EDISON

Regional REIT

Growing high yield asset base

Interim results update

Real estate

Regional REIT's (RGL) interim results show strong growth in assets, with the portfolio reaching £640m compared with £386m at the time of the IPO in November 2015. Rental income during the period was solid but lacked some of the momentum we had hoped for given the continuing positive supply-demand situation in regional commercial property markets. This should accelerate in H2 and through next year as recently acquired assets contribute fully and as occupancy increases, including the launch of several key refurbishment projects. RGL's dividend yield, fully covered by earnings, is highly attractive, while its regional focus should prove more resilient to macroeconomic headwinds than London real estate.

Year end	Net rental income (£m)	EPRA EPS* (p)	EPRA NAV/ share (p)	DPS (p)	P/EPRA NAV (x)	Yield (%)
12/15**	4.6	0.9	107.8	1.00	0.97	1.0%
12/16	38.1	7.8	106.9	7.65	0.98	7.3%
12/17e	44.7	7.9	108.8	7.85	0.96	7.5%
12/18e	49.8	8.9	116.6	8.35	0.90	8.0%

Note: *EPRA EPS is adjusted to exclude exceptional expenses and estimated performance fees. **56-day trading period only.

H1 asset growth with earnings to follow

H117 contracted rent rose from £44.0m at end-2016 to £54.6m, primarily reflecting a significant expansion of the asset base but also active letting activity. Occupancy (by value) rose to 83.3% (end-2016: 82.7%) but was slightly lower on a like-for-like basis. Continuing refurbishments were more of a drag in H1 than we had allowed for, dampening rental income and increasing void costs, but the managers are confident of increasing momentum in H2, when four major refurbishment projects are due to complete, and when recently acquired assets make a full period contribution.

Progress continues, cautiously deferred

Despite some softening of UK economic growth expectations, both occupier and investment demand for regional property remains positive, supported by lower rentals compared with London, a lack of supply, and the broader business base of the economy outside London. We have taken a slightly more cautious interpretation of management's c 90% occupancy target, looking for 89% and deferring the point at which this is reached until the end of 2018 (85% at the end of 2017). Our forecast 2017 DPS is unchanged, but for 2018 it falls (5%) in line with lower forecast earnings.

Valuation: High yield, fully covered

RGL's prospective dividend yield of 7.5% is currently the highest of all UK REITs, while its price/EPRA NAV of 0.96% sits within the middle of the range despite a strong focus on asset management with potential for capital gains. The geographic spread of its non-London portfolio, its sector and tenant diversity, and high asset yield all mitigate macroeconomic risks. The successful launch of major refurbishment projects later in the year would provide scope for gains.

4 October 2017

Price	**105p**
Market cap	**£315m**

Net debt (£m) as at 30 June 2017	299.6
Net LTV as at 30 June 2017	47.2%
Shares in issue	300.5m
Free float	80%
Code	RGL
Primary exchange	LSE
Secondary exchange	N/A

Share price performance

%	1m	3m	12m
Abs	2.19	(0.24)	0.24
Rel (local)	1.62	(1.91)	(6.95)
52-week high/low		109.0p	100.2p

Business description

Regional REIT (RGL) owns a commercial property portfolio of predominantly offices and light industrial units located in the regional centres of the UK. It is actively managed and targets a total shareholder return of 10-15% with a strong focus on income.

Next events

Payment of Q2 dividend	13 October 2017
Q3 trading update	16 November 2017

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Edison profile page

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Investment summary

Income momentum to follow asset growth in H2

RGL's portfolio reached £640m in value as of 30 June 2017, compared with £386m at the time of listing, and the managers remains committed to an opportunistic acquisitive growth strategy while the medium-term outlook for regional property remains favourable. Despite some softening of UK economic growth expectations, both occupier and investment demand for regional property remains positive, especially for industrial property. In addition to the focus on regional property assets, predominantly quality offices and light industrial units, a key element of the investment strategy is to acquire undermanaged and unloved properties and create value through active asset management. H117 saw progress on a number of fronts but most obviously in asset growth with the £129m acquisition of assets from Conygar. This was not seen in rental income growth compared with the end of 2016, but H217 will include a full period contribution from the assets acquired in H117 and should also benefit from the progress that the managers indicate across the portfolio, including a number of key refurbishment projects coming on stream.

Financials: Tempering earnings growth but increasing NAV

The financial outlook remains one of rental income growth driven mainly by continuing occupancy improvement in respect of the current portfolio, particularly as refurbished space is let, with costs reducing as a result of lower voids and scale efficiencies from continuing acquisitions. We have taken a slightly more cautious interpretation of management's c 90% occupancy target, looking for 89% and deferring the point at which this is reached from the current year until the end of 2018 (85% at the end of 2017). The impact on 2017 estimates is modest, with no change to DPS. For 2018, our EPRA EPS and DPS estimates are reduced by c 5% but our EPRA NAV estimate increases as we take a more positive view of occupancy improvement generating valuation gains at unchanged yields.

Valuation: Attractive yield supports double-digit total return

RGL is targeting a total return of 10-15% pa with a strong focus on income but with additional capital appreciation driven by specific asset management initiatives within the portfolio. Fully covered dividends totalling 7.65p were declared in 2016, in line with a stated commitment of providing a 7-8% yield on the 100p price at which the shares were first issued. For the first and second quarters of 2017, dividends of 1.8p per share have been declared, a 2.9% increase year-on-year, and our forecast full year dividend per share of 7.85p represents a 2.6% increase for the year. Annualised total shareholder return from IPO through H117, excluding IPO costs, is 12.1%. RGL offers the second highest prospective dividend yield within the UK REIT universe while trading at a c 4% discount to NAV.

Sensitivities: Protection from high-yield, diversified asset base

The commercial property sector is cyclical; occupier demand is sensitive to economic growth while valuation yields and capital values are affected by investment flows and monetary conditions. The diversity of RGL's portfolio and tenant base mitigate the cyclical risk. 90.9% of RGL's debt is fixed or hedged and planned refinancing will materially extend maturity. H117 gearing of 47.3% was down from a peak of c 49% immediately after the Conygar asset purchase in March and the managers target further reductions.

