accretive yields will be a key re-rating catalyst for the stock.

Where we differ: Lower operating expense: We have incorporated lower operating expenses as we believe Menara Shell will be able to register better yields of 6.3% vs our previous forecast of 6.1%.

Potential catalyst: MRCB connection. MQREIT has the right of first refusal to MRCB's stable of investment properties, which is worth up to RM1.5bn in aggregate. Notable assets include Ascott Sentral (serviced apartments), Plaza Alam Sentral (retail), Sooka Sentral (lifestyle/retail) and Kompleks Sentral (industrial). The REIT also may acquire office assets from the Quill Group, the original sponsor of MQREIT with a remaining stake of c.17.7%. However, MQREIT's current gearing of c.37% indicates that new equity issuance will likely be necessary for sizeable acquisitions in the near term.

Valuation:

Our DDM-derived TP rises to RM1.38 after our earnings upgrade. Our TP factors in 7.4% cost of equity and 1.0% TG.

Key Risks to Our View:

Delayed leasing could be a drag on earnings. The office sector outlook faces challenges due to excess supply, especially in Kuala Lumpur and Cyberjaya, where the REIT has exposure. Occupancies could be a risk factor. Delayed leasing of released spaces may result in reduced earnings.

At A Glance

Issued Capital (m shrs)	1,068
Mkt. Cap (RMm/US\$m)	1,356 / 326
Major Shareholders (%)	
Malaysian Resources Corp	31.2
Quill group of companies	17.7
Capitaland Financial Ltd	17.7
Free Float (%)	33.5
3m Avg. Daily Val (US\$m)	0.10
ICB Industry : Real Estate / Real Estate Investment Trusts	



WHAT'S NEW**3QFY17 results above expectations**

- MQREIT's 3QFY17 net distributable income came in at RM21.4m (+40.4% y-o-y). This brings 9MFY17 income to RM66.6m which was above our expectation but in line with consensus'.
- The increase in income is attributable to the contribution from the sizeable Menara Shell injection from 4Q16 onwards and higher rental income due to step-up rent adjustments from QB2, QB3, QB5 and Wisma Technip. 3QFY17 recorded a NPI margin of c.76.5%.
- In addition, property operating expenses were also higher at RM10.5m (+51.2% y-o-y) due to the acquisition of Menara Shell. The higher finance costs this quarter were mainly due to higher borrowings after the drawdown of RM164m CPs on 22 December 2016 to finance the acquisition of Menara Shell and RM191m MTN to refinance the RM190m MTN that matured on 6 March 2017.

Stable occupancy, some lease expiries coming up

- Portfolio occupancy was steady at c.96.6%, slightly higher vs. 2QFY17's 96.5%.

Quarterly / Interim Income Statement (RMm)

FY Dec	3Q2016	2Q2017	3Q2017	% chg yoy	% chg qoq
Gross revenue	32.5	45.1	44.8	37.9	(0.6)
Property expenses	(7.0)	(10.2)	(10.5)	51.2	3.6
Net Property Income	25.5	34.9	34.3	34.3	(1.8)
Other Operating expenses	(2.7)	(13.5)	(13.6)	409.2	1.1
Other Non Opg (Exp)/Inc	0.0	0.0	0.0	N/A	N/A
Net Interest (Exp)/Inc	(7.6)	0.60	0.71	N/A	18.2
Exceptional Gain/(Loss)	0.0	0.0	0.0	N/A	N/A
Net Income	15.2	22.0	21.4	40.4	(3.0)
Tax	0.0	0.0	0.0	N/A	N/A
Minority Interest	0.0	0.0	0.0	N/A	N/A
Net Income after Tax	15.2	22.0	21.4	40.4	(3.0)
Net Inc available for Dist.	15.2	22.0	21.4	40.4	(3.0)
Ratio (%)					
Net Prop Inc Margin	78.6	77.4	76.5		
Dist. Payout Ratio	0.0	205.0	0.0		

Source of all data: Company, AllianceDBS

- About c.14.1%% of total NLA are due for renewal in FY17, out of which c.8.0% of these leases have been renewed while 2.0% have not. The remaining 4% will expire in the months ahead. Management will continue to fill up the balance vacant spaces in FY17. The expiring leases in FY18 form 26% of total NLA, and 13% in FY19.
- Going forward, we expect some challenges in negotiating positive rental reversions, and occupancy replenishment for MQREIT's office assets. This is due to additional space coming onstream, exacerbating the office supply overhang, particularly in Kuala Lumpur and Selangor where MQREIT's office assets are located.

