

MRCB-Quill REIT

In an Era of Oversupply, Who Survives?

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MQREIT witnessed steep YTD declines of 18%, with low PBV's of 0.79x (vs. peers of 0.78-1.45x). We believe this is due to office oversupply and potential OPR hike concerns, which are not alarming. Pricing in these risks; (i) assuming lower reversions, and (ii) applying a temporary risk premium (+50 bps) on valuations, MQREIT still commands attractive yields of 8.1%. Maintain **OUTPERFORM** on lower TP of RM1.25 post lowering our earnings estimates by 4-6%.

Steep YTD decline of 18%, trading at a low PBV of 0.79x. MQREIT saw one of the steepest YTD declines, at 18% vs. large cap (>RM1b) peers under our coverage of 4-15%, save for CMMT. Its PBV is also trading at the lower end at 0.79x (vs. peers 0.78-1.45x). We believe investors are concerned about the oversupply of office spaces in the Klang Valley, which is a cause for concern, as well as a second potential OPR hike in 2H18, which is perceived to affect MREIT's valuations (*refer overleaf*). We are of the view that these concerns do not pose significant risk to MQREIT, and it is still able to command attractive yields even after pricing in these risks.

Yes, there is oversupply, but will all assets go bust? Office occupancy in Greater KL is c.80% over the past 5 years while rental rates have remained subdued. However, MQREIT's office assets are faring better than the industry average at 96% occupancy currently, and >90% historically. We believe MQREIT's assets will be able to rise above tough market conditions due to its quality asset positioning being (i) strategically located in MSC zones while (ii) KL Sentral assets enjoy superior connectivity, as well as (iii) enriched by a host of reputable tenants. This is backed by long lease terms of c.5-15 years, which are favourable in an era of oversupply, as the REIT is able to retain occupancy and rental over longer periods (*refer overleaf*).

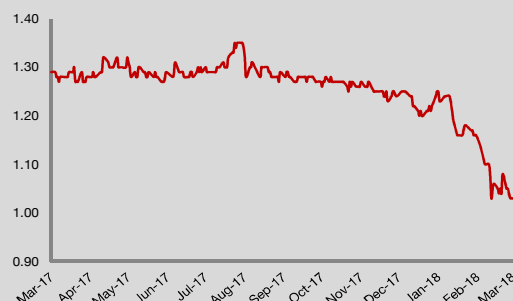
Taking it a notch lower to factor for investors' concerns. FY17 has seen flattish to mid-single digit reversions, which will mostly accrete in FY18 as most leases will expire in 2H17. While we believe this is achievable, it has become apparent that investors are extremely doubtful. So to reflect the concerns of earnings quality, we opt to assume flat to mildly negative reversion (from low single digits) for FY18-19. As such, we expect the impact of lower reversions to be felt partially in FY18, but mostly in FY19. This is to ensure more conservative earnings estimates in light of unfavourable market conditions while we reckon that management will opt to maintain occupancy over bullish reversions. **All in, we lower FY18-19E earnings by 4-6% to RM90.4-90.7m (*refer overleaf*).**

Maintain OUTPERFORM but lower our TP to RM1.25 (from RM1.30) on a lower FY18E GDPS of 8.30 sen (from 8.40 sen). We maintain our +2.6ppt spread to the 10-year MGS target of 4.00%, which is the highest among large cap MREITs (>RM1b) under our coverage (between +1.30ppt to +2.30ppt), as MQREIT is slightly smaller than large cap REITs, while the office segment is weighed down by oversupply fears. Note that we have recently assumed a temporary risk premium (+50 bps) on all MREITs' spreads to address investors' concerns of an OPR hike. Despite our conservative valuations, we are comfortable with our **OUTPERFORM** call as MQREIT is commanding attractive gross yield of 8.1% (net yield of 7.3%) vs. MREIT peers (>RM1b) under our coverage with an average 6.6% yield (net: 6.0%).

OUTPERFORM ↔

Price: RM1.02
Target Price: RM1.25 ↓

Share Price Performance



KLCI 1,856.35
YTD KLCI chg 3.3%
YTD stock price chg -18.4%

Stock Information

Shariah Compliant	No
Bloomberg Ticker	MQREIT MK Equity
Market Cap (RM m)	1,089.4
Issued shares	1,068.0
52-week range (H)	1.36
52-week range (L)	1.02
3-mth avg daily vol:	443,148
Free Float	54%
Beta	0.6

Major Shareholders

Malaysian Resources Corporation Berhad	27.9%
Capitaland Limited	11.0%
Employees Provident Fund Board	7.1%