Active management of regional commercial property

Regional REIT (RGL) is a UK-based real estate investment trust (incorporated in Guernsey) that was admitted to the premium segment of the Official List and to trading on the Main Market of the London Stock Exchange (LSE) in November 2015. The shares became a constituent of the FTSE All-Share Index in March 2016 and the FTSE EPRA NARIT Index in June 2016. RGL is externally managed by London & Scottish Investments (LSI), the asset manager, and Toscafund Asset Management (Toscafund), the investor manager, and was formed by the combination of two UK commercial property investment funds previously created by the managers. Through investments in UK commercial property (predominantly office and industrial property) in the main regional centres of the UK, effectively outside the M25 motorway, RGL aims to deliver an attractive total return to investors. It targets a 10-15% total return pa with a strong focus on income in addition to capital growth.

RGL is committed to an opportunistic acquisitive growth strategy and the portfolio has now reached £640m in value compared with £386m at the time of listing. The portfolio remains highly diversified by region, property, and tenants, and can fairly be seen as representative of the UK economy as a whole (Exhibit 3). In addition to the focus on regional property assets, predominantly quality offices and light industrial units, a key element of the investment strategy is to acquire under-managed and unloved secondary (rather than prime) properties and create value through active asset management, provided by a well-resourced, dedicated team with cross-cycle experience. The managers seek properties where there are opportunities to create additional value through lease renewals and rent increases, minimising voids through effective marketing of vacant space, enhancing the tenant mix and covenant strength, and refurbishment, extension, or change of use. When properties have met their return objectives they are assessed for sale, or to hold if their income and capital growth outlook looks strong, allowing the recycling of resources into new value-creating opportunities.

Experienced external management

The day-to-day management of the portfolio is provided by LSI, subject to the investment objectives of the board. It advises on the acquisition, management and disposal of the real estate assets and is also responsible for debt funding negotiations. Tosca is responsible for the management functions of the company.

LSI is a privately owned property investment manager, established in 2012, although the senior management team has worked together for a much longer period (managing the Credential portfolio) and has experience of managing portfolios for cash in down cycles. It is based in Glasgow with offices in Leeds, Manchester, and London, and manages c £765m in real estate assets, of which c £650m relates to RGL. It currently employs 56 staff (including 22 property managers, 14 finance staff, and four support staff), 48 of whom are dedicated to, or spend the majority of their time, working on RGL .

Both the asset and investment management contracts initially run for five years, at which point 12 months' notice could be given; beyond five years the contract has a three-year term subject to 12 months' notice being given at any point. The management fee is initially 1.1% of net assets, split equally between LSI and Tosca. On incremental net assets above £500m the fee will drop to 0.9%. In addition, a property management fee of 4% of annual gross rental income is payable to LSI. The combined fees represented 11.5% of H117 gross rental income. An additional incentive is provided to the managers by way of a performance fee with an initial period calculated from the listing date until the end of FY18, and payable in 2019. The performance fee is set at 15% of total EPRA NAV per share return (EPRA NAV growth plus dividends declared) exceeding 8% pa, subject to a high-water mark (the greater of the highest year-end NAV per share in prior periods or the IPO price of

100p). It is payable 50% in cash and 50% in shares. Starting with FY19, the performance fee will be calculated annually and payable one-third in cash and two-thirds in shares. The initial performance fee will not be known with certainty until the end of 2018 but £1.1m has been accrued within expenses up to 30 June 2017. Our estimates include further allowance for future performance fee costs based upon our forecast NAV total return.

After the initial five-year term of the asset and investment management contracts, subject to EPRA net assets having reached £750m, the board and managers may decide to internalise the management of Regional REIT, subject to approval by independent shareholders.

Regional REIT has a five-member board and is chaired by Kevin McGrath (biography on page 14). There are four non-executive directors, three of whom RGL considers independent plus Stephen Inglis, representing LSI.

Toscafund Limited has a significant 9.0% shareholding in RGL, and Conygar Investment Company became an 8.8% shareholder in March 2017 as a result of receiving new RGL shares issue in part-payment for its sale of assets. One-third of its holding was subject to a lock-in of six months from completion, recently expired, with one-third locked-in for 12 months from completion and the balance locked-in for 18 months from completion.

Portfolio and rental update

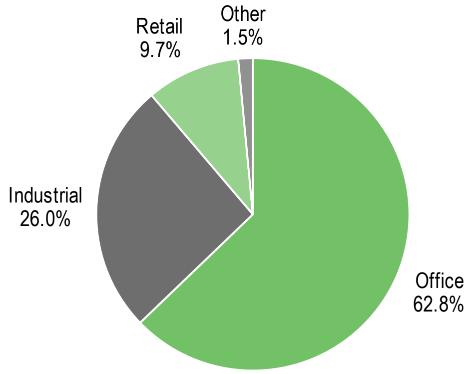
Having listed with an established portfolio of 128 properties valued at £386m, the portfolio has since been increased to 150 properties valued at a little more than £640m as of 30 June 2017 with a contracted gross rental income of £54.6m (2016: £44.0m), and a vacancy rate (by value) of 16.7% (2016: 17.3%). The properties include 1,093 separate rental units, let to 823 different tenants.

H117 included the £129m acquisition of a mixed portfolio of 31 properties from Conygar, with a contracted rent roll. The office, retail, and leisure properties were complementary to the existing portfolio and offer additional asset management opportunities. The portfolio was acquired with a contracted rent roll of c £9.7m (net initial yield 7.0%), which has since increased to £10.7m as of end-H117, with occupancy increasing to 89.3% (by value) from 82.9% in September 2016, prior to acquisition.

Since the half year end, RGL has acquired one office property in the buoyant Bristol market for £6.6m (rental income of £595,000 pa) and has sold one non-core property in Bath for £4.6m (rental income of £298,000 pa).

