

Company Guide

MRCB-Quill REIT



Version 10 | Bloomberg: MQREIT MK | Reuters: MQRE.KL

Refer to important disclosures at the end of this report

AllianceDBS Research, Malaysia Equity

18 Jan 2019

HOLD (Downgrade from BUY)

Last Traded Price (17 Jan 2019): RM1.12 (KLCI : 1,682.97)

Price Target 12-mth: RM1.15 (3% upside) (Prev RM1.24)

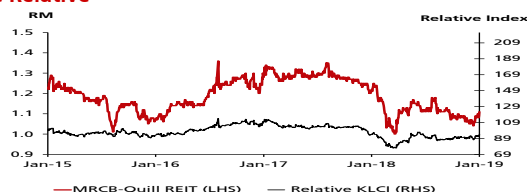
Analyst

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What's New

- FY18 earnings were line with expectations
- Loss of revenue from QB8
- Cut earnings by 7% for FY19F-20F; expect lower occupancy
- Downgrade to HOLD with lower TP of RM1.15

Price Relative



Forecasts and Valuation

FY Dec (RMm)	2018A	2019F	2020F	2021F
Gross Revenue	173	172	176	180
Net Property Inc	134	130	130	131
Total Return	73.1	79.1	79.3	80.1
Distribution Inc	86.6	76.7	76.9	77.7
EPU (sen)	6.82	7.37	7.37	7.44
EPU Gth (%)	4	8	0	1
DPU (sen)	8.08	7.15	7.15	7.21
DPU Gth (%)	(4)	(12)	0	1
NAV per shr (sen)	128	128	128	129
PE (X)	16.4	15.2	15.2	15.1
Distribution Yield (%)	7.2	6.4	6.4	6.4
P/NAV (x)	0.9	0.9	0.9	0.9
Aggregate Leverage (%)	37.6	37.8	38.0	38.1
ROAE (%)	5.3	5.8	5.7	5.8

Distn. Inc Chng (%):	(7)	(7)	na
Consensus DPU (sen):	8.30	8.40	N/A
Other Broker Recs:	B: 4	S: 0	H: 4

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

Tough market

Downgrade to HOLD. We cut our earnings to reflect lower occupancy rates. We believe MRCB-Quill REIT (MQREIT) may face challenges with occupancy. 19% of total net lettable area (NLA) is due for renewal in FY19. Following our earnings cut of c.7% for FY19-20F, stock returns are limited. We downgrade our recommendation from BUY to HOLD. The office market is facing major headwinds due to market oversupply. There is also lower demand as tenants opt to downsize operations. The confirmation of asset injections from its sponsor MRCB at accretive yields will be a key re-rating catalyst for the stock.

Where we differ: Tough office market to pressure rental reversion rates: We have incorporated flat rental reversion for some of the offices under the MQREIT portfolio, as well as lower occupancy rates, with the market 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. Notable assets include Ascott Sentral (serviced apartments), Plaza Alam Sentral (retail), Sooka Sentral (lifestyle/retail) and Kompleks Sentral (industrial). The REIT may also acquire office assets from the Quill Group, the original sponsor of MQREIT with a remaining stake of c.10.9%. However, MQREIT's current gearing of c.38% indicates that new equity issuance will likely be necessary for sizeable acquisitions in the near term.

Valuation:

Our DDM-derived TP is reduced to RM1.15. Our TP factors in 7.6% cost of equity and 1.0% terminal growth.

Key Risks to Our View:

Delayed leasing could be a drag on earnings. The office sector 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)	1,072
Mkt. Cap (RMm/US\$m)	1,200 / 292
Major Shareholders (%)	
Malaysian Resources Corp	27.9
Quill group of companies	10.9
Capitaland Financial Ltd	10.9
Free Float (%)	33.5
3m Avg. Daily Val (US\$m)	0.02
ICB Industry : Financials / Real Estate Investment Trust	



MRCB-Quill REIT**WHAT'S NEW****Earnings in line with expectations****4QFY18 results within expectations**

MQREIT's 4QFY18 core earnings came in at RM19.6m (-8.8% y-o-y). After stripping out an exceptional loss of RM9.4m, FY18 came in at RM82.5m (-6.3% y-o-y). Exceptional items include revaluation loss of RM5.4m, gains on divestment of property of RM2.2m and deferred tax on Real Property Gains Tax (RPGT) of RM6.1m. FY18 numbers are in line with our expectations but below consensus.