Summary Earnings Table

FY Dec (RM'm)	2017A	2018E	2019E
Turnover	180.1	184.3	184.1
EBIT	126.4	128.0	127.8
PBT	71.3	91.6	90.7
Net Profit	71.3	91.6	90.7
Core NP*	88.0	90.4	90.7
Consensus (CNP)	n.a.	91.9	94.7
Earnings Revision	n.a.	-4%	-6%
Core EPS (sen)	8.2	8.4	8.3
Core EPS growth (%)	-17%	1%	-1%
NDPS (sen)	7.6	7.5	7.4
BVPS (RM)	1.29	1.28	1.28
Core PER	12.4	12.2	12.3
Price/BV (x)	0.8	0.8	0.8
Gearing (x)	0.37	0.38	0.38
Net Div. Yield (%)	7.4	7.3	7.2

*Core NP refers to RNI



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OTHER POINTS

We are not concerned of a potential OPR hike affecting MQREIT as 76% of its borrowings are on fixed rates. Assuming a 50bps hike in interest rates in CY18, we believe this will only lower MQREIT's earnings by 1% which we deem as insignificant. Additionally, we note a weak correlation between OPR hikes and the 10-year MGS (<20% correlation) historically. Evidently, the 10-year MGS did not react to the recent 25 bps OPR earlier this year, and is still stable at 3.94% currently. Note that our in-house view is that the probability of another 25 bps OPR hike is low, but we have taken a conservative stance and accounted for a 50bps hike in our valuations.

Yes, there is oversupply, but will all assets go bust? Office occupancy in Greater KL is c.80% over the past 5 years while rental rates have remained subdued. However, MQREIT's office assets are faring better than the industry average at 96% occupancy currently, and >90% historically. We believe MQREIT's assets will be able to rise above tough market conditions due to its quality asset positioning.

The bulk of MQREIT's assets are strategically located in prominent locations such as KL Sentral and Cyberjaya, which are MSC-status areas, giving MQREIT's assets an added advantage as MSC status companies are likely to renew lease terms to enjoy various financial and non-financial incentives. Secondly, KL Sentral assets (i.e. Menara Shell and Platinum Sentral) that make up c.62% of portfolio value and 45% of NLA, enjoy superior connectivity as the centre point of the largest transit hub in Malaysia. MQREIT's tenants include prominent names such as DHL, IBM, BMW, and Shell at Menara Shell that help ensure earnings sustainability.

This is backed by MQREIT's long lease terms of 5-15 years, with a weighted average term to expiry of 5.3 years vs. retail MREITs which have shorter expiry cycles of 2-3 years. Longer lease terms are favourable in an era of oversupply of office spaces and soft demand, as the REIT is able to retain occupancy and rental over longer periods.

Outlook. FY18-19E leases up for expiry are minimal at 28-15% of net lettable assets (NLA) which is manageable under current market conditions where the office market is facing an oversupply situation, and risk of tenant attrition. We expect capex in FY18-19 of RM12-10m, mainly for maintenance. MQREIT's disposal of QB8 is expected to be completed by 2Q18, but this is mostly neutral to FY18E CNP as we expect the net gains on disposal of 0.12 sen per unit to offset the loss of income.

We lower FY18-19E by 4-6% to RM90.4-90.7m on assumptions of more conservative reversions going forward, lowering our EPS by 4-6% as well. However, we expect FY18-19E GDPU to decline by only 1-2% to 8.30-8.20 sen (from 8.40-8.40 sen) on a higher payout ratio of 98-99% (from 95-95% vs. FY17A payout of 97%) as we infer that management will strive to achieve consistent yearly dividend payout. This implies FY18-19E gross yield/net yield of 8.1-8.0%/7.3-7.2%.

Risks to our call include bond yield expansions or compressions and weaker-than-expected rental reversions.