Increase earnings by 3-4% for FY17-19F

- We bump up our earnings forecast by 4%/3%/3% for FY17F/18F/19F to take into account lower-than-expected operating expenses.

Valuation

We maintain our HOLD recommendation with a higher TP of RM1.38, following our earnings upgrade. Our DDM-derived TP is based on 7.4% cost of equity and 1% TG.

CRITICAL DATA POINTS TO WATCH

Revamped profile with new injections. MQREIT's asset portfolio has undergone a drastic shift with the acquisition of the RM740m Platinum Sentral (PS) asset in FY15 and the acquisition of Menara Shell for RM640m in Dec 2016. We forecasted an FY17 NPI yield of 6.3% for Menara Shell, which will result in a 7% dilution in DPU due to the equity fund-raising exercise. The injection of PS and Menara Shell is expected to increase the overall occupancy levels from 96% in FY17 to 97% in FY19 and our forecast average rent psf from RM6.80 in FY17 to RM7.20 in FY19. We are positive of MQREIT's DPU growth from FY17 onwards, as the recent developments will improve the quality of MQREIT's overall asset portfolio.

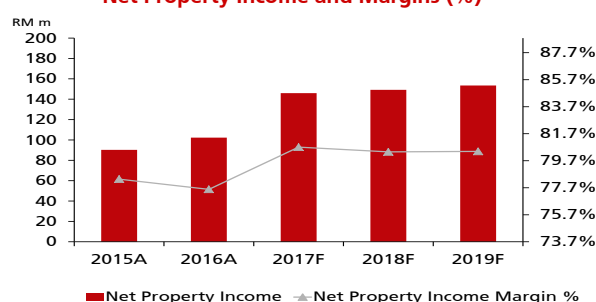
Minimal rent escalation for office spaces. MQREIT has nine other assets which are primarily office spaces with valuations generally below the RM150m level for each asset. They are mostly located in the suburban Cyberjaya and Petaling Jaya areas. Rental reversions have been mild or flat as competition is rife within those areas. We expect these assets to contribute c.43%/43% of MQREIT's overall topline in FY17F/FY18F.

Expect to maintain healthy occupancy. Portfolio occupancy has generally been fairly decent at above the 90% level, but has been dragged by the complete vacancy of the Quill Building 10 (QB10) from early 2013. However, the completion of the disposal of QB10 in early Sep 2015 and the acquisition of the fully-occupied PS and Menara Shell will have a net effect of raising overall occupancy to 97%. Going forward, expiring leases in FY17 are 14% of total NLA, and 26% in FY18. We expect some challenges in occupancy replenishment, but we believe management focus will be on filling up occupancy rather than negotiating positive rental reversions. Furthermore, management will be carrying out asset-enhancement works on selected properties within its portfolio, notably, Quill Building 1-DHL and Quill Building 4-DHL. These enhancements will revolve around helping tenants to conserve energy and costs, and reduce their carbon footprint.

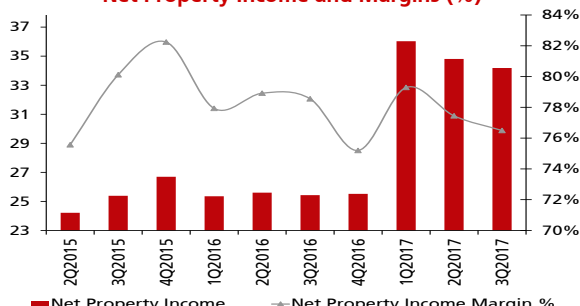
Possible acquisition of major shareholder's assets in the long term.