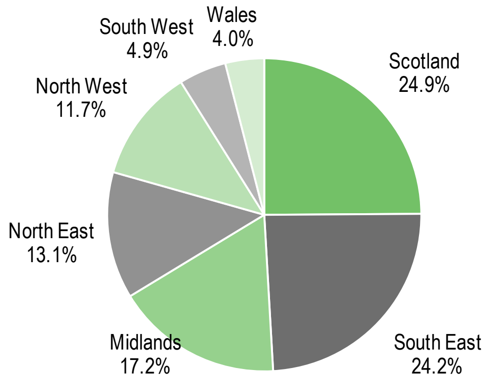
Exhibits 1 and 2 show the portfolio split by sector and geography as at 30 June 2017. RGL's strategy is focused on office and light industrial property (88.8%) and over time the managers expect to dispose of the retail assets. The geographic positioning of the portfolio is well diversified although with a relatively large historical weighting towards Scotland. The Scottish weighting has reduced from the time of listing as planned, and is likely to fall further over time. However, as of now the managers are content to maintain the Scottish weight, believing that the political risk of Scottish secession from the UK has receded and that investor interest in the region is likely to support valuations.

Exhibit 1: Segment split by valuation



Source: Company data as at 30 June 2017

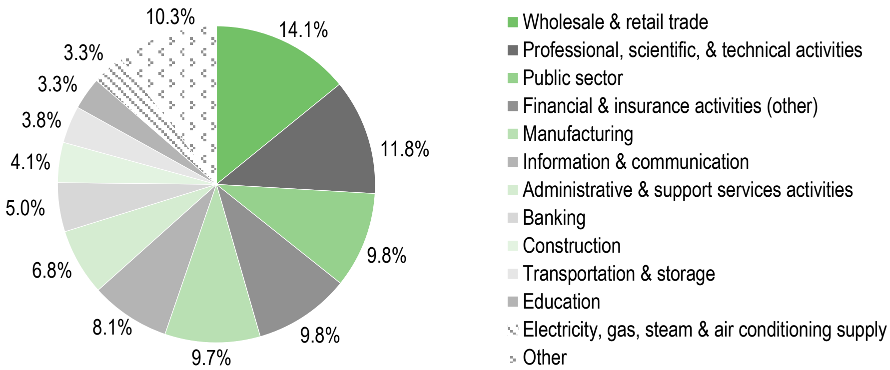
Exhibit 2: Regional split by valuation



Source: Company data as at 30 June 2017

The portfolio is based on exposure to a wide range of businesses (Exhibit 3) that can fairly be said to represent the UK economy as a whole. Exposure to banking, most often highlighted as having an above average "Brexit" risk, is 5%, with no exposure in London. The largest single tenant represents 3% of the portfolio.

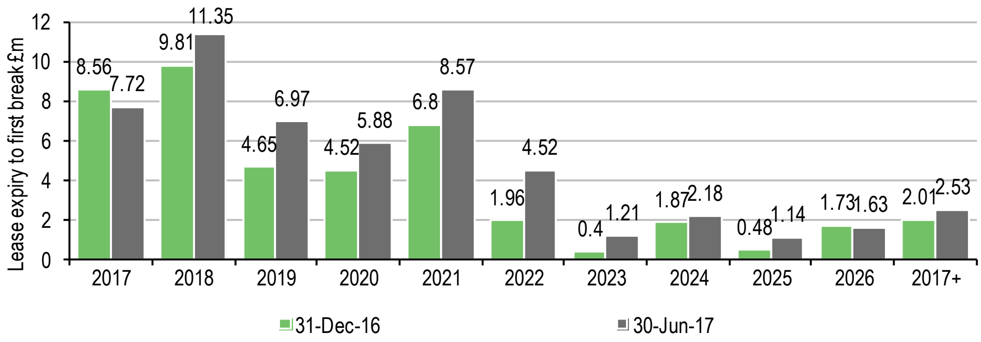
Exhibit 3: Standard industrial classification mix (% gross contracted rent)



Source: Company data as at 30 June 2017

46 new leases were agreed in H117, totalling 173,000sqft of space, and providing c £1.6m of contracted rental income. In total, 63 leases came up for renewal during the period, totalling 407,229sqft of space and quite a lot of this space is being "held over" by tenants still in occupation while new lease terms are concluded. Including tenants that are currently holding over, leases that were renewed, and the acquisition of new tenants, 80% (by value) of the units with lease renewals in the period remained occupied at 30 June 2017. In Exhibit 4 we show the lease expiry to first break profile as at end-2016 and at H117. The two positions cannot be directly compared because of the impact on the portfolio of the Conygar assets acquired (£9.7m of contracted rents with a WAULT to first lease break option of 3.8 years) during the period. The weighted average unexpired lease term (WAULT) on the overall RGL portfolio (including the Conygar assets at H117) increased to 5.3 years (end-2016: 5.2 years; and H116: 5.0 years), while the WAULT to first lease break was 3.5 years (end-2016 and H116 both 3.6 years).

Exhibit 4: Lease expiry to first break



Source: Regional REIT. Note: Excludes income from tenants that remain in occupation post lease expiry. 30 June 2017 includes Conygar assets acquired in the period.

It is clear that the next 18 months will remain a busy period for lease renewals and that managing this process, along with the letting of refurbished space, is key to RGL achieving its targeted returns.

Overall portfolio occupancy by value was 83.3% at H117 (end-2016: 82.7%; and H116: 81.4%). On a like-for-like basis, adjusting for the Conygar portfolio acquisition, it was 82.0% (end-2016: 82.8%). Within RGL's office property portfolio, occupancy by value increased from 80.5% at end-2016 to 81.6% at H117, but the like-for-like position showed a small decline from 80.4% to 80.3%, affected by the ongoing refurbishment programme. At the start of the year RGL indicated that it would make gross capital investment (before dilapidation recoveries and other recoveries) of c £17m in 2017, a substantial increase on 2016. There are four major refurbishment projects (in Aylesbury, Birmingham, Bristol, and Leeds) that account for c £13m of this total, all of which are scheduled for completion by year end, for which the managers will seek pre-lets.