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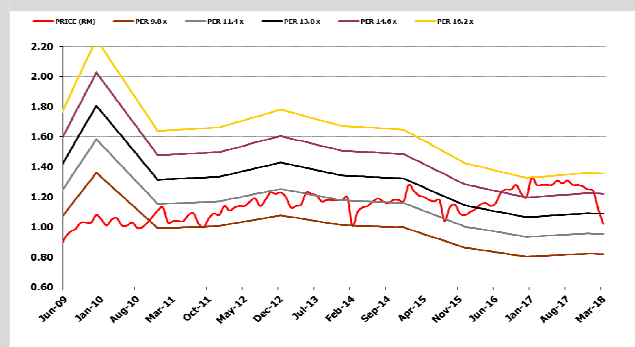
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Income Statement						Financial Data & Ratios					
FY Dec (RM m)	2015A	2016A	2017A	2018E	2019E	FY Dec (RM m)	2015A	2016A	2017A	2018E	2019E
Revenue	115.2	131.8	180.1	184.3	184.1	Growth (%)					
EBITDA	80.5	94.8	126.5	128.0	127.9	Revenue	64.0	14.4	36.7	2.3	-0.1
Depreciation	0.0	-0.1	-0.1	-0.1	-0.1	EBITDA	140.7	17.8	33.4	1.2	-0.1
EBIT	80.5	94.7	126.4	128.0	127.8	EBIT	140.7	17.7	33.4	1.2	-0.1
Interest Income	0.9	2.4	3.6	1.9	2.2	Pre-tax Income	50.7	11.4	5.4	28.5	-1.1
Interest	-28.0	-33.0	-40.5	-39.6	-39.3	Net Income	50.7	11.4	5.4	28.5	-1.1
Others	-9.8	-12.4	-14.9	-14.8	-14.9	Core Net Income	58.1	9.5	48.8	2.7	0.3
Exceptionals/FV	6.7	3.5	-18.2	1.3	0.0	Profitability (%)					
PBT	60.7	67.6	71.3	91.6	90.7	EBITDA Margin	69.9	71.9	70.2	69.5	69.4
Taxation	0.0	0.0	0.0	0.0	0.0	EBIT Margin	69.9	71.9	70.2	69.4	69.4
Minority Interest	0.0	0.0	0.0	0.0	0.0	PBT Margin	52.7	51.3	39.6	49.7	49.2
Net Profit	60.7	67.6	71.3	91.6	90.7	Net Margin	46.9	51.3	39.6	49.7	49.2
Core NP (RNI)	54.0	59.2	88.0	90.4	90.7	Effective Tax Rate	0.0	0.0	0.0	0.0	0.0
Balance Sheet						ROE	8.4	6.5	6.1	6.5	6.5
FY Dec (RM m)	2015A	2016A	2017A	2018E	2019E	ROA	4.9	3.6	3.6	3.9	3.9
Fixed Assets	1572	2222	2160	2232	2242	DuPont Analysis					
Intangibles	0	0	0	0	0	Net margin (%)	46.9	51.3	39.6	49.0	49.2
Other FA	2	3	22	2	2	Assets Turnover (x)	0.1	0.1	0.1	0.1	0.1
Inventories	1	0	0	0	0	Leverage Factor (x)	1.7	1.8	1.7	1.7	1.7
Receivables	6	18	6	9	10	ROE (%)	8.4	6.5	6.1	6.5	6.5
Other CA	0	0	25	0	0	Leverage					
Cash	45	54	76	57	57	Debt/Asset (x)	0.42	0.37	0.37	0.38	0.38
Total Assets	1625	2298	2289	2300	2312	Debt/Equity (x)	0.76	0.63	0.62	0.63	0.63
Payables	14	28	20	17	16	N.Debt/(Cash)	645	798	777	821	821
ST Borrowings	189	189	117	188	188	N.Debt/Equity (x)	0.71	0.59	0.56	0.59	0.59
Other ST	0	35	5	0	0	Valuations					
LT Borrowings	501	662	737	690	690	Core EPS (sen)	8.2	10.2	8.2	8.4	8.3
Other LT	16	23	24	16	16	GDPS (sen)	8.4	8.4	8.4	8.3	8.2
Minority Int.	0	0	0	0	0	NDPS (sen)	7.5	7.5	7.6	7.5	7.4
Net Assets	904	1360	1385	1389	1401	BV/share (RM)	1.39	1.37	1.32	1.29	1.28
Share Capital	751	1232	1232	1236	1249	Core PER (x)	12.5	10.0	12.4	12.2	12.3
Reserves	153	128	153	153	153	Gross Div. Yield	8.2	8.2	8.2	8.1	8.0
S. Equity	904	1360	1385	1389	1401	Net Div. Yield (%)	7.4	7.2	7.4	7.3	7.2
Cashflow Statement						PBV (x)	0.75	0.75	0.79	0.79	0.80
FY Dec (RM m)	2015A	2016A	2017A	2018E	2019E	EV/EBITDA (x)	14.0	12.1	13.8	13.6	13.7
Operating CF	87	105	132	123	126						
Investing CF	-726	-647	-659	12	10						
Financing CF	665	551	530	-132	-121						
Net Change in	26	9	3	3	15						
Free Cash Flow	74	94	-524	126	129						

Source: Kenanga Research

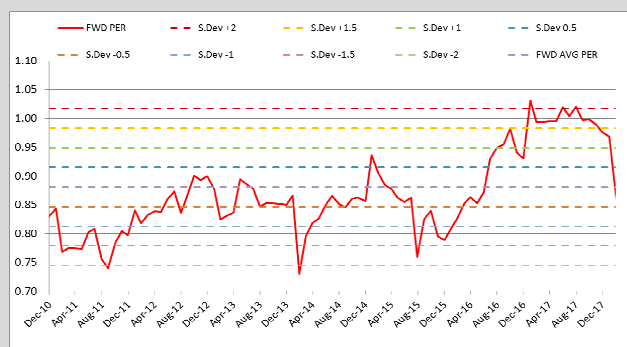
*FY18-19E per share data is based on our enlarged share base of 1081-1094m on assumptions from managers fee's units over FY18-19E, while historical share base is based on actual share base per annum.

