

# Company Guide

# MRCB-Quill REIT



Version 8 | Bloomberg: MQREIT MK | Reuters: MQRE.KL  
Refer to important disclosures at the end of this report

AllianceDBS Research, Malaysia Equity

22 Jan 2018

## HOLD

Last Traded Price ( 19 Jan 2018): RM1.22 (KLCI : 1,828.83)  
Price Target 12-mth: RM1.27 (4% upside) (Prev RM1.38)

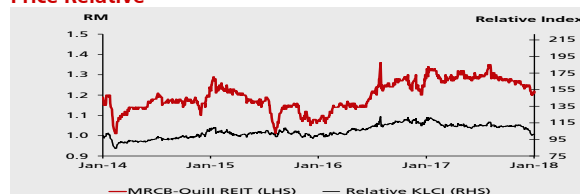
### Analyst

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### What's New

- In-line FY17 earnings
- Stable occupancy but some lease expiries coming up
- Cut earnings to account for disposal of Quill Building 8 as well as flat rental reversions for FY18/19F
- Maintain HOLD with lower TP of RM1.27

### Price Relative



### Forecasts and Valuation

FY Dec (RMm)	2017A	2018F	2019F	2020F
Gross Revenue	180	175	180	184
Net Property Inc	140	134	136	136
Total Return	69.9	82.6	85.3	85.5
Distribution Inc	89.6	80.1	82.7	82.9
EPU (sen)	6.55	7.72	7.96	7.97
EPU Gth (%)	12	18	3	0
DPU (sen)	8.39	7.49	7.72	7.73
DPU Gth (%)	62	(11)	3	0
NAV per shr (sen)	130	130	130	130
PE (X)	18.6	15.8	15.3	15.3
Distribution Yield (%)	6.9	6.1	6.3	6.3
P/NAV (x)	0.9	0.9	0.9	0.9
Aggregate Leverage (%)	37.5	37.7	37.9	38.1
ROAE (%)	5.1	6.0	6.1	6.1

Distn. Inc Chng (%):	(14)	(14)	-
Consensus DPU (sen):	8.40	8.50	N/A
Other Broker Recs:	B: 4	S: 0	H: 4

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

## Challenging office market

**Maintain HOLD with lower TP of RM1.27.** We have cut our forecast by 14%/14% for FY18F/19F for the disposal of Quill Building 8 as well as flat rental reversions. 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: Believe tough office market to pressure rental reversion rates:** We have incorporated flat rental reversion for some of the offices under the MQREIT portfolio as we expect rental reversions to be pressured by incoming office supply.

**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 decreases to RM1.27 after our earnings cut. Our TP factors in 7.0% cost of equity and 1.0% terminal growth.

### 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)	1,303 / 329
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)	0.12
ICB Industry : Financials / Real Estate Investment Trust	



## WHAT'S NEW

## Portfolio pressured by office space

- MQREIT's FY17 net distributable income came in at RM89.6m (+61.7% y-o-y), in line with our/consensus expectations.
- The increase in distributable 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 QB3, QB2 and Wisma Technip. FY17 recorded a NPI margin of c.77.7%.
- 4Q17 recorded a core realised net income of RM21.5m (+60.8% y-o-y). This is partly due to the higher interest income of RM34.6m (+35.2% y-o-y) which mitigated the higher finance costs in 4Q17 after the drawdown of RM164m commercial papers (CPs) on 22 December 2016 to finance the acquisition of Menara Shell and RM191m medium term note (MTN) to refinance the RM190m MTN that matured on 6 March 2017.
- In addition, property operating expenses were also higher at RM10.0m (+18.6% y-o-y) due to the acquisition of Menara Shell. There was also a revaluation loss of RM18.2m.
- A DPU of 4.16 sen was declared, which brings FY17 DPU to 8.39 sen – thus implying a payout ratio of c.97% (FY16: c.100%).

## Stable occupancy, some lease expiries coming up

- Portfolio occupancy was steady at c.96.3%, slightly lower vs. 3QFY17's 96.6%.
- About c.14.0% of total NLA is due for renewal in FY17, out of which c.11.0% of these leases have been renewed while 3.0% have not. 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, which could exacerbate the office supply overhang, particularly in Kuala Lumpur and Selangor where MQREIT's office assets are located.