In the industrial portfolio, occupancy by value decreased from 86.2% at end-2016 to 84.1% at H117 or from 86.7% to 83.9% on a like-for-like basis following H117 lease expiries on two properties (in Barnsley and a property unit in Erith) where RGL plans to refurbish the properties and then re-let at significantly higher targeted rents. In Erith, RGL has already re-let two property units at significantly higher rents and is close to completing a let on a third. Industrial occupancy will benefit from post-H117 lettings on industrial units in Basildon and Dumfries. Taken together, these four properties represent 5.7% of the overall expected rental value of the industrial portfolio.

Occupancy and rental income growth slightly deferred

As we note in the financials section below, gross rental income in H117 of £23.0m was slightly lower than the £23.3m generated in H216, despite the c 24% growth in contracted gross rents to £54.6m as at 30 June 2017 from £44.0m at 31 December 2016. The first point to make is that the Conygar assets acquired at the end of March accounted for most of the increase in gross contracted rents, but did not contribute fully to the period. Additionally, H216 benefited from non-recurring rental top-up guarantees received on some acquired properties in H116. Clearly, H117 has seen much activity on the leasing front and the occupancy position is solid, but the trajectory towards increasing rental income from occupancy improvement towards the c 90% targeted by management has been slower than we would have hoped and, while the target remains, it is now unlikely to be met in the current financial year. The Conygar assets will contribute fully to H217 and the managers are very optimistic about the prospects for letting progress on refurbished space (of which more below) by year-end 2017, which will contribute to rental income growth through 2018. Our updated assumptions, including the potential contribution from additional asset acquisition, are reviewed in the financial section.

Positive regional and secondary market dynamics

In recent months the regional commercial property market has remained robust, both in terms of occupational demand from businesses looking to accommodate their continuing growth or relocate to the regions, and from the perspective of investors, seeking attractive returns. The managers believe that this will continue through 2017 and 2018, which could result in a resumption of the narrowing of the yield gap that remains between prime and secondary property, the focus of the RGL portfolio.

Unlike the central London commercial property market, where supply has increased while occupier demand has weakened, vacancy rates across the 10 major regional centres have remained strong overall, with limited new supply, and a lack of new build. Exhibit 5 shows the most recent quarterly market survey of market forecasts conducted by the Investment Property Forum (IPF, canvassing a group of fund managers and surveyors under the IPF Research Programme). The IPF forecasts, which relate to the whole of the UK, including the dominant London market, indicate an increase in 2017 total return expectations since earlier in the year, but a weakening of medium-term expectations.

Exhibit 5: Consensus commercial property return expectations (whole of UK market including London)

	Rental value growth %				Capital value growth %				Total return %			
	2017	2018	2019	2017/21	2017	2018	2019	2017/21	2017	2018	2019	2017/21
Office	0.2	(1.0)	(0.1)	0.5	0.7	(2.2)	(0.9)	(0.1)	5.0	2.2	3.6	4.4
Industrial	3.3	2.1	1.7	2.2	6.8	1.9	0.8	2.2	12.2	7.1	6.1	7.5
Standard retail	0.8	0.2	0.6	0.8	1.3	(0.8)	(0.1)	0.4	5.9	3.8	4.6	5.2
Shopping centre	0.4	(0.1)	0.4	0.6	(0.1)	(1.7)	(0.8)	(0.3)	4.8	3.3	4.4	4.8
Retail warehouse	0.5	0.1	0.4	0.6	0.2	(1.3)	(0.5)	(0.1)	5.9	4.5	5.3	5.8
All property	0.9	0.2	0.6	0.9	1.8	(0.8)	(0.3)	0.4	6.7	4.1	4.6	5.4

Source: Investment Property Forum UK Consensus Forecasts Report (Summer 2017)

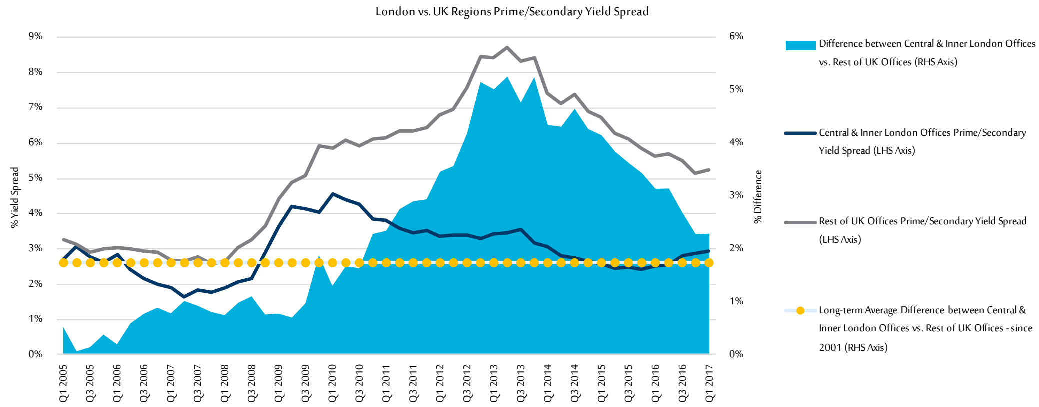
All sectors, led by industrial property, are expected to show rental growth in 2017 and medium-term total return forecasts for industrial property are the strongest of all the sectors, which is positive for the regions and RGL. More generally, the forecasts indicate that income (rather than capital value increase) will be the driver of medium-term returns across the market.

Looking more specifically at the regional markets, CBRE estimates take-up of office space across the 10 key regional cities of 2.8m sqft in H117, a robust result but 5% down on H116, and enough to support ongoing rental growth amid a shortage of new supply. A limited supply of prime properties seems likely to result in increased demand for high-quality secondary properties and recently refurbished office space.

