

Malaysia Flash Note

Refer to important disclosures at the end of this report

Malaysia Equity Research

26 Jan 2016

MRCB-Quill REIT (MQREIT MK) : **HOLD**

Analyst

Mkt. Cap: US\$167m | **3m Avg. Daily Val:** US\$0.05m

Malaysian Research Team +603 2604 3333;

Last Traded Price: RM1.08

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Price Target: RM1.20 (11% upside)

Shariah Compliant: No

Stay steady and HOLD MQREIT

- **4Q15 earnings in line; boosted by contributions from Platinum Sentral (PS)**
- **Declares DPU of 4.37 sen, ex-date 5 Feb**
- **Outlook for office rental growth remains lukewarm; however, potential earnings re-rating from proposed acquisition of Menara Shell**
- **Maintain HOLD, TP RM1.20; pending further guidance from management on proposed acquisition of Menara Shell**

Highlights

Earnings as expected

- MQREIT's FY15 net distributable income of RM50.9m was in line within our/consensus expectations.
- 4Q15 recorded core realised net income of RM16.4m (+92.5% y-o-y); taking into account contribution from the sizeable Platinum Sentral (PS) injection from 2Q15 onwards.
- FY15 NPI margin of c.78% was as expected, higher than 76% in FY14 as PS carries higher margins. There was also a gain of disposal of RM0.6m from the sale of QB10 in Sept 2015 and a revaluation gain of RM6.7m.
- DPU of 4.37 sen was declared, which brings FY15 DPU to 8.47 sen implying a payout ratio of c.94% (FY14: c.96%). We also note that there was a dilution from FY14's initial DPU of 10.3 sen (adjusted DPU 8.38 sen); due to FY15's right issues of RM206m to finance the acquisition of PS.

Higher occupancy, some lease expiries coming up

- Portfolio occupancy was steady at c.97%, up from 91% at end-FY14 due to the disposal of the fully

vacant QB10 and minor take-ups at PS retail and Plaza Mont Kiara.

- About c.25% of total NLA was due for renewal in FY15, out of which 94% of these leases have been renewed. The bulk (190k sq ft or 11% of total) comes from a single tenant (DHL). Expiring leases in FY16 are 7% of total NLA, and 10% in FY17.

Outlook

Lukewarm outlook for office space. We expect some challenges in negotiating positive rental reversions, and occupancy replenishment going forward for MQREIT's office assets. This is due to additional space coming on stream, prolonging the office supply overhang, particularly in Kuala Lumpur and Selangor where MQREIT's office assets are located.

Sizeable buy from MRCB. MQREIT announced that it had entered into a Heads of Agreement (HoA) with 348 Sentral Sdn Bhd, subsidiary of major shareholder Malaysian Resources Corp (MRCB), for the proposed acquisition of Menara Shell for RM640m. The definitive sale and purchase agreement (SPA) will only be entered into after due diligence is completed by MQREIT. We are positive on this news as Menara Shell is a well-located office asset and have near-full occupancy, with established tenants like Shell People Services Asia Sdn Bhd, AmlInsurance General Bhd and Tradewinds Corporation. The total NLA of 556,468 sq ft implies a price of RM1,180psf. While no rental or NPI guidance was given, our back of envelope calculations suggest

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FY16 NPI could be raised by 41%-52% from the acquisition of Menara Shell assuming its NPI yield of 6.0%-7.5%.

Under review pending further guidance. DPU accretion to unitholders remains uncertain at this point in time as it depends on Menara Shell's NPI yield and its funding structure. Given the size of the proposed acquisition, significant equity funding will be required. Our sensitivity analysis below shows that the proposed acquisition will only lead to DPU accretion regardless of the funding structure if NPI yield is 7.5% or above. Pending SPA announcement and further details from management, we make no changes to our forecast.

DPU sensitivity analysis

FY15 DPU (sen)	8.47		
	Menara Shell NPI Yield*		
DPU (sen)	6.5%	7.0%	7.5%
50:50 Debt-equity structure*	8.48	8.80	9.11
45:55 Debt-equity structure*	8.29	8.59	8.89
40:60 Debt-equity structure*	8.12	8.40	8.69

*assumptions

Source: AllianceDBS

Valuation:

Our DDM-derived TP is RM1.20, assuming 8.4% cost of equity and 1% terminal growth. Although the proposed

acquisition of Menara Shell could potentially be a re-rating catalyst, we maintain our HOLD recommendation pending further guidance from management.

Key risk:

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.

Significant equity funding needed. MQREIT's relatively high gearing of c.42.8% implies immediate debt headroom of only c.RM116m, given the 50% cap as per REIT regulations. As such, the proposed acquisition of Menara Shell will have to be significantly funded by equity which raises the risks of near-term dilution. Our earlier sensitivity analysis indicates that unit base could potentially be raised by 42%-56%. Another wrinkle in the fold is the 25% public spread requirement - as the major shareholders (MRCB, Quill group, and CapitaLand) already collectively hold 67% of MQREIT.

Quarterly / Interim Income Statement (RMm)

FY Dec	4Q2014	3Q2015	4Q2015	% chg yoy	% chg qoq
Gross revenue	18.2	31.8	32.6	79.2	2.4
Property expenses	(4.8)	(6.3)	(5.8)	21.3	(8.6)
Net Property Income	13.4	25.5	26.8	99.7	5.1
Other Operating expenses	(1.6)	(2.4)	(2.8)	79.4	17.1
Other Non Opg (Exp)/Inc	0.0	0.0	0.0	N/A	N/A
Net Interest (Exp)/Inc	(3.4)	(8.0)	(7.6)	127.5	(4.2)
Exceptional Gain/(Loss)	6.12	0.59	6.68	N/A	N/A
Net Income	14.6	15.7	23.1	57.6	46.5
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	14.6	15.7	23.1	57.6	46.5
Total Return	14.6	15.7	23.1	nm	nm
Non-tax deductible Items	0.0	0.0	0.0	nm	nm
Net Inc available for Dist.	8.51	15.1	16.4	92.5	8.2
Ratio (%)					
Net Prop Inc Margin	73.8	80.1	82.2		
Dist. Payout Ratio	95.7	0.0	176.5		

Source of all data: Company, AllianceDBS Research

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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