## Cut earnings by 14% for FY18-19F

We have cut our earnings by 14% for FY18-19F as we account for the disposal of Quill Building 8 – DHL as well as flat rental reversions as we expect the challenging prospect in the office segment to continue.

## Valuation

We maintain our HOLD recommendation with a lower TP of RM1.27, following our earnings cut. Our DDM-derived TP is based on 7.0% cost of equity and 1% terminal growth.

## Quarterly / Interim Income Statement (RMm)

FY Dec	4Q2016	3Q2017	4Q2017	% chg yoy	% chg qoq
Gross revenue	34.1	44.8	44.7	31.1	(0.3)
Property expenses	(8.5)	(10.5)	(10.0)	18.6	(4.8)
Net Property Income	25.6	34.3	34.6	35.2	1.0
Other Operating expenses	(4.3)	(3.7)	(3.9)	(9.4)	5.0
Other Non Opg (Exp)/Inc	0.0	0.0	0.0	N/A	N/A
Net Interest (Exp)/Inc	(8.0)	(9.2)	(9.3)	(16.2)	(0.5)
Exceptional Gain/(Loss)	3.54	0.0	(18.2)	N/A	N/A
<b>Net Income</b>	<b>16.9</b>	<b>21.4</b>	<b>3.32</b>	<b>(80.4)</b>	<b>(84.5)</b>
Tax	0.0	0.0	0.0	N/A	N/A
Minority Interest	0.0	0.0	0.0	N/A	N/A
<b>Net Income after Tax</b>	<b>16.9</b>	<b>21.4</b>	<b>3.32</b>	<b>(80.4)</b>	<b>(84.5)</b>
Net Inc available for Dist.	13.4	21.4	21.5	60.8	0.6
<b>Ratio (%)</b>					
Net Prop Inc Margin	75.2	76.5	77.6		
Dist. Payout Ratio	205.2	0.0	206.6		

Source of all data: Company, AllianceDBS

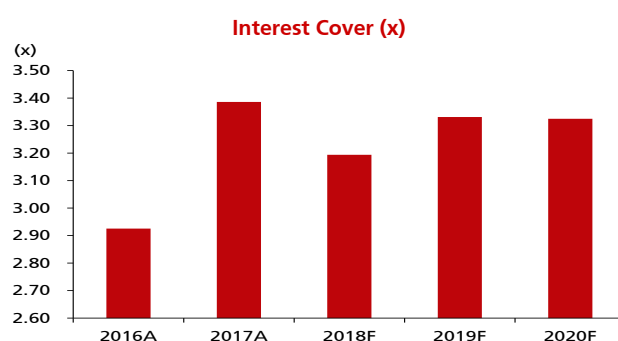
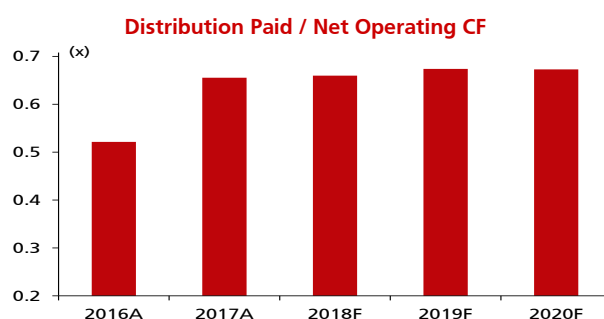
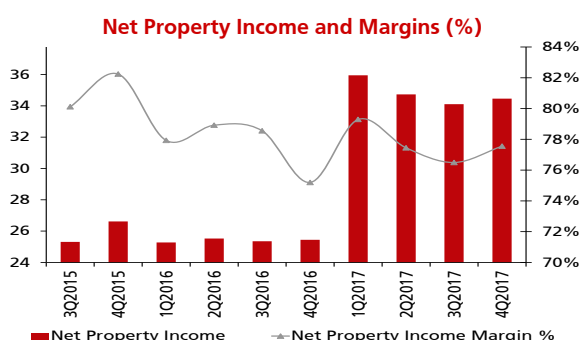
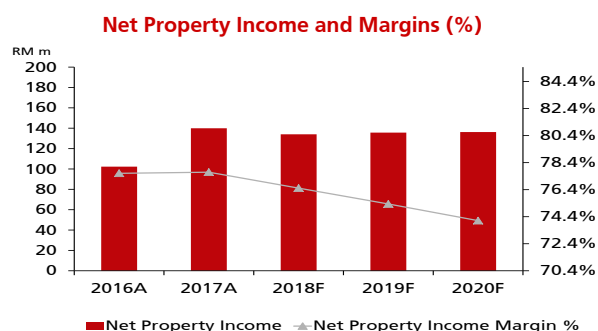
### CRITICAL DATA POINTS TO WATCH