Knight Frank estimates a continued good level of take-up of industrial units of more than 50,000sqft across the UK, 2% up y-o-y but lower than H216. IPD data showing a 4% rental value growth support the IPF forecasts shown in Exhibit 5, again driven by a shortage of suitable space.

For the manager, a key metric is the spreads between the yield on prime and secondary properties in the UK regions. These have fallen from the high levels of 2013-14 but remain c 1.7% above the long-term average, indicating a continuing opportunity for secondary property to outperform prime (Exhibit 6). The path to closing the gap is uncertain, but the market backdrop for regional property suggests that it should at least in part be driven by positive secondary performance rather than prime underperformance.

Exhibit 6: Prime-secondary regional property yield spread remains above average



Source: Company presentation, Cushman & Wakefield, MSCI/IPD (June 2017)

Financials

RGL recently reported interim results for the period to 30 June 2016. The performance during the period was solid, but in terms of occupancy and rental growth the trajectory was lower than that experienced earlier in the year. The managers are confident of building momentum in H216 as several flagship refurbishment projects come on stream for letting. We provide a brief summary of the key points from the results before discussing the outlook and estimate revisions.

- The gross investment portfolio increased to £640.4m (2016: £502.3m) including £130.5m in net additions from acquisitions, disposals and capex, and a £7.5m revaluation gain (2.2% like-for-like increase).
- Gross rental income increased by 16.6% to £23.0m compared with H116 (£19.7m), but was slightly lower than in H216 (£23.3m). H216 benefited from non-recurring rental top-up guarantees received on some acquired properties in H116.
- Period-end occupancy (value basis) was 83.3% compared with 81.4% at end-H116 and 82.7% at end-2016.
- The total expense ratio (before performance fee accrual) increased to 33.7% (H116: 31.8%; 2016: 28.2%), while performance fee accrual continued. Before performance fees, operating profits increased 13.3% y-o-y to £15.2m (H116: £13.4m), but declined versus H216 (£16.7m). Property expenses in H117 were negatively affected by higher agents fees related to the heavy letting activity during the half.
- Net finance expense increased by 39%, reflecting the growth in borrowing to finance portfolio growth.
- PBT, on an IFRS basis including revaluation gains, increased to £32.9m compared with £21.1m in H116 and £13.4m in H216.
- Earnings on an EPRA basis (excluding revaluation movements on property and derivative financial assets, as well as a small amount of goodwill written off) and further adjusted for the performance fee accrual, were £9.2m, a similar level to H116 but down from £11.6m in H216.
- Net LTV was 47.3% compared with c 49% immediately after the Conygar portfolio acquisition and compared with 40.6% at end-2016. The managers are in advanced refinancing discussions that are likely to see the existing bank facilities rationalised and maturity significantly extended without additional cost.

- Fully diluted EPRA NAV was 107.3p per share at H117 (2016: 106.9p) after payment of dividends per share totalling 4.2p during the period.

Estimate revisions

The outlook remains one of rental income growth driven mainly by continuing occupancy improvement in respect of the current portfolio, particularly as refurbished space is let, with costs reducing as a result of lower voids and scale efficiencies.

We have made a slightly more cautious interpretation of management's c 90% occupancy target, looking for 89% and deferring the point at which this is reached from the current year until the end of 2018 (85% at the end of 2017). This is the main material change to our estimates, which are shown in detail on page 13.

Exhibit 7: Estimate revisions

	Net rental income (£m)			EPRA EPS* (p)			EPRA NAV (p)			DPS (p)		
	New	Old	% chg.	New	Old	% chg.	New	Old	% chg.	New	Old	% chg.
12/17e	44.7	45.8	-3%	7.9	8.2	-4%	108.8	109.3	0%	7.9	7.9	-1%
12/18e	49.8	51.7	-4%	8.9	9.4	-5%	116.6	110.7	5%	8.4	8.8	-5%

Source: Edison Investment Research. Note: *EPRA EPS adjusted for performance fees and exceptional items.

Given the continuing heavy re-letting schedule and noting that gross contracted rental income of £54.6m, on a full occupancy basis, is not substantially different from the H117 expected rental value (ERV) on the portfolio of £65.1m, we have made no assumption of rental growth (per sqft of space) over the forecast period. Nor have we assumed any additional asset acquisition in our forecasts although this is likely and the stated intention of the managers, but provide a detailed illustration of the potential impact below.

We believe that RGL's dividend intentions for the current year have been fairly well flagged by the 2.9% y-o-y growth in its quarterly dividends year to date and we have made no change to our 2017 DPS estimates. For 2018 we have reduced our DPS estimate in line with EPRA EPS (adjusted for performance fees and exceptional items). Our new EPRA NAV estimates benefit from revaluation gains generated in H117, with forecast revaluation gains reflecting the growth in net contracted rental income and a stable net initial yield (NIY), 7.1% at end-H117.

Debt refinancing to improve profile and extend maturity

RGL has indicated that it is in advanced refinancing discussions on its £335.0m of long-term debt (£331.8m as per balance sheet plus unamortised loan arrangement fees). Built up through the group's formation and subsequent acquisitions, there are currently eight separate bank facilities plus the zero dividend preference shares (ZDPs) that were acquired with the Conygar portfolio. The debt maturity is currently relatively short term (2.3 years as at H117) with an average cost of 3.4% before interest rate hedging costs, or 3.7% after. A number of the facilities are expected to be consolidated into one new fixed-rate facility with a 10-year maturity. This will not include RGL's more expensive current bank facility (the Longbow facility) at a fixed 5.0% that matures in August 2019, although this remains under review for potential refinancing on suitable terms. Also not included is the ZDP at a fair value including unamortised costs of £36.2m at H117 and with a yield of 6.5% to maturity in January 2019. We view the refinancing positively as it will simplify the group's borrowing and significantly extend the maturity while management expects no increase in interest costs as a result.