A DPU of 8.08 sen was declared for FY18 (-3.7% y-o-y).

The drop in the quarter was mainly due to lower revenue generated from Platinum Sentral, as well as loss of revenue from the disposal of QB8 – DHL XPJ which took place on 12 April 2018.

Property operating expenses inched down to RM10.0m (-0.3% y-o-y) as it tightened control on costs and reduced expenses from the disposal of QB8. Net property income (NPI) for the quarter came in at RM32.7m (-5.7% y-o-y).

Occupancy pressured

Portfolio occupancy fell to 93% in 4QFY18 vs 94% in 3QFY18. We understand there was lower occupancy in QB5 – IBM, as well as Platinum Sentral and Menara Shell as tenants opt to downsize operations.

About 28.0% of total NLA is due for renewal in FY18, of which c.75.0% has been renewed. The expiring leases in FY19 form 19% of total NLA and 18% in FY20. We understand rental reversions were flattish as it focused on tenant retention to cope with a challenging operating environment. Going forward, we expect some challenges in negotiating positive rental reversions due to the oversupply of office space in the market.

Cut earnings to reflect lower occupancy

We make some changes to our occupancy rates for QB5 – IBM, Wisma Technip, Platinum Sentral and Menara Shell. This brings portfolio occupancy to 92% from 95% previously. Filling up spaces could be a challenge, coupled with the 19% of total NLA due for renewal in FY19. Overall, our earnings are cut by c.7% for FY19F-20F.

Valuation

We downgrade our BUY call to HOLD with lower TP of RM1.15. Our DDM-derived TP employs 7.6% cost of equity and 1% terminal growth. Key concerns to the stock include the challenge of filling up vacancies, as well as pressured rental rates as in competing with new supply. As we factor in weakness in the office market, the stock offers limited upside at this juncture. Downside risks include slower than expected pick-up in filling up vacancies.

Quarterly Income Statement (RMm)

FY Dec	4Q2017	3Q2018	4Q2018	% chg yoy	% chg qoq
Gross revenue	44.7	43.3	42.7	(4.5)	(1.4)
Property expenses	(10.0)	(9.9)	(10.0)	(0.3)	0.7
Net Property Income	34.6	33.3	32.7	(5.7)	(2.0)
Other Operating expenses	(3.9)	(3.7)	(3.9)	(0.5)	4.5
Other Non Opg (Exp)/Inc	0.0	0.0	0.0	N/A	N/A
Net Interest (Exp)/Inc	(9.3)	(9.1)	(9.2)	0.6	(1.6)
Exceptional Gain/(Loss)	(18.2)	0.0	(11.6)	N/A	N/A
Net Income	3.32	20.6	8.05	142.2	(60.9)
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	3.32	20.6	8.05	142.2	(60.9)
Total Return	3.32	20.6	8.05	142.2	(60.9)
Non-tax deductible Items	(18.2)	0.0	(5.4)	(70.1)	nm
Net Inc available for Dist.	21.5	20.6	19.6	(8.8)	(4.7)
Ratio (%)					
Net Prop Inc Margin	77.6	77.1	76.6		
Dist. Payout Ratio	103.8	0.0	90.6		