**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. The injection of PS and Menara Shell has contributed positively to the group's earnings with better occupancy levels from 96% in FY17 from 95% in FY16. However, we forecast occupancy rates to hover around 95%-96% for FY18F-20F as the oversupply in the office market may dampen occupancy growth. Our forecast for average rent psf range from RM7.30 in FY18 to RM7.50 in FY20.

**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.45%/44% of MQREIT's overall topline in FY18F/FY19F.

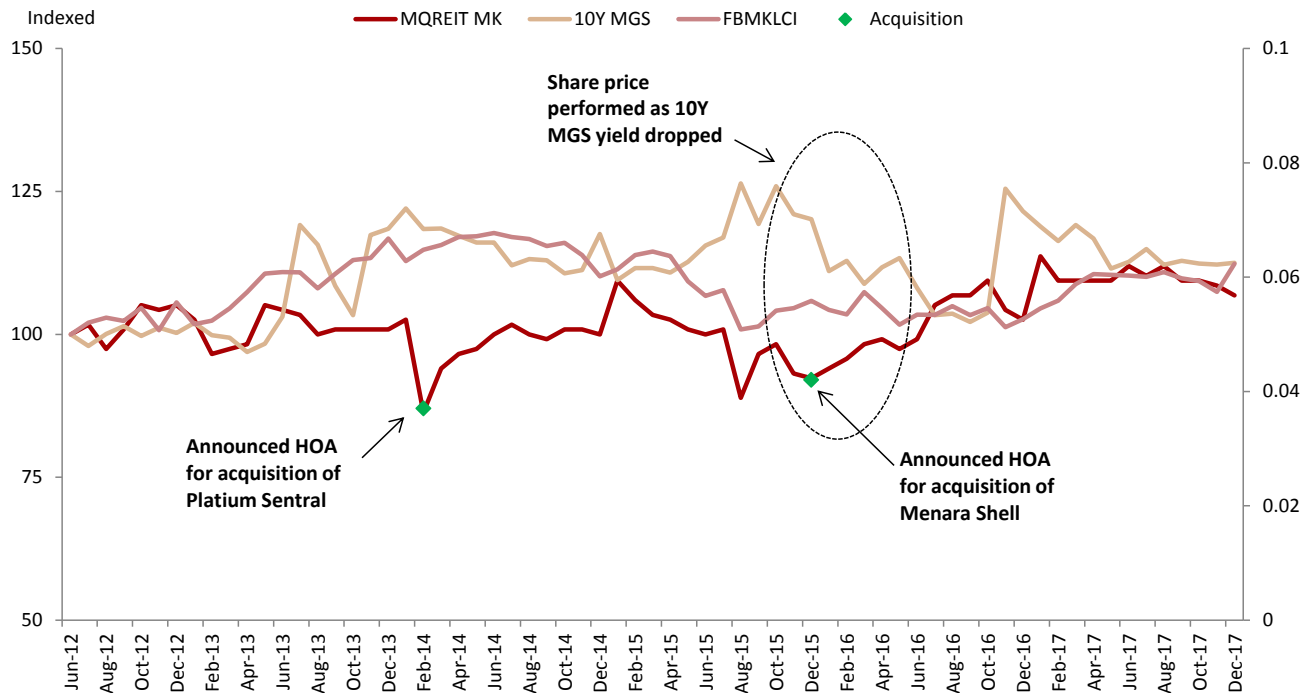
**Expect healthy occupancy to persist.** Portfolio occupancy has generally been fairly decent at above the 90% level. However, the acquisition of the fully-occupied PS and Menara Shell will have a net effect of raising overall occupancy to 96%. Going forward, expiring leases in FY18 are 28% of total NLA, and 15% in FY19. 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.37%, 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.