RGL targets a gearing ratio (borrowing net of cash to investment property) of c 35% over the longer term, but is comfortable with higher levels over the short term to facilitate accretive acquisition growth. It has set a maximum limit of 50%. At the end of 2016, gearing was at 40.6%, rising to c 49% with the Conygar portfolio acquisition, and closing H117 at 47.3%, relatively high in a sectoral context. Refinancing the relatively expensive ZDP with bank debt at maturity would likely lower the cost of borrowing but would leave the gearing ratio unchanged from its current level, while simply issuing new equity to repay the ZDP would immediately lower gearing but would be dilutive of earnings and NAV per share. The managers have some time to decide, but most likely in our view is some combination of the two, with the effects rolled into RGL's ongoing acquisition programme. Given the positive spread between available yields and funding costs, as well as a positive supply-demand balance in the occupier market, RGL plans further acquisitions. Indeed, the managers indicate that a number of potential opportunities are being considered. RGL has also indicated that acquisitions will be accretive to earnings. In the following section we illustrate how ongoing acquisitions (from £50m to £150m of gross assets) could be financed by a blend of debt and equity in a way that would both avoid earnings per share dilution and lower the average group gearing, moving the latter closer to management's longer-term targets.

Impact of acquisitions

In Exhibits 8 and 9, we illustrate the potential impact of RGL's key financial metrics of asset acquisitions ranging from £50-150m. We have based our illustration on a potential rental yield of 8% on the assets acquired with no requirement for additional administrative costs other than investment and asset management fees and property management fees. We have allowed for an interest cost of 3.35% on marginal debt, slightly above the current level on RGL's bank debt. Clearly, there are many moving parts to the illustration and in practice any future acquisitions could differ quite materially from this. The chosen rental yield on the assets acquired has a significant impact on the result, but we note that while an 8% yield, similar to the equivalent yield on the existing assets (8.3% at 30 June) is a fairly demanding assumption, we have assumed no benefits from the asset management of the newly acquired assets. Given the strategy of targeting undermanaged, under-let and under-rented properties, we believe we have been conservative and that there would be additional income and valuation upside (lower LTV) that is not captured by our illustration. New equity is assumed to be issued at around the current market price, a balance between the more likely options of a share placement at a small discount to the market price or an equity swap (as in the case of the Conygar acquisition) at, or closer to NAV.

Exhibit 8: Illustrated impact of portfolio additions (£50-150m gross assets)

Net additions to portfolio (£000s unless otherwise stated)	50,000	100,000	150,000
Assumed yield on assets	8.00%	8.00%	8.00%
Incremental net rental income	4,000	8,000	12,000
Investment & asset management fees	(358)	(715)	(1,073)
Property management fees	(176)	(352)	(527)
Total incremental expenses	(533)	(1,067)	(1,600)
Total incremental expenses/net income	13.3%	13.3%	13.3%
Assumed cash/debt consideration	17,500	35,000	52,500
Assumed cash/debt as % of total consideration	35%	35%	35%
Assumed equity consideration	32,500	65,000	97,500
Assumed marginal cost of debt	3.35%	3.35%	3.35%
Incremental finance expense	(586)	(1,173)	(1,759)
Incremental earnings	2,880	5,761	8,641
Incremental earnings as % of new equity investment	8.9%	8.9%	8.9%
New equity	32,500	65,000	97,500
Assumed issue price (p)	105.0	105.0	105.0
New shares issued (m)	31.0	61.9	92.9
2018e average number of shares (m)	300.5	300.5	300.5
Pro forma average number of shares (m)	331.5	362.4	393.4

Source: Edison Investment Research

By assuming a mix of 35% debt and 65% equity in the illustrated acquisitions, there is either no earnings dilution or small accretion depending on the amount of new assets acquired; EPRA NAV per share dilution is minimal; and the group gearing/net LTV is reduced. The results are summarised in Exhibit 9. By assuming £150m in acquisitions, the pro forma 2018 group LTV is reduced by 2.0% to 44.4%. Clearly, the closer to NAV that RGL can issue equity, the better the result in terms of pro forma EPRA EPS and NAV. Sticking with £150m in acquisitions, if new shares could be issued at the 2018 forecast NAV of 116.8p rather than at around the current share price (100p), as in a "NAV-for-NAV" swap similar to the Conygar acquisition, this would obviously avoid NAV dilution and would enhance EPS by 4%.

Exhibit 9: Impact of illustrative acquisitions on key financial metrics

Net additions to portfolio (£000s unless stated otherwise)	50,000	100,000	150,000
2018e EPRA earnings	26,802	26,802	26,802
Pro forma 2018e earnings	26,802	26,802	26,802
Earnings enhancement	29,683	32,563	35,444
2018e EPRA EPS	11%	21%	32%
Pro forma 2018e EPRA EPS	8.9	8.9	8.9
EPS enhancement/(dilution)	9.0	9.0	9.0
2018e DPS	0%	1%	1%
Dividend cover (EPRA EPS/DPS)	8.4	8.4	8.4
Pro forma dividend cover	1.07	1.07	1.07
2018e EPRA NAV per share	1.07	1.08	1.08
Pro forma 2018e EPRA NAV per share	116.8	116.8	116.8
NAV enhancement/(dilution)	115.7	114.8	114.0
2018e LTV	-1%	-2%	-2%
Pro forma Group LTV	46.4%	46.4%	46.4%

Source: Edison Investment Research

Valuation and returns

RGL is targeting a total return of 10-15% pa with a strong focus on income, but with additional capital appreciation driven by specific asset management initiatives within the portfolio. Fully covered dividends totalling 7.65p were declared in 2016, comprising three quarterly dividends of 1.75p and a final dividend of 2.4p, in line with a stated commitment of providing a 7-8% yield on the 100p price at which the shares were first issued. For the first and second quarters of 2017, dividends of 1.8p per share have been declared, a 2.9% increase y-o-y, and our forecast full year dividend per share of 7.85p represents a 2.6% increase for the year.