As developer MRCB is a major shareholder with a 31% stake following the injection of PS, MQREIT has obtained the right of first refusal to the former's stable of investment properties. Notable assets include Ascott Sentral (serviced apartments), Plaza Alam Sentral (retail), Sooka Sentral (lifestyle/retail) and Kompleks Sentral (industrial). Collectively, they carry a book value of c.RM340m, and could see injection values of up to RM860m. The REIT also may acquire office assets from the Quill Group, the original sponsor of MQREIT with a remaining stake of c.17.7%. Nonetheless, we highlight that gearing is currently at c.43%, implying limited debt headroom – additional unit issuance would be necessary to fund any big-ticket purchase, and thus earnings accretion from future acquisitions will likely be negated by the impact of dilution from equity issuance.

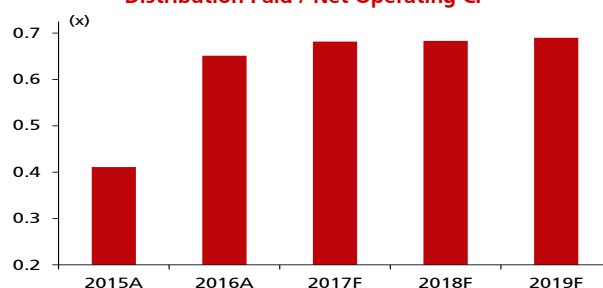
Net Property Income and Margins (%)



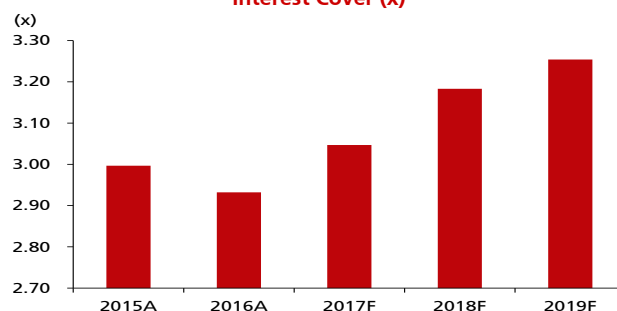
Net Property Income and Margins (%)



