

# Company Guide

## MRCB-Quill REIT

Edition 1 Version 1 | Bloomberg: QUIL MK | Reuters: QCAP.KL

Refer to important disclosures at the end of this report

Malaysia Equity Research

23 Oct 2015

### HOLD

Last Traded Price: RM1.15 (KLCI : 1,705.09)

Price Target : RM1.20 (4% upside) (Prev RM1.25)

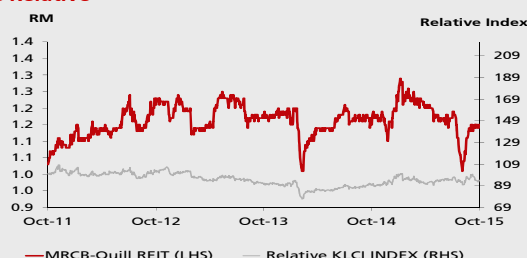
Shariah Compliant: No

**Where we differ:** Higher property and management cost assumptions than consensus

#### Analyst

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#### Price Relative



#### Forecasts and Valuation

FY Dec (RM m)	2014A	2015F	2016F	2017F
Gross Revenue	70	109	124	129
Net Property Inc	53	86	98	101
Total Return	40	50	57	58
Distribution Inc	33	50	57	58
EPU (sen)	10.3	8.4	8.6	8.8
EPU Gth (%)	10	(19)	2	3
DPU (sen)	8.4	8.4	8.6	8.8
DPU Gth (%)	0	0	2	3
NAV per shr (sen)	138.7	133.5	133.6	133.5
PE (X)	11.1	13.7	13.4	13.1
Distribution Yield (%)	7.3	7.3	7.4	7.7
P/NAV (x)	0.8	0.9	0.9	0.9
Aggregate Leverage (%)	36.3	44.4	44.7	45.0
ROAE (%)	7.5	7.0	6.4	6.6

Distn. Inc Chng (%): 0 0 0

Consensus DPU (sen): 8.3 8.5 8.9

Other Broker Recs: B: 3 S: 0 H: 3

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

### OFFICE BLUES

**Modest near-term growth.** We have a HOLD call on MQREIT as the mild growth outlook and vacancy risks are adequately priced in, with it trading at c.1% yield above other M-REITs under our coverage. While the major Platinum Sentral acquisition in 1Q15 had increased its asset size by nearly 90% to RM1.55bn, we expect flat DPU growth in FY15 due to the dilutive effects of new units issued. DPU growth had been flat since FY13, due to mild reversions on its core office assets as well as some vacancy issues.

**Lukewarm office space outlook.** We expect some challenges in negotiating positive rental reversions, and occupancy replenishment going forward for MQREIT's office-focused portfolio. This is due to additional incoming supply prolonging the office space supply overhang. As at 1H15, the National Property Information Centre (NAPIC) expects an additional 9% of incoming office space for Malaysia, with the bulk (83%) of that coming from Kuala Lumpur, Putrajaya and Selangor – where MQREIT has exposure – with expected space additions of 6%, 14% and 21% respectively.

**MRCB connection.** MQREIT has the rights of first refusal to Malaysian Resources Corp's (MRCB) stable of investment properties, which may carry values of up to RM1.5bn in aggregate. However, MQREIT's current gearing of c.44% implies additional debt headroom of only c.RM100m – implying that new unit issuance will likely be necessary for sizeable acquisitions in the near term.

#### Valuation:

Rolling forward our DDM-based valuation and imputing a higher risk-free rate of 4.3%, our TP is RM1.20, assuming 8.4% cost of equity and 1% terminal growth.

#### Key Risks to Our View:

**Earnings stability.** Our earnings forecast assumes no additional vacancies and immediate renewal/refilling of expiring leases. Delayed replenishment of released spaces will be earnings negative and may de-rate the stock downwards.