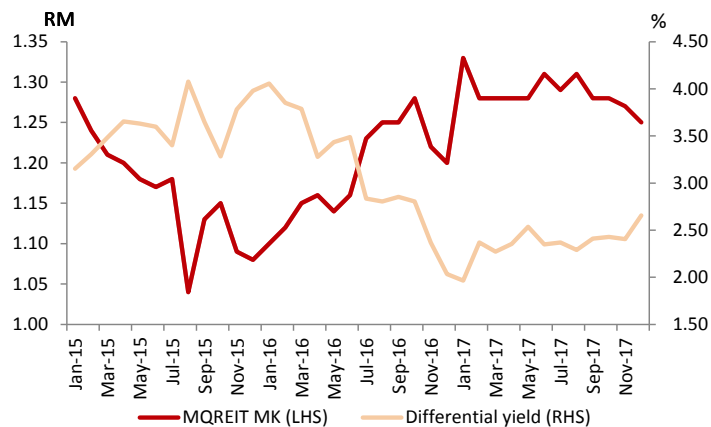
Source: Company, AllianceDBS

## Appendix 1: Factors driving historical share price performance



Source: Company, AllianceDBS, Bloomberg Finance L.P

## MQREIT's share price versus yield spread



Source: Company, AllianceDBS, Bloomberg Finance L.P

## Remarks

Interestingly, the yield spread between MQREIT's distribution yield and the 10Y MGS yields has a negative correlation of 0.87. This shows that share price increases when the MQREIT 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.37-38%. 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.RM283m in FY18F. However, the average cost of debt of 4.7% is manageable, as interest payments are still adequately covered by its cash inflows. Interest rate risk is contained as 76% 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.

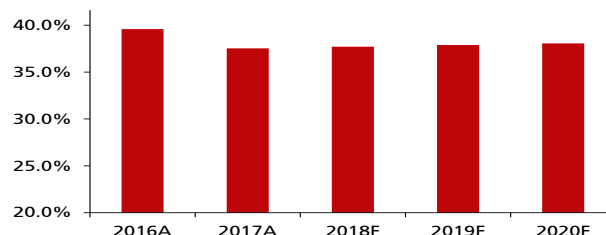
### Key Risks:

**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.

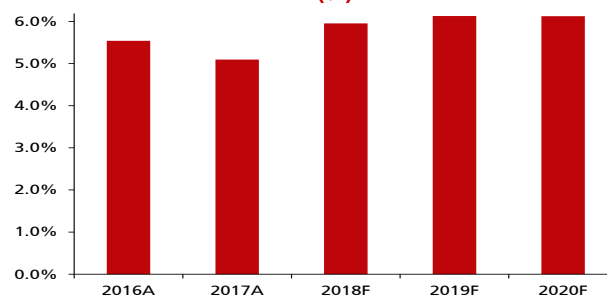
### Company Background

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.

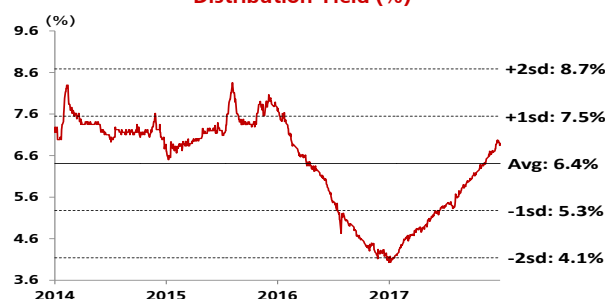
Aggregate Leverage (%)



ROE (%)



Distribution Yield (%)



PB Band (x)



Source: Company, AllianceDBS

## Key Assumptions

FY Dec	2016A	2017A	2018F	2019F	2020F
Portfolio NLA (k sq ft)	1,723.0	2,280.0	2,214.8	2,214.8	2,214.8
Agg. occupancy rate (%)	95.5%	96.3%	95.5%	95.6%	95.6%
Average PS rents (RM psf/mth)	7.3	7.3	7.3	7.5	7.5
Average non-PS rents (RM psf/mth)	6.4	6.9	6.9	7.1	7.2