Distribution Paid / Net Operating CF

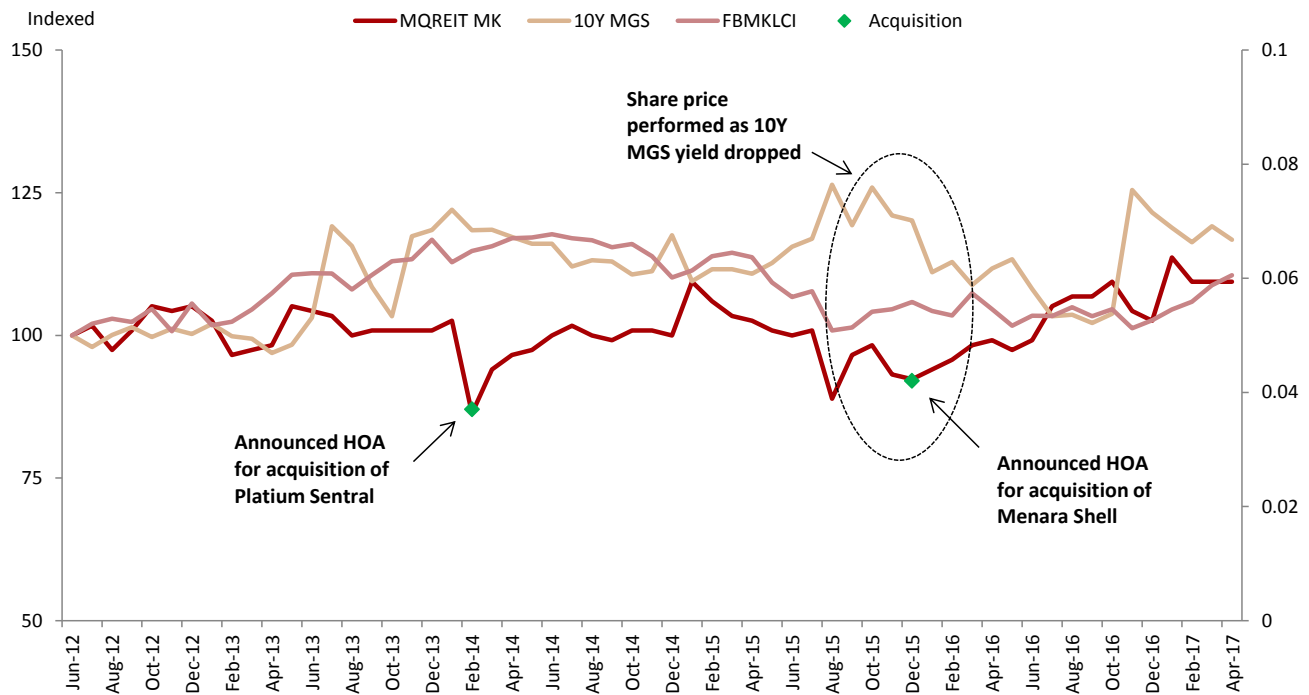


Interest Cover (x)



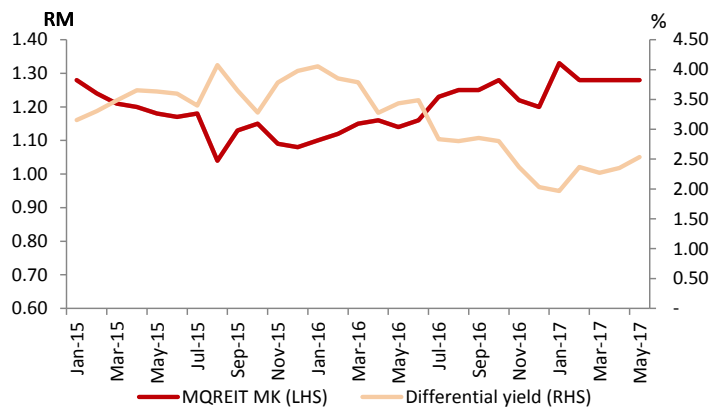
Source: Company, AllianceDBS

Appendix 1: Factors driving historical share price performance



Source: Company, AllianceDBS

MQRUIT's share price versus yield spread



Source: Company, AllianceDBS

Remarks

Interestingly, the yield spread between MQRUIT's distribution yield and the 10Y MGS yields has a negative correlation of 0.83. This shows that share price increases when MQRUIT distribution yield is higher than the 10Y MGS yield. Investors may shift to REITs if their yields are more attractive.

Balance Sheet:

Gearing is manageable for now. With borrowings taken up to part-fund the PS acquisition and Menara Shell, MQREIT has a gearing level of c.41-42%. Note that this is near the cap of 50% as per the Securities Commission Malaysia's REIT guidelines, and implies additional debt headroom of c.RM180m in FY17F. However, the average cost of debt of 4.4-4.6% is manageable, as interest payments are still adequately covered by its cash inflows. Interest rate risk is contained as all of its debts are on fixed interest rates. Debt maturity is staggered with 14% maturing in 2018, and the remaining 45% in 2020.

Share Price Drivers:

Acquisition newsflow. One of MQREIT's appeals is the availability of an asset acquisition pipeline of completed investment properties from sponsor MRCB. The confirmation of injections at accretive yields will be a key re-rating catalyst for the stock.

Forward yield spread. A REIT's attractiveness depends on its distribution yield, relative to other fixed-income assets. A common benchmark is the REIT's yield spread over the indicative 10-year Malaysian Government Securities yield, which is currently near the c.4% level.

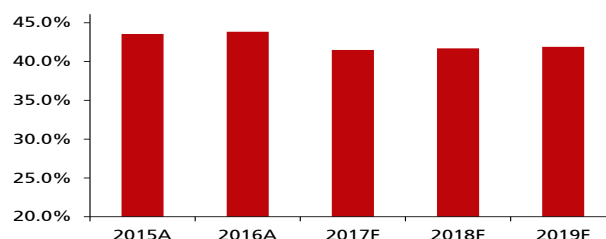
Key Risks:

Soft office rental market. The office sector outlook remains tepid due to excess supply, especially in Kuala Lumpur and Cyberjaya, where the REIT has exposure. Rental reversion potential is relatively weak and occupancies could be a risk factor.