#### At A Glance

Issued Capital (m shrs)	661
Mkt. Cap (RMm/US\$m)	761 / 177
Major Shareholders	
Malaysian Resources Corp (%)	31.1
Quill group of companies (%)	17.7
Capitaland Financial Ltd (%)	17.7
Free Float (%)	33.5
3m Avg. Daily Val (US\$m)	0.0
ICB Industry : Real Estate / Real Estate Investment Trusts	

## CRITICAL DATA POINTS TO WATCH

## Earnings Drivers:

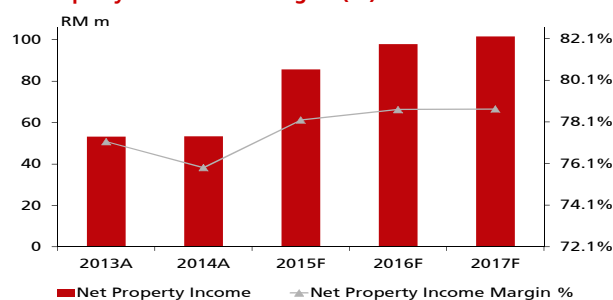
**Revamped profile with Platinum Sentral.** MQREIT's asset portfolio underwent a drastic shift with the acquisition of the RM740m Platinum Sentral (PS) asset, which comprises 445k sq ft NLA of offices and 56k sq ft of retail space in the vibrant Kuala Lumpur Sentral transport hub. The office spaces spanning across five blocks are mainly leased out on long-term contracts to government-linked companies like SME Corp, SPAD (Land Public Transport Commission) and PEMANDU at above-average rental rates of >RM9psf/mth. The contracts range from 5-15 years and some have built-in step-ups every three years. Earnings risk is relatively low given the tenant profiles and the prime asset location.

**Minimal rent escalation on office spaces.** MQREIT has nine other assets which are primarily office spaces with valuations generally below the RM150m level each. 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 them to make up c.60% of MQREIT's overall top line going forward.

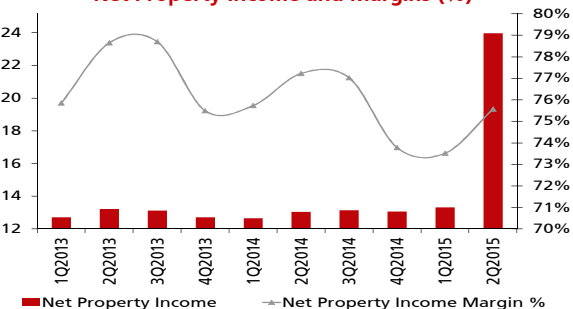
**Expect to maintain healthy occupancy.** Portfolio occupancy has generally been fair at above the 90% level, brought down mainly by the complete vacancy of the Quill Building 10 (QB10) in early 2013. However, the completion of QB10 disposal in early Sep-15 and the acquisition of the fully-occupied PS will have a net effect of raising overall occupancy to 96%. For 2H15, c.14% of expiring NLA remains to be renewed – though this comes mainly from a single tenant (DHL) which according to management's guidance, are likely to renew. Going forward, only 7% and 10% of NLA is expiring in FY16 and FY17 respectively and as such, vacancy risk is generally contained in the near term.

**Possible acquisition of major shareholder's assets over the long term.** As developer Malaysian Resources Corp (MRCB) has become 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 the Menara Shell (office), Ascott Sentral (serviced apartments), Plaza Alam Sentral (retail), Sooka Sentral (lifestyle/retail); and Kompleks Sentral (industrial). Collectively, they carry a book value of RM770m, and could see injection values of up to RM1.5bn. The REIT also may acquire office assets from the Quill Group, the original sponsor of MQREIT with remaining stake of c.17.7%. Nonetheless, we highlight that gearing is currently above 44%, 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 dilution from equity issuance.

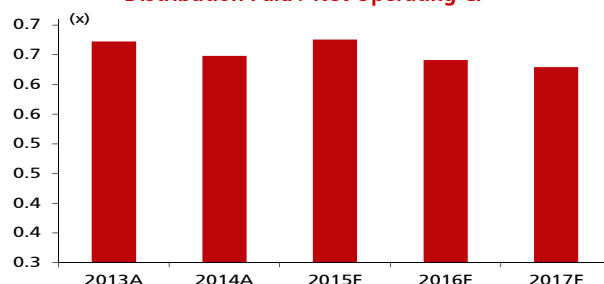
## Net Property Income and Margins (%)