Source of all data: Company, AllianceDBS

MRCB-Quill REIT

CRITICAL DATA POINTS TO WATCH

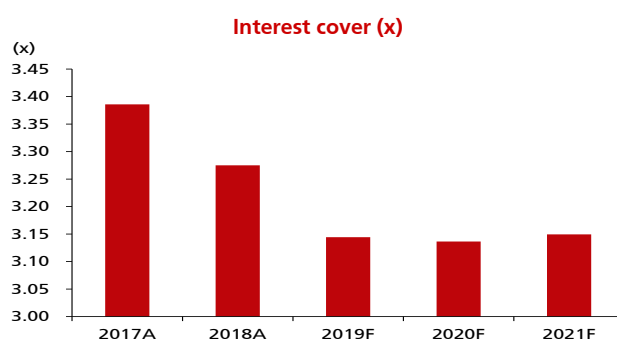
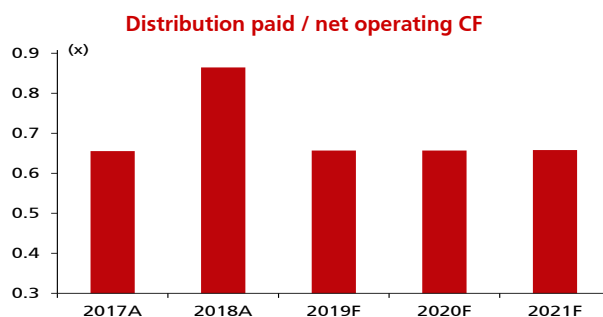
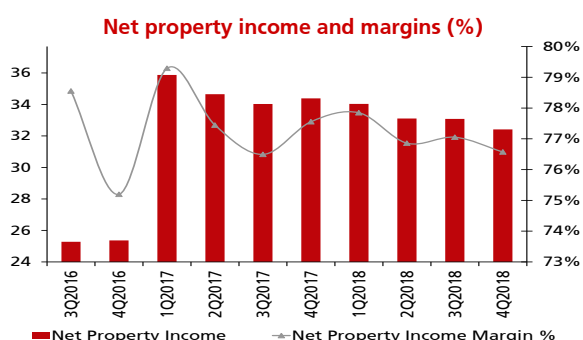
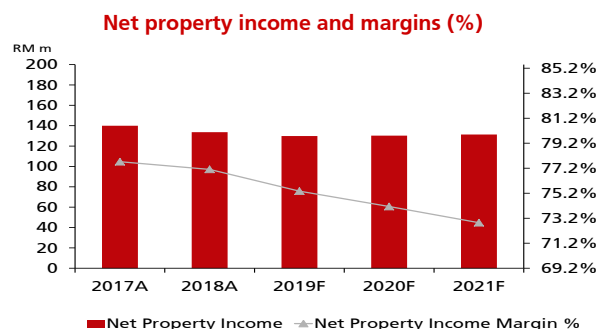
Revamped profile with new injections. MQREIT's asset portfolio has undergone a drastic shift with the acquisition of the RM740m Platinum Sentral (PS) asset in FY15 and the acquisition of Menara Shell for RM640m in Dec 2016. The injection of PS and Menara Shell has contributed positively to the group's earnings with better occupancy levels from 96% in FY17 from 95% in FY16. However, we forecast occupancy rates to hover around 92% for FY19F-20F as the oversupply in the office market may dampen occupancy growth. Our forecast for average rent per square foot (psf) range from RM7.10 in FY19 to RM7.20 in FY20.

Minimal rent escalation for office spaces. MQREIT has eight 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.44%/44% of MQREIT's overall topline in FY19F/FY20F.

Expect pressure on healthy occupancy. Portfolio occupancy has generally been fairly decent at above the 90% level. Going forward, expiring leases in FY19 are 19% of total NLA and 18% in FY20. We expect some challenges in occupancy replenishment, but we believe that the management's 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 in its portfolio, notably Wisma Technip, Quill Building 5 - IBM, Platinum Sentral and Menara Shell. These enhancements will revolve around helping tenants to conserve energy and costs and reduce their carbon footprints.