The annualised total return on EPRA NAV (NAV TR) from the November IPO to H117 is an annualised 12.1% before the one-off IPO costs and 10.7% after. The H117 NAV TR was 4.4% and our estimates imply a 9.1% NAV TR for the discrete 2017 year as a whole, including an assumption for full year valuation movements based on the impact of expected H2 letting activity on the externally provided portfolio valuation, which may prove conservative. For 2018, our estimates imply an increase in NAV TR to 13.7%.

Turning to a comparison with REIT peers, RGL continues to offer a prospective yield that is well above the peer group average (Exhibit 10) and yet its price to EPRA NAV ratio remains broadly in the middle of the peer group (Exhibit 11). This would appear to be an attractive combination given the medium-term prospects for regional commercial property, RGL's diverse and high-yielding portfolio and its potential for capital growth from continued asset management. This would be especially the case if RGL can successfully manage down its current overall group gearing while avoiding dilution of returns, capturing scale economies to offset lower marginal gearing on acquisitions as illustrated above.

Exhibit 10: UK REITs by prospective dividend yield

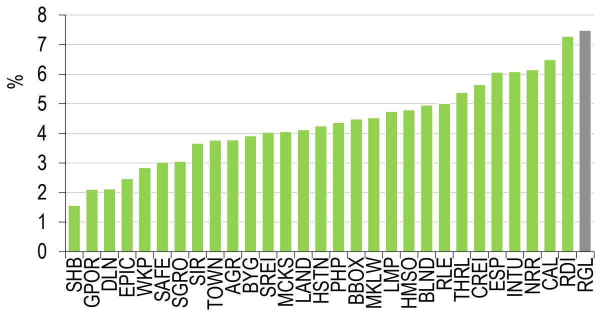
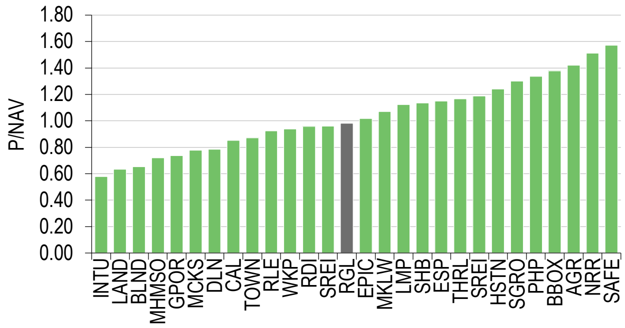


Exhibit 11: UK REITs by P/NAV



Source: Bloomberg, data as at 3 October 2017

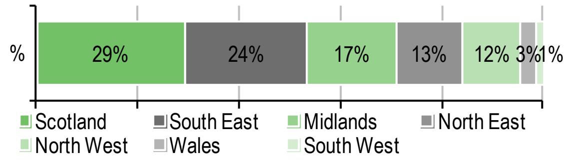
Sensitivities

- Sector risk: property is a cyclical sector. RGL mitigates this inherent cyclical risk by having a large diversified portfolio, with multiple tenants, and property-specific asset management plans to increase occupancy.
- Macro risk: the main risk is the wider economy. The outlook for the UK is for continued growth, but the Bank of England has recently reduced its forecasts for GDP growth for this year and next, citing headwinds in the run-up to Brexit. For 2017 its forecast reduced to 1.7% from 1.9% and for 2018 it now expects 1.6%, down from 1.7%. A slight slowdown to 1.6% and 1.7% is then expected in 2018 and 2019. The change in forecast comes after the Office for National Statistics reported disappointing Q2 GDP growth of 0.3%.
- Inflation and interest rates are a risk for the sector. With inflation already rising, partly due to sterling depreciation and rising oil prices, the prospect of higher interest rates becomes more imminent. RGL has a policy of hedging at least 90% of its interest rate exposure using interest rate derivatives and fixed-rate facilities. At H117 90.9% of outstanding debt was either fixed rate or hedged. Rising interest rates would therefore have little impact on cash earnings, although a knock-on effect on NAV is likely, as yields increase.
- Management risk: RGL is externally managed, with both the asset management and investment management contracts in place for an initial five years from the November 2015 IPO, at which point 12 months' notice may be given. Although Stephen Inglis, the property investment director and chief investment officer of the asset manager, LSI, is significantly involved in the management of the RGL portfolio, we note that LSI is backed by an experienced and growing team.