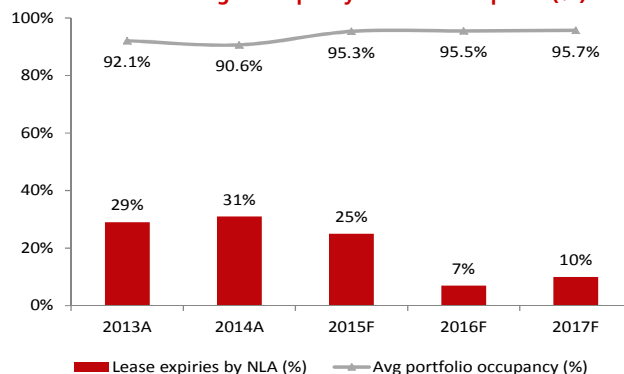
## Net Property Income and Margins (%)



## Distribution Paid / Net Operating CF



## Portfolio Average Occupancy and Lease Expiries (%)



## Existing and Incoming Office Space as at 1H2015

Area	Existing (m sq ft)	Incoming (m sq ft)	% Incoming / Existing
Kuala Lumpur	88.9	5.6	6%
Putrajaya	21.8	3.2	14%
Selangor	32.8	6.8	21%
All other states	69.4	3.2	5%
<b>Malaysia</b>	<b>212.9</b>	<b>18.7</b>	<b>9%</b>

Source: Company, AllianceDBS, National Property Information Centre

### Balance Sheet:

**Gearing near the limit, though manageable for now.** With the borrowings taken up to part-fund the PS acquisition, MQREIT has a gearing level of 44%. Note that this is near the cap of 50% as per REIT guidelines, and implies additional debt headroom of <RM100m. 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 rates. Debt maturity is staggered with 26% maturing in 2016, 16% in 2018, and the remaining 58% in 2020.

### Share Price Drivers:

**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 Security yield, which is currently near the 4.2% level.

### Key Risks:

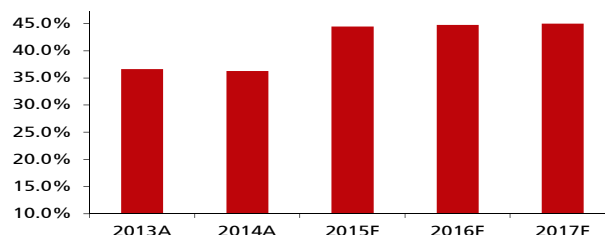
**Soft office rental market.** The office sector outlook remains tepid due to excess supply, especially in Kuala Lumpur and Cyberjaya, where the REIT has exposure. Rental reversion potential is relatively weak and occupancies could be a risk factor.

**Higher gearing and financing costs.** After the Platinum Sentral injection, MQREIT's gearing is now at 44%, near the 50% regulatory cap. Financing costs are also slated to rise because of additional facilities, but it is reassuring that all its borrowings are now at fixed interest rates.

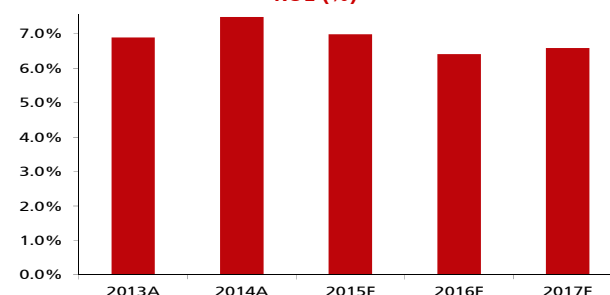
### COMPANY BACKGROUND

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, a retail/commercial asset in Mont' Kiara, an industrial asset in Shah Alam, an office building in Kuala Lumpur and a hypermarket in Penang.

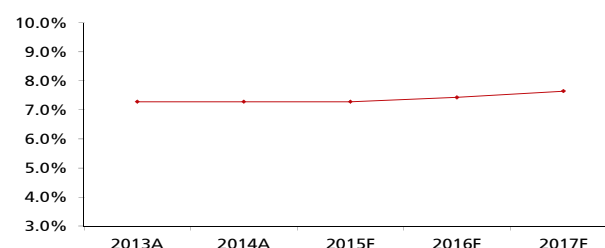
Aggregate Leverage (%)



ROE (%)



Distribution Yield (%)



PB Band (x)



Source: Company, AllianceDBS

## Key Assumptions

FY Dec	2013A	2014A	2015F	2016F	2017F
Portfolio NLA (k sq ft)	1,289.8	1,289.8	1,723.0	1,723.0	1,723.0
Agg. occupancy rate (%)	92.1	90.6	95.7	95.7	95.7
Average PS rents (RM psf/mth)	N/A	N/A	8.7	8.7	9.1
Average non-PS rents (RM psf/mth)	4.8	5.0	5.2	5.3	5.5