## Income Statement (RMm)

FY Dec	2016A	2017A	2018F	2019F	2020F
Gross revenue	132	180	175	180	184
Property expenses	(29.5)	(40.2)	(41.1)	(44.4)	(47.6)
<b>Net Property Income</b>	<b>102</b>	<b>140</b>	<b>134</b>	<b>136</b>	<b>136</b>
Other Operating expenses	(12.4)	(14.9)	(13.8)	(13.9)	(13.9)
Other Non Opg (Exp)/Inc	0.0	0.0	0.0	0.0	0.0
Net Interest (Exp)/Inc	(30.7)	(36.9)	(37.6)	(36.6)	(36.8)
Exceptional Gain/(Loss)	3.54	(18.2)	0.0	0.0	0.0
<b>Net Income</b>	<b>62.7</b>	<b>69.9</b>	<b>82.6</b>	<b>85.3</b>	<b>85.5</b>
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
<b>Net Income After Tax</b>	<b>62.7</b>	<b>69.9</b>	<b>82.6</b>	<b>85.3</b>	<b>85.5</b>
Total Return	62.7	69.9	82.6	85.3	85.5
Non-tax deductible Items	7.28	(19.7)	2.48	2.56	2.57
Net Inc available for Dist.	55.4	89.6	80.1	82.7	82.9
<b>Growth &amp; Ratio</b>					
Revenue Gth (%)	14.4	36.7	(2.8)	2.8	2.0
N Property Inc Gth (%)	13.3	36.8	(4.2)	1.3	0.4
Net Inc Gth (%)	3.3	11.5	18.1	3.3	0.3
Dist. Payout Ratio (%)	93.7	101.7	97.0	97.0	97.0
Net Prop Inc Margins (%)	77.6	77.7	76.5	75.4	74.1
Net Income Margins (%)	47.6	38.8	47.1	47.3	46.5
Dist to revenue (%)	42.1	49.7	45.7	45.9	45.1
Managers & Trustee's fees	9.4	8.3	7.9	7.7	7.6
ROAE (%)	5.5	5.1	6.0	6.1	6.1
ROA (%)	3.2	3.0	3.6	3.7	3.7
ROCE (%)	4.6	5.5	5.3	5.3	5.3
Int. Cover (x)	2.9	3.4	3.2	3.3	3.3

Source: Company, AllianceDBS

### Quarterly / Interim Income Statement (RMm)

FY Dec	4Q2016	1Q2017	2Q2017	3Q2017	4Q2017
Gross revenue	34.1	45.6	45.1	44.8	44.7
Property expenses	(8.5)	(9.4)	(10.2)	(10.5)	(10.0)
Net Property Income	25.6	36.1	34.9	34.3	34.6
Other Operating expenses	(4.3)	(3.7)	(13.5)	(3.7)	(3.9)
Other Non Opg (Exp)/Inc	0.0	0.0	0.0	0.0	0.0
Net Interest (Exp)/Inc	(8.0)	(9.3)	0.60	(9.2)	(9.3)
Exceptional Gain/(Loss)	3.54	0.0	0.0	0.0	(18.2)
<b>Net Income</b>	<b>16.9</b>	<b>23.2</b>	<b>22.0</b>	<b>21.4</b>	<b>3.32</b>
Tax	0.0	0.0	0.0	0.0	0.0
Minority Interest	0.0	0.0	0.0	0.0	0.0
<b>Net Income after Tax</b>	<b>16.9</b>	<b>23.2</b>	<b>22.0</b>	<b>21.4</b>	<b>3.32</b>
Net Inc available for Dist.	13.4	23.2	22.0	21.4	21.5
<b>Growth &amp; Ratio</b>					
Revenue Gth (%)	5	34	(1)	(1)	0
N Property Inc Gth (%)	0	41	(3)	(2)	1
Net Inc Gth (%)	11	37	(5)	(3)	(84)
Net Prop Inc Margin (%)	75.2	79.3	77.4	76.5	77.6
Dist. Payout Ratio (%)	205.2	0.0	205.0	0.0	206.6