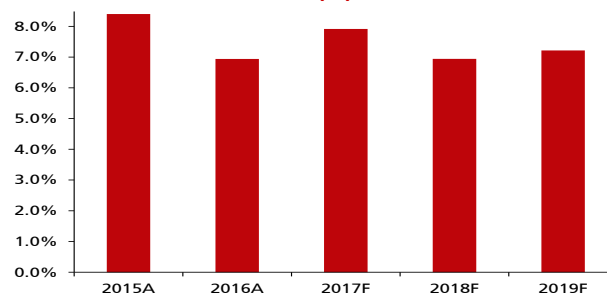
Company Background

MRCB-Quill REIT is a real estate investment trust that focuses on office properties. Its largest asset is Platinum Sentral with 445k-sq-ft NLA in the Kuala Lumpur Sentral transport hub. Its other assets include five office assets in Cyberjaya, one retail/commercial asset, one industrial asset and one hypermarket.

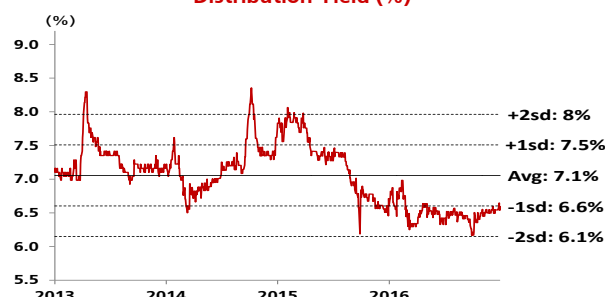
Aggregate Leverage (%)



ROE (%)



Distribution Yield (%)



PB Band (x)



Source: Company, AllianceDBS

Key Assumptions

FY Dec	2015A	2016A	2017F	2018F	2019F
Portfolio NLA (k sq ft)	1,723.0	1,723.0	2,280.0	2,280.0	2,280.0
Agg. occupancy rate (%)	95.5%	96.7%	96.8%	97.0%	97.0%
Average PS rents (RM)	6.9	7.3	7.3	7.3	7.6
Average non-PS rents (RM)	5.7	6.4	6.8	7.0	7.2

Income Statement (RMm)

FY Dec	2015A	2016A	2017F	2018F	2019F
Gross revenue	115	132	181	186	191
Property expenses	(24.9)	(29.5)	(34.8)	(36.4)	(37.3)
Net Property Income	90.3	102	146	149	153
Other Operating expenses	(9.2)	(12.4)	(14.0)	(14.1)	(14.1)
Other Non Opg (Exp)/Inc	0.0	0.0	0.0	0.0	0.0
Net Interest (Exp)/Inc	(27.1)	(30.7)	(43.3)	(42.5)	(42.8)
Exceptional Gain/(Loss)	6.68	3.54	0.0	0.0	0.0
Net Income	60.7	62.8	88.6	92.7	96.5
Tax	0.0	0.0	0.0	0.0	0.0
Minority Interest	0.0	0.0	0.0	0.0	0.0
Preference Dividend	0.0	0.0	0.0	0.0	0.0
Net Income After Tax	60.7	62.8	88.6	92.7	96.5
Total Return	54.0	58.8	88.6	92.7	96.5
Non-tax deductible Items	9.78	0.0	0.0	0.0	0.0
Net Inc available for Dist.	50.9	58.8	88.6	92.7	96.5

Growth & Ratio

Revenue Gth (%)	64.0	14.4	37.1	2.7	2.8
N Property Inc Gth (%)	69.3	13.3	42.7	2.3	2.8
Net Inc Gth (%)	50.7	3.4	41.2	4.6	4.1
Dist. Payout Ratio (%)	94.3	100.0	100.0	100.0	100.0
Net Prop Inc Margins (%)	78.4	77.6	80.7	80.4	80.4
Net Income Margins (%)	52.7	47.6	49.0	49.9	50.6
Dist to revenue (%)	44.2	44.6	49.0	49.9	50.6
Managers & Trustee's fees	8.0	9.4	7.7	7.6	7.4
ROAE (%)	8.4	6.9	7.9	6.9	7.2
ROA (%)	4.9	3.8	4.5	4.0	4.2
ROCE (%)	6.6	5.6	6.7	5.9	6.0
Int. Cover (x)	3.0	2.9	3.0	3.2	3.3