## Income Statement (RM m)

FY Dec	2013A	2014A	2015F	2016F	2017F
Gross revenue	69	70	109	124	129
Property expenses	(16)	(17)	(24)	(26)	(27)
<b>Net Property Income</b>	<b>53</b>	<b>53</b>	<b>86</b>	<b>98</b>	<b>101</b>
Other Operating expenses	(6)	(6)	(9)	(9)	(9)
Other Non Opg (Exp)/Inc	0	0	0	0	0
Net Interest (Exp)/Inc	(13)	(13)	(27)	(32)	(34)
Exceptional Gain/(Loss)	2	6	0	0	0
<b>Net Income</b>	<b>37</b>	<b>40</b>	<b>50</b>	<b>57</b>	<b>58</b>
Tax	0	0	0	0	0
Minority Interest	0	0	0	0	0
Preference Dividend	0	0	0	0	0
<b>Net Income After Tax</b>	<b>37</b>	<b>40</b>	<b>50</b>	<b>57</b>	<b>58</b>
Total Return	37	40	50	57	58
Non-tax deductible Items	4	8	0	0	0
Net Inc available for Dist.	33	33	50	57	58

## Growth &amp; Ratio

Revenue Gth (%)	(0.8)	1.9	55.9	13.5	3.7
N Property Inc Gth (%)	(1.9)	0.2	60.6	14.2	3.7
Net Inc Gth (%)	(8.6)	9.9	23.7	13.9	3.0
Dist. Payout Ratio (%)	94.7	95.7	99.9	99.9	100.0
Net Prop Inc Margins (%)	77.2	75.9	78.2	78.7	78.7
Net Income Margins (%)	53.2	57.3	45.5	45.7	45.4
Dist to revenue (%)	47.4	46.5	45.5	45.6	45.4
Managers & Trustee's fees to sales %)	8.4	8.3	8.3	7.0	6.8
ROAE (%)	6.9	7.5	7.0	6.4	6.6
ROA (%)	4.3	4.7	4.0	3.5	3.6
ROCE (%)	5.6	5.6	6.2	5.5	5.7
Int. Cover (x)	3.7	3.6	2.9	2.8	2.7

Growth came from Platinum Sentral injection, contributing from 2Q15.

Assume ramping up to full payout.

Source: Company, AllianceDBS

**Quarterly / Interim Income Statement (RM m)**

FY Dec	2Q2014	3Q2014	4Q2014	1Q2015	2Q2015
Gross revenue	17	18	18	19	32
Property expenses	(4)	(4)	(5)	(5)	(8)
Net Property Income	13	14	13	14	24
Other Operating expenses	(2)	(1)	(2)	(2)	(3)
Other Non Opg (Exp)/Inc	0	0	0	0	0
Net Interest (Exp)/Inc	(3)	(3)	(3)	(3)	(8)
Exceptional Gain/(Loss)	0	0	6	0	0
<b>Net Income</b>	<b>9</b>	<b>9</b>	<b>15</b>	<b>8</b>	<b>14</b>
Tax	0	0	0	0	0
Minority Interest	0	0	0	0	0
<b>Net Income after Tax</b>	<b>9</b>	<b>9</b>	<b>15</b>	<b>8</b>	<b>14</b>
Net Inc available for Dist.	16	0	17	7	14
<b>Growth &amp; Ratio</b>					
Revenue Gth (%)	1	1	4	2	73
N Property Inc Gth (%)	3	1	(1)	2	78
Net Inc Gth (%)	5	4	64	(43)	65
Net Prop Inc Margin (%)	77.2	77.0	73.8	73.5	75.6
Dist. Payout Ratio (%)	95.6	0.0	95.7	88.6	101.7