### Balance Sheet (RMm)

FY Dec	2016A	2017A	2018F	2019F	2020F
Investment Properties	2,225	2,181	2,191	2,201	2,211
Other LT Assets	0.23	0.17	0.17	0.17	0.17
Cash & ST Invt	54.1	101	107	112	118
Inventory	0.0	0.0	0.0	0.0	0.0
Debtors	18.3	5.96	5.80	5.96	6.08
Other Current Assets	0.0	0.0	0.0	0.0	0.0
<b>Total Assets</b>	<b>2,297</b>	<b>2,288</b>	<b>2,304</b>	<b>2,319</b>	<b>2,335</b>
ST Debt	224	122	132	142	152
Creditor	28.4	20.3	21.3	22.4	23.5
Other Current Liab	0.0	0.0	0.0	0.0	0.0
LT Debt	685	737	737	737	737
Other LT Liabilities	0.0	24.5	24.5	24.5	24.5
Unit holders' funds	1,360	1,385	1,389	1,394	1,398
Minority Interests	0.0	0.0	0.0	0.0	0.0
<b>Total Funds &amp; Liabilities</b>	<b>2,297</b>	<b>2,288</b>	<b>2,304</b>	<b>2,319</b>	<b>2,335</b>
Non-Cash Wkg. Capital	(10.0)	(14.3)	(15.5)	(16.4)	(17.4)
Net Cash/(Debt)	(855)	(758)	(762)	(767)	(771)
<b>Ratio</b>					
Current Ratio (x)	0.3	0.8	0.7	0.7	0.7
Quick Ratio (x)	0.3	0.8	0.7	0.7	0.7
Aggregate Leverage (%)	39.6	37.5	37.7	37.9	38.1
Z-Score (X)	0.9	1.0	1.0	0.9	0.9

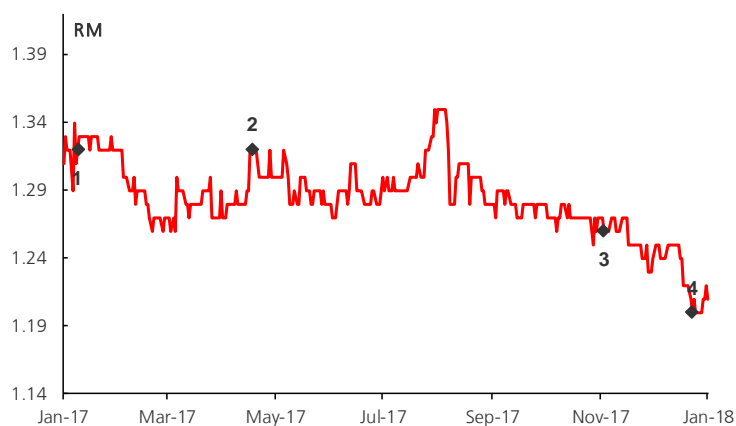
Source: Company, AllianceDBS

## Cash Flow Statement (RMm)

FY Dec	2016A	2017A	2018F	2019F	2020F
Pre-Tax Income	62.7	69.9	82.6	85.3	85.5
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.	15.7	3.99	1.18	0.90	1.00
Other Operating CF	30.7	36.9	37.6	36.6	36.8
<b>Net Operating CF</b>	<b>109</b>	<b>111</b>	<b>121</b>	<b>123</b>	<b>123</b>
Net Invnt in Properties	(649)	(0.4)	(10.0)	(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	1.62	2.16	3.80	5.33	5.61
<b>Net Investing CF</b>	<b>(647)</b>	<b>1.78</b>	<b>(6.2)</b>	<b>(4.7)</b>	<b>(4.4)</b>
Distribution Paid	(56.9)	(72.6)	(80.1)	(82.7)	(82.9)
Chg in Gross Debt	161	1.00	10.0	10.0	10.0
New units issued	488	0.0	0.0	0.0	0.0
Other Financing CF	(33.4)	(37.2)	(41.4)	(41.9)	(42.4)
<b>Net Financing CF</b>	<b>559</b>	<b>(109)</b>	<b>(112)</b>	<b>(115)</b>	<b>(115)</b>
Currency Adjustments	0.0	0.0	0.0	0.0	0.0
Chg in Cash	20.8	3.78	3.66	3.46	3.56
Operating CFPS (sen)	8.75	10.0	11.2	11.4	11.4
Free CFPS (sen)	(50.5)	10.3	10.4	10.5	10.6

Source: Company, AllianceDBS

## Target Price &amp; 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
3:	20 Nov 17	1.26	1.38	HOLD
4:	09 Jan 18	1.20	1.38	HOLD

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

Source: AllianceDBS

Analyst: Siti Ruzanna Mohd Faruk



## 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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Published by  
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