Source: Company, AllianceDBS

Quarterly / Interim Income Statement (RMm)

FY Dec	3Q2016	4Q2016	1Q2017	2Q2017	3Q2017
Gross revenue	32.5	34.1	45.6	45.1	44.8
Property expenses	(7.0)	(8.5)	(9.4)	(10.2)	(10.5)
Net Property Income	25.5	25.6	36.1	34.9	34.3
Other Operating expenses	(2.7)	(4.3)	(3.7)	(13.5)	(13.6)
Other Non Opg (Exp)/Inc	0.0	0.0	0.0	0.0	0.0
Net Interest (Exp)/Inc	(7.6)	(8.0)	(9.3)	0.60	0.71
Exceptional Gain/(Loss)	0.0	3.54	0.0	0.0	0.0
Net Income	15.2	16.9	23.2	22.0	21.4
Tax	0.0	0.0	0.0	0.0	0.0
Minority Interest	0.0	0.0	0.0	0.0	0.0
Net Income after Tax	15.2	16.9	23.2	22.0	21.4
Net Inc available for Dist.	15.2	13.4	23.2	22.0	21.4
Growth & Ratio					
Revenue Gth (%)	0	5	34	(1)	(1)
N Property Inc Gth (%)	(1)	0	41	(3)	(2)
Net Inc Gth (%)	(1)	11	37	(5)	(3)
Net Prop Inc Margin (%)	78.6	75.2	79.3	77.4	76.5
Dist. Payout Ratio (%)	0.0	205.2	0.0	205.0	0.0

Balance Sheet (RMm)

FY Dec	2015A	2016A	2017F	2018F	2019F
Investment Properties	1,572	1,582	2,222	2,232	2,242
Other LT Assets	1.83	1.83	1.83	1.83	1.83
Cash & ST Invt	46.0	47.5	73.6	76.1	78.6
Inventory	0.0	0.0	0.0	0.0	0.0
Debtors	5.65	6.25	8.86	9.10	9.36
Other Current Assets	0.0	0.0	0.0	0.0	0.0
Total Assets	1,625	1,637	2,306	2,319	2,332
ST Debt	191	201	440	450	460
Creditor	13.6	14.3	15.0	15.7	16.5
Other Current Liab	0.0	0.0	0.0	0.0	0.0
LT Debt	516	516	516	516	516
Other LT Liabilities	0.0	0.0	0.0	0.0	0.0
Unit holders' funds	904	905	1,334	1,336	1,338
Minority Interests	0.0	0.0	0.0	0.0	0.0
Total Funds & Liabilities	1,625	1,637	2,306	2,319	2,332
Non-Cash Wkg. Capital	(7.9)	(8.0)	(6.1)	(6.6)	(7.2)
Net Cash/(Debt)	(662)	(670)	(883)	(891)	(898)
Ratio					
Current Ratio (x)	0.3	0.2	0.2	0.2	0.2
Quick Ratio (x)	0.3	0.2	0.2	0.2	0.2
Aggregate Leverage (%)	43.6	43.8	41.5	41.7	41.9
Z-Score (X)	0.9	1.0	1.0	1.0	1.0

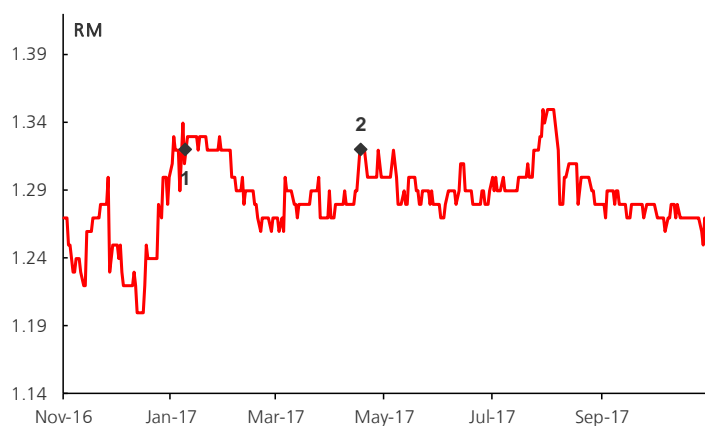
Source: Company, AllianceDBS

Cash Flow Statement (RMm)