**Balance Sheet (RM m)**

FY Dec	2013A	2014A	2015F	2016F	2017F
Investment Properties	826	838	1,555	1,565	1,575
Other LT Assets	1	1	1	1	1
Cash & ST Invt	31	23	49	50	51
Inventory	0	0	0	0	0
Debtors	3	6	10	11	11
Other Current Assets	0	0	0	0	0
<b>Total Assets</b>	<b>860</b>	<b>868</b>	<b>1,615</b>	<b>1,627</b>	<b>1,639</b>
ST Debt	5	2	405	415	425
Creditor	12	12	13	13	14
Other Current Liab	0	0	0	0	0
LT Debt	310	313	313	313	313
Other LT Liabilities	0	0	0	0	0
Unit holders' funds	533	541	884	886	887
Minority Interests	0	0	0	0	0
<b>Total Funds &amp; Liabilities</b>	<b>860</b>	<b>868</b>	<b>1,615</b>	<b>1,627</b>	<b>1,639</b>
Non-Cash Wkg. Capital	(9)	(6)	(3)	(3)	(3)
Net Cash/(Debt)	(284)	(292)	(669)	(678)	(687)
<b>Ratio</b>					
Current Ratio (x)	2.0	2.0	0.1	0.1	0.1
Quick Ratio (x)	2.0	2.0	0.1	0.1	0.1
Aggregate Leverage (%)	36.6	36.3	44.4	44.7	45.0
Z-Score (X)	1.3	1.3	0.6	0.7	0.7

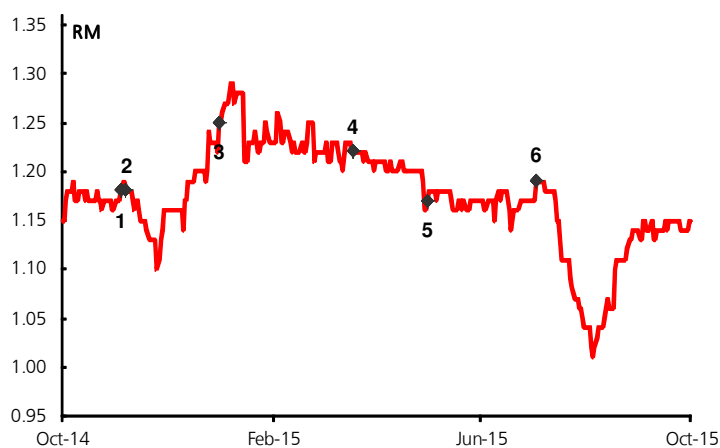
Source: Company, AllianceDBS

## Cash Flow Statement (RM m)

FY Dec	2013A	2014A	2015F	2016F	2017F
Pre-Tax Income	37	40	50	57	58
Dep. & Amort.	0	0	0	0	0
Tax Paid	0	0	0	0	0
Associates & JV Inc/(Loss)	0	0	0	0	0
Chg in Wkg.Cap.	1	(3)	(3)	(1)	0
Other Operating CF	11	13	27	32	34
<b>Net Operating CF</b>	<b>49</b>	<b>50</b>	<b>74</b>	<b>88</b>	<b>93</b>
Net Invnt in Properties	(3)	(6)	(718)	(10)	(10)
Other Invts (net)	0	0	0	0	0
Invts in Assoc. & JV	0	0	0	0	0
Div from Assoc. & JVs	0	0	0	0	0
Other Investing CF	1	1	1	1	1
<b>Net Investing CF</b>	<b>(2)</b>	<b>(5)</b>	<b>(717)</b>	<b>(9)</b>	<b>(9)</b>
Distribution Paid	(33)	(33)	(50)	(57)	(58)
Chg in Gross Debt	0	0	403	10	10
New units issued	0	0	342	0	0
Other Financing CF	(13)	(14)	(27)	(34)	(35)
<b>Net Financing CF</b>	<b>(46)</b>	<b>(47)</b>	<b>668</b>	<b>(80)</b>	<b>(84)</b>
Currency Adjustments	0	0	0	0	0
Chg in Cash	0	(1)	25	(1)	0
Operating CFPS (sen)	12.2	13.7	12.9	13.4	13.9
Free CFPS (sen)	11.7	11.4	(108.4)	11.8	12.5

Source: Company, AllianceDBS

## Target Price &amp; Ratings History



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

S.No.	Date	Closing Price	Target Price	Rating
1:	24 Nov 14	1.18	1.25	HOLD
2:	27 Nov 14	1.18	1.25	HOLD
3:	20 Jan 15	1.25	1.25	HOLD
4:	08 Apr 15	1.22	1.25	HOLD
5:	21 May 15	1.17	1.25	HOLD
6:	23 Jul 15	1.19	1.25	HOLD

Source: AllianceDBS

## DISCLOSURE

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### 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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