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

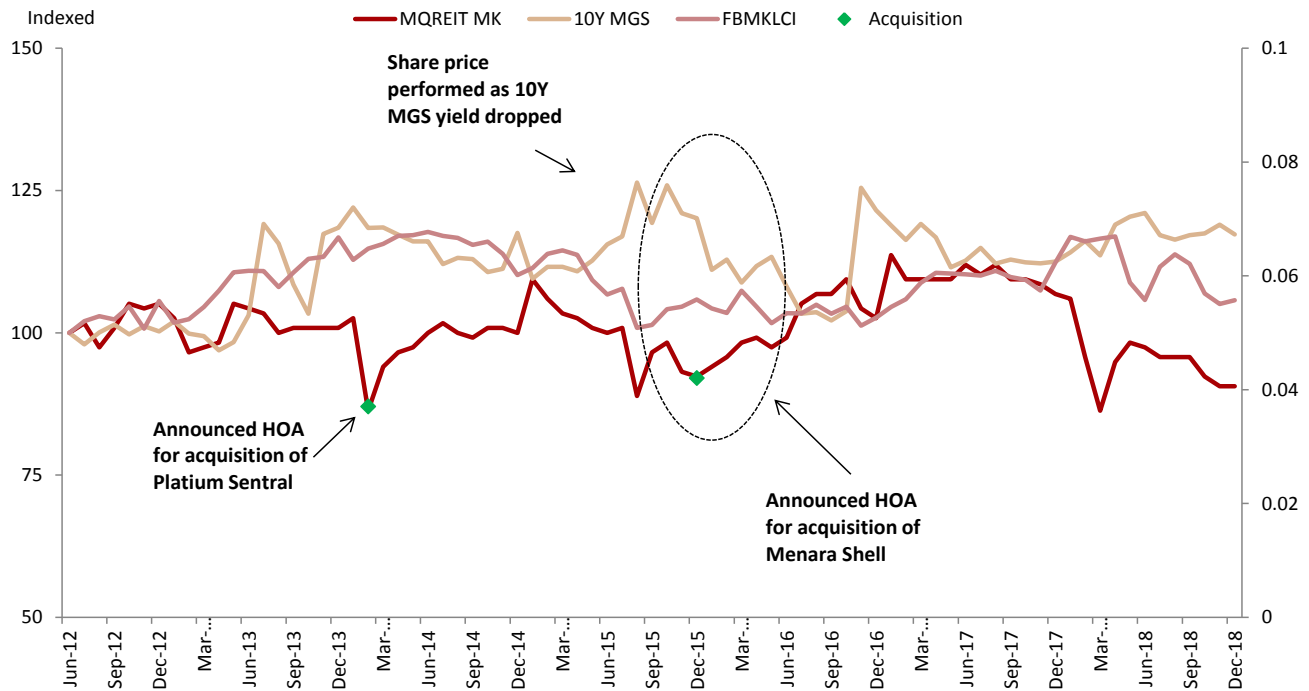
As developer MRCB is a major shareholder with a 28% stake following the injection of PS, MQREIT has obtained the right of first refusal to the former's stable of investment properties. Notable assets include Ascott Sentral (serviced apartments), Plaza Alam Sentral (retail), Sooka Sentral (lifestyle/retail) and Kompleks Sentral (industrial). Collectively, they carry a book value of c.RM340m and could see injection value of up to RM860m. The REIT may also acquire office assets from the Quill Group, the original sponsor of MQREIT with a remaining stake of c.10.9%. Nonetheless, we highlight that gearing is currently at c.38%, implying limited debt headroom. An additional unit issuance would be necessary to fund any big-ticket purchases. Earnings accretion from future acquisitions will likely be negated by the dilution from an equity issuance.



Source: Company, AllianceDBS

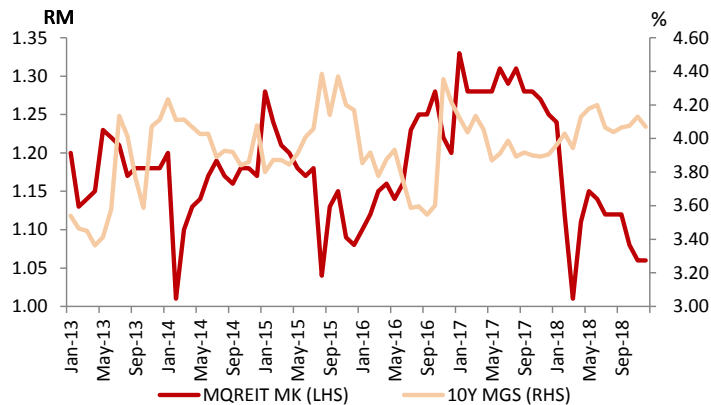
MRCB-Quill REIT

Appendix 1: Factors driving historical share price performance



Source: Company, AllianceDBS, Bloomberg Finance L.P

MQRUIT's share price versus 10Y MGS



Remarks

Interestingly, MQRUIT share price and the 10Y MGS yields have minimal correlation over a long period. However, we note that the negative correlation is particularly strong during periods of rising or declining bond yields which may explain investors' preference for REITs as a defensive play.

MRCB-Quill REIT

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. 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 FY19F. However, the average cost of debt of 4.5% 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 45% in 2020, 19% in 2021 and 22% in 2022.

Share Price Drivers:

Acquisition newsflow. One of MQREIT's appeals is the availability of an asset acquisition pipeline of completed investment properties from its 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.

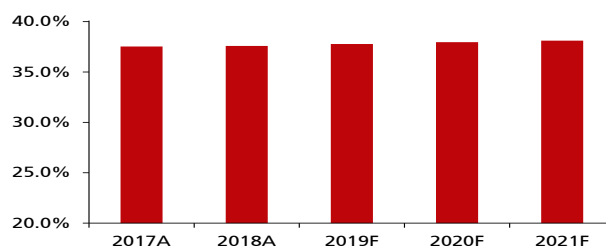
Key Risks:

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.