FY Dec	2015A	2016A	2017F	2018F	2019F
Pre-Tax Income	60.7	58.8	88.6	92.7	96.5
Dep. & Amort.	0.0	0.0	0.0	0.0	0.0
Tax Paid	0.0	0.0	0.0	0.0	0.0
Associates & JV Inc/(Loss)	0.0	0.0	0.0	0.0	0.0
Chg in Wkg.Cap.	6.43	0.08	(1.9)	0.51	0.53
Other Operating CF	27.1	31.4	43.3	42.5	42.8
Net Operating CF	94.2	90.3	130	136	140
Net Invnt in Properties	(752)	(10.0)	(640)	(10.0)	(10.0)
Other Invts (net)	0.0	0.0	0.0	0.0	0.0
Invts in Assoc. & JV	0.0	0.0	0.0	0.0	0.0
Div from Assoc. & JVs	0.0	0.0	0.0	0.0	0.0
Other Investing CF	0.89	1.70	2.37	3.68	3.80
Net Investing CF	(751)	(8.3)	(638)	(6.3)	(6.2)
Distribution Paid	(38.7)	(58.8)	(88.6)	(92.7)	(96.5)
Chg in Gross Debt	389	10.0	239	10.0	10.0
New units issued	342	0.0	427	0.0	0.0
Other Financing CF	(28.9)	(33.1)	(45.7)	(46.1)	(46.6)
Net Financing CF	663	(81.9)	532	(129)	(133)
Currency Adjustments	0.0	0.0	0.0	0.0	0.0
Chg in Cash	6.55	0.08	24.1	0.51	0.53
Operating CFPS (sen)	14.7	13.6	12.4	12.6	13.0
Free CFPS (sen)	(110)	12.1	(47.7)	11.8	12.1

Source: Company, AllianceDBS

Target Price & Ratings History



S.No.	Date of Report	Closing Price	12-mth Target Price	Rating
1:	26 Jan 17	1.32	1.37	HOLD
2:	05 May 17	1.32	1.34	HOLD

Note: Share price and Target price are adjusted for corporate actions.

Source: AllianceDBS

Analyst: Siti Ruzanna MOHD FARUK

DISCLOSURE

Stock rating definitions

STRONG BUY	-	> 20% total return over the next 3 months, with identifiable share price catalysts within this time frame
BUY	-	> 15% total return over the next 12 months for small caps, >10% for large caps
HOLD	-	-10% to +15% total return over the next 12 months for small caps, -10% to +10% for large caps
FULLY VALUED	-	negative total return > -10% over the next 12 months
SELL	-	negative total return of > -20% over the next 3 months, with identifiable catalysts within this time frame

Commonly used abbreviations

Adex = advertising expenditure	EPS = earnings per share	PBT = profit before tax
bn = billion	EV = enterprise value	P/B = price / book ratio
BV = book value	FCF = free cash flow	P/E = price / earnings ratio
CF = cash flow	FV = fair value	PEG = P/E ratio to growth ratio
CAGR = compounded annual growth rate	FY = financial year	q-o-q = quarter-on-quarter
Capex = capital expenditure	m = million	RM = Ringgit
CY = calendar year	M-o-m = month-on-month	ROA = return on assets
Div yld = dividend yield	NAV = net assets value	ROE = return on equity
DCF = discounted cash flow	NM = not meaningful	TP = target price
DDM = dividend discount model	NTA = net tangible assets	trn = trillion
DPS = dividend per share	NR = not rated	WACC = weighted average cost of capital
EBIT = earnings before interest & tax	p.a. = per annum	y-o-y = year-on-year
EBITDA = EBIT before depreciation and amortisation	PAT = profit after tax	YTD = year-to-date

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