Fwd PER Band



Source: Bloomberg, Kenanga Research

Fwd PBV Band



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Peer Comparison

NAME	Price (29/3/18)	Mkt Cap	PER (x)			Est. NDiv. Yld. **	Historical ROE	P/BV	Net Profit (RMm)			FY18/19 NP Growth	FY19/20 NP Growth	Target Price	Rating							
	(RM)		(RMm)	FY17/18	FY18/19				FY19/20	(%)	(%)					(x)	FY17/18	FY18/19	FY19/20	(%)	(%)	(RM)
M-REIT & PROPERTY INVESTMENT UNDER COVERAGE																						
KLCCSS *	7.14	12,890	19.2	17.9	17.6	5.0%	5.2%	1.0	671.5	719.2	731.7	7.1%	1.7%	7.00	UNDERPERFORM							
Pavilion REIT	1.38	4,188	18.0	16.6	15.7	5.6%	8.0%	1.0	232.4	264.6	279.4	13.8%	5.6%	1.60	OUTPERFORM							
IGB REIT*	1.54	5,419	17.7	17.9	17.5	5.6%	8.1%	1.4	303.4	303.9	312.2	0.2%	2.7%	1.70	OUTPERFORM							
Sunway REIT*	1.61	4,742	17.7	16.1	15.9	5.6%	8.0%	1.1	267.4	294.0	298.0	9.9%	1.4%	1.75	OUTPERFORM							
CapitaMalls (M) Trust*	1.07	2,183	13.7	13.4	13.2	6.7%	6.2%	0.9	167.4	164.0	165.0	-2.0%	0.6%	1.35	OUTPERFORM							
Axis REIT*	1.27	1,565	17.2	16.1	14.6	5.6%	8.1%	1.0	90.8	97.7	107.5	7.6%	10.0%	1.25	MARKET PERFORM							
MRCB-Quill REIT	1.02	1,089	12.4	12.2	12.3	7.4%	6.1%	0.8	88.0	90.4	90.7	2.7%	0.3%	1.25	OUTPERFORM							
* Core NP and Core PER																						
CONSENSUS NUMBERS																						
YTL Hospitality REIT	1.11	1,892	16.8	13.4	12.9	7.3%	5.0%	0.8	141.3	147.0	151.5	4.1%	3.1%	1.36	BUY							
Al-'Aqar Healthcare REIT	1.12	816	9.6	19.0	n.a.	7.9%	9.3%	0.9	64.3	n.a.	n.a.	n.a.	n.a.	n.a.	BUY							
AmanahRaya REIT	0.84	482	15.2	11.7	n.a.	8.2%	4.5%	0.7	41.0	n.a.	n.a.	n.a.	n.a.	1.12	BUY							
AmFIRST REIT	0.60	412	16.9	n.a.	n.a.	n.a.	2.8%	0.5	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	BUY							
Hektar REIT	1.18	545.1	15.4	n.a.	n.a.	n.a.	5.3%	0.8	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	BUY							
Tower REIT	1.01	283.3	14.3	n.a.	n.a.	n.a.	3.6%	0.5	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	BUY							
UOA REIT	1.48	625.9	16.5	n.a.	n.a.	n.a.	5.4%	0.9	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	BUY							
Atrium REIT	1.10	134.0	7.4	n.a.	n.a.	n.a.	10.3%	0.7	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	BUY							
Al-Salam REIT	0.90	522.0	12.9	13.6	13.4	6.3%	6.6%	0.8	37.2	38.8	38.9	4.2%	0.4%	1.00	BUY							
KIP REIT	0.79	397	n.a.	n.a.	n.a.	n.a.	n.a.	0.8	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	BUY							

Source: Bloomberg, Kenanga Research

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Stock Ratings are defined as follows:**Stock Recommendations**

OUTPERFORM	: A particular stock's Expected Total Return is MORE than 10%
MARKET PERFORM	: A particular stock's Expected Total Return is WITHIN the range of -5% to 10%
UNDERPERFORM	: A particular stock's Expected Total Return is LESS than -5%

Sector Recommendations***

OVERWEIGHT	: A particular sector's Expected Total Return is MORE than 10%
NEUTRAL	: A particular sector's Expected Total Return is WITHIN the range of -5% to 10%
UNDERWEIGHT	: A particular sector's Expected Total Return is LESS than -5%

*****Sector recommendations are defined based on market capitalisation weighted average expected total return for stocks under our coverage.**

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