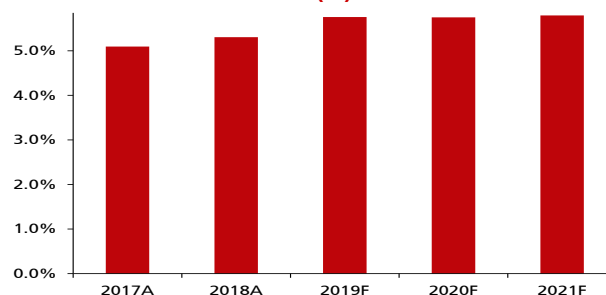
Company Background

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.

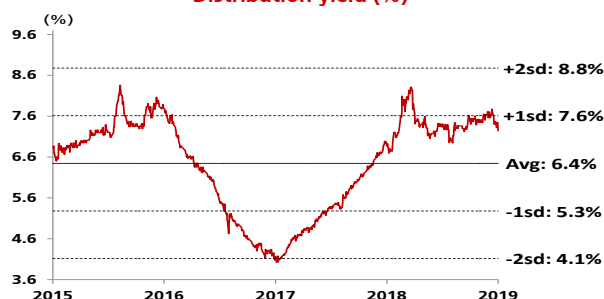
Aggregate leverage (%)



ROE (%)



Distribution yield (%)



PB band (x)



Source: Company, AllianceDBS

MRCB-Quill REIT**Key Assumptions**

FY Dec	2017A	2018A	2019F	2020F	2021F
Portfolio NLA (k sq ft)	3,282.4	3,217.2	3,217.2	3,217.2	3,217.2
Agg. occupancy rate (%)	97.7%	95.6%	91.9%	91.9%	91.9%
Average PS rents (RM psf/mth)	7.3	7.3	7.5	7.5	7.5
Average non-PS rents (RM psf/mth)	6.9	6.9	7.1	7.2	7.4

Income Statement (RMm)

FY Dec	2017A	2018A	2019F	2020F	2021F
Gross revenue	180	173	172	176	180
Property expenses	(40.2)	(39.7)	(42.5)	(45.5)	(49.0)
Net Property Income	140	134	130	130	131
Other Operating expenses	(14.9)	(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	(36.9)	(36.3)	(36.9)	(37.1)	(37.3)
Exceptional Gain/(Loss)	(18.2)	(9.4)	0.0	0.0	0.0
Net Income	69.9	73.1	79.1	79.3	80.1
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	69.9	73.1	79.1	79.3	80.1
Total Return	69.9	73.1	79.1	79.3	80.1
Non-tax deductible Items	(19.7)	(13.5)	2.37	2.38	2.40
Net Inc available for Dist.	89.6	86.6	76.7	76.9	77.7
Growth & Ratio					
Revenue Gth (%)	36.7	(3.7)	(0.6)	2.0	2.6
N Property Inc Gth (%)	36.8	(4.5)	(2.9)	0.3	0.8
Net Inc Gth (%)	11.5	4.6	8.2	0.2	1.1
Dist. Payout Ratio (%)	101.7	105.0	97.0	97.0	97.0
Net Prop Inc Margins (%)	77.7	77.1	75.4	74.1	72.8
Net Income Margins (%)	38.8	42.2	45.9	45.1	44.4
Dist to revenue (%)	49.7	49.9	44.5	43.8	43.1
Managers & Trustee's fees	8.3	8.6	8.0	7.9	7.7
ROAE (%)	5.1	5.3	5.8	5.7	5.8
ROA (%)	3.0	3.2	3.5	3.5	3.5
ROCE (%)	5.5	5.3	5.2	5.1	5.2
Int. Cover (x)	3.4	3.3	3.1	3.1	3.1

Source: Company, AllianceDBS

MRCB-Quill REIT**Quarterly / Interim Income Statement (RMm)**

FY Dec	4Q2017	1Q2018	2Q2018	3Q2018	4Q2018
Gross revenue	44.7	44.0	43.4	43.3	42.7
Property expenses	(10.0)	(9.8)	(10.0)	(9.9)	(10.0)
Net Property Income	34.6	34.3	33.4	33.3	32.7
Other Operating expenses	(3.9)	(4.3)	(3.0)	(3.7)	(3.9)
Other Non Opg (Exp)/Inc	0.0	0.0	0.0	0.0	0.0
Net Interest (Exp)/Inc	(9.3)	(9.0)	(9.1)	(9.1)	(9.2)
Exceptional Gain/(Loss)	(18.2)	0.0	2.20	0.0	(11.6)
Net Income	3.32	21.0	23.5	20.6	8.05
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	3.32	21.0	23.5	20.6	8.05
Total Return	3.32	21.0	23.5	20.6	8.05
Non-tax deductible Items	(18.2)	0.0	0.0	0.0	(5.4)
Net Inc available for Dist.	21.5	21.0	21.3	20.6	19.6
Growth & Ratio					
Revenue Gth (%)	0	(1)	(1)	0	(1)
N Property Inc Gth (%)	1	(1)	(3)	0	(2)
Net Inc Gth (%)	(84)	532	12	(12)	(61)
Net Prop Inc Margin (%)	77.6	77.8	76.9	77.1	76.6
Dist. Payout Ratio (%)	103.8	0.0	101.9	0.0	90.6

Balance Sheet (RMm)

FY Dec	2017A	2018A	2019F	2020F	2021F
Investment Properties	2,181	2,179	2,189	2,199	2,208
Other LT Assets	0.17	0.35	0.35	0.35	0.35
Cash & ST Invt	101	85.8	91.0	96.0	101
Inventory	0.0	0.0	0.0	0.0	0.0
Debtors	5.96	6.34	6.30	6.42	6.59
Other Current Assets	0.0	0.0	0.0	0.0	0.0
Total Assets	2,288	2,271	2,287	2,302	2,316
ST Debt	122	0.0	10.0	20.0	29.0
Creditor	20.3	15.8	16.6	17.4	18.3
Other Current Liab	0.0	16.2	16.2	16.2	16.2
LT Debt	737	854	854	854	854
Other LT Liabilities	24.5	13.4	13.4	13.4	13.4
Unit holders' funds	1,385	1,372	1,377	1,381	1,385
Minority Interests	0.0	0.0	0.0	0.0	0.0
Total Funds & Liabilities	2,288	2,271	2,287	2,302	2,316
Non-Cash Wkg. Capital	(14.3)	(25.6)	(26.5)	(27.2)	(27.9)
Net Cash/(Debt)	(758)	(768)	(773)	(778)	(782)
Ratio					
Current Ratio (x)	0.8	2.9	2.3	1.9	1.7
Quick Ratio (x)	0.8	2.9	2.3	1.9	1.7
Aggregate Leverage (%)	37.5	37.6	37.8	38.0	38.1
Z-Score (X)	0.0	0.0	0.0	0.0	NA

Source: Company, AllianceDBS

MRCB-Quill REIT

Cash Flow Statement (RMm)

FY Dec	2017A	2018A	2019F	2020F	2021F
Pre-Tax Income	69.9	79.3	79.1	79.3	80.1
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.	3.99	(11.7)	0.83	0.70	0.70
Other Operating CF	36.9	36.3	36.9	37.1	37.3
Net Operating CF	111	104	117	117	118
Net Invnt in Properties	(0.4)	(3.8)	(10.0)	(10.0)	(9.0)
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	2.16	3.69	4.29	4.55	4.80
Net Investing CF	1.78	(0.2)	(5.7)	(5.5)	(4.2)
Distribution Paid	(72.6)	(89.8)	(76.7)	(76.9)	(77.7)
Chg in Gross Debt	1.00	0.0	10.0	10.0	9.00
New units issued	0.0	3.97	0.0	0.0	0.0
Other Financing CF	(37.2)	(39.2)	(41.2)	(41.7)	(42.1)
Net Financing CF	(109)	(125)	(108)	(109)	(111)
Currency Adjustments	0.0	0.0	0.0	0.0	0.0
Chg in Cash	3.78	(21.3)	3.20	3.08	3.11
Operating CFPS (sen)	10.0	10.8	10.8	10.8	10.9
Free CFPS (sen)	10.3	9.33	9.95	9.96	10.1

Source: Company, AllianceDBS

Target Price & Ratings History



S.No.	Date of Report	Closing Price	12-mth Target Price	Rating
1:	22 Jan 18	1.24	1.27	HOLD
2:	18 May 18	1.10	1.27	BUY
3:	09 Aug 18	1.18	1.27	BUY
4:	28 Nov 18	1.07	1.24	BUY

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

Source: AllianceDBS

Analyst: Siti Ruzanna Mohd Faruk

MRCB-Quill REIT

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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