Exhibit 12: Financial summary

Year end 31 December	£000s	2015	2016	2017e	2018e
PROFIT & LOSS		**IFRS**	**IFRS**	**IFRS**	**IFRS**
Gross rental income		5,361	42,994	51,042	55,388
Non-recoverable property costs		(754)	(4,866)	(6,370)	(5,580)
Revenue		4,608	38,128	44,672	49,808
Administrative expenses (excluding performance fees)		(1,353)	(7,968)	(8,586)	(9,465)
EBITDA		3,255	30,160	36,086	40,344
Gain on disposal of investment properties		87	518	(41)	0
Change in fair value of investment properties		23,784	(6,751)	9,938	22,839
Operating profit before financing costs		27,126	23,927	45,982	63,183
Performance fees		0	(249)	(1,986)	(1,632)
Exceptional items		(5,296)	0	0	0
Finance income		177	193	207	120
Finance expense		(997)	(8,822)	(12,687)	(13,661)
Net movement in the fair value of derivative financial investments and impairment of goodwill		115	(1,654)	168	0
Profit Before Tax		21,124	13,395	31,684	48,010
Tax		0	23	(11)	0
Profit After Tax (FRS 3)		21,124	13,418	31,673	48,010
Adjusted for the following:					
Performance fees		0	249	1,986	1,632
Exceptional items		5,296	0	0	0
Net gain/(loss) on revaluation		(23,784)	6,751	(9,938)	(22,839)
Net movement in the fair value of derivative financial investments		(180)	865	(447)	0
Gain on disposal of investment properties		(86)	(518)	41	0
Profit before Tax (norm)		2,371	20,765	23,315	26,802
Period end number of shares (m)		274.2	274.2	300.5	300.5
Average Number of Shares Outstanding (m)		274.2	274.4	294.6	300.5
Fully diluted average number of shares outstanding (m)		274.2	274.4	294.6	300.5
IFRS EPS - fully diluted (p)		7.7	4.9	10.8	16.0
EPRA EPS – adjusted (p)		0.9	7.8	7.9	8.9
EPRA EPS (p)		(1.1)	7.7	7.2	8.4
Dividend per share (p) - declared basis		1.00	7.65	7.85	8.35
Dividend cover		N/M	102%	101%	107%
BALANCE SHEET					
Non-current assets		407,492	506,401	658,805	689,644
Investment properties		403,703	502,425	655,338	686,177
Other non-current assets		3,790	3,976	3,467	3,467
Current Assets		35,803	27,574	37,035	34,527
Trade and other receivables		11,848	11,375	14,039	14,573
Cash and equivalents		23,954	16,199	22,996	19,954
Current Liabilities		(21,485)	(23,285)	(34,360)	(35,317)
Trade and other payables		(12,576)	(14,601)	(20,736)	(21,218)
Bank and loan borrowings - current		(200)	0	0	0
Other current liabilities		(8,709)	(8,684)	(13,623)	(14,100)
Non-current liabilities		(126,469)	(218,955)	(334,803)	(338,661)
Bank borrowings		(126,469)	(217,442)	(296,448)	(297,686)
Zero dividend preference shares (ZDPs)		0	0	(37,320)	(39,940)
Other non-current liabilities		0	(1,513)	(1,035)	(1,035)
Net Assets		295,341	291,735	326,677	350,193
Derivative interest rate swaps		416	1,513	963	963
EPRA net assets		295,757	293,248	327,640	351,156
IFRS NAV per share (p)		107.7	106.4	108.7	116.5
Fully diluted EPRA NAV per share (p)		107.8	106.9	108.8	116.6
LTV		-5.9%	40.6%	47.8%	46.4%
CASH FLOW					
Cash (used in)/generated from operations		(2,232)	31,434	37,794	39,136
Net finance expense		(424)	(6,626)	(8,892)	(9,683)
Tax paid		0	(1,715)	51	0
Net cash flow from operations		(2,656)	23,093	28,953	29,453
Net investment in investment properties		1,157	(99,286)	(13,400)	(8,000)
Acquisition of subsidiaries, net of cash acquired		26,659	(5,573)	209	0
Other investing activity		13	60	8	0
Net cash flow from investing activities		27,828	(104,799)	(13,183)	(8,000)
Equity dividends paid		0	(15,723)	(17,834)	(24,494)
Bank debt drawn/(repaid)		(1,217)	91,417	9,265	0
Other financing activity		0	(1,744)	(404)	0
Net cash flow from financing activity		(1,217)	73,950	(8,973)	(24,494)
Net Cash Flow		23,955	(7,756)	6,797	(3,041)
Opening cash		0	23,955	16,199	22,996
Closing cash		**23,955**	**16,199**	**22,996**	**19,954**
Closing debt		(126,669)	(217,442)	(333,768)	(337,626)
Closing net debt		(102,714)	(201,243)	(310,772)	(317,672)

Source: Company data, Edison Investment Research

Contact details	Annualised net rental income by UK region as at 30 June 2017
Toscafund Asset Management LLP 7th Floor, 90 Long Acre London WC2E9RA +44 (0) 207 845 6100 www.regionalreit.com	

The board

Chairman Regional REIT: Kevin McGrath

Kevin McGrath is a chartered surveyor with 30 years of property experience. He is a member of the Royal Institute of Chartered Surveyors, the Investment Property Forum, the Worshipful Company of Chartered Surveyors, and he is a Freeman of the City of London. He is chairman of M&M Property Asset Management. Prior roles include managing director and senior adviser of F&C REIT Asset Management, founding equity partner in REIT Asset Management, and senior investment surveyor with Hermes Investment Management.

Independent NED & senior independent director: William Eason

Bill Eason is Director of Charities at Quilter Cheviot. He has been managing diversified high net worth portfolios since 1973, and became a member of the London Stock Exchange in 1976. He was chief investment officer at Laing & Cruickshank Investment Management, and a former chairman of Henderson High Income Trust. He is currently a director of Henderson International Income Trust and The European Investment Trust, an associate of the Society of Investment Professionals and a fellow of the Chartered Institute for Securities and Investment.

Asset Manager rep. (London & Scottish Investments): Stephen Inglis

Stephen Inglis is group property director and chief investment officer of the asset manager London & Scottish Investments (LSI), and serves as a NED on the board of Regional REIT. He has 25 years' experience in the property market. Since joining LSI in 2013, where he has responsibility for all property functions, he has acquired or sold more than 150 properties in deals valued at more than £350m. He was heavily involved in the setting up and equity raising for Tosca Property Fund 1, and was instrumental in the equity raising for Tosca Property Fund II.

Independent NED: Daniel Taylor

Dan Taylor is the founder and CEO of Westchester Capital, an investment and advisory firm specialising in real estate. From 2011 to 2015 he was chairman and a principal shareholder of AIM-listed Avanta Serviced Office Group, the UK's second largest serviced office provider until the sale of the business to Regus. Over his career Dan has held both executive and non-executive directorships for various private and listed companies and has extensive experience in investment management, corporate finance and corporate governance.

Independent NED: Tim Bee

Tim Bee joined the board as a NED in place of Martin McKay on 7 July 2017. He is the chief legal counsel of Toscafund Asset Management LLP. Tim joined Toscafund in May 2014, having previously been a corporate partner at two leading London-based law firms. He qualified as a solicitor in 1988 and has extensive experience in mergers and acquisitions, equity capital markets and financial services.

Principal shareholders	(%)
Toscafund (notified 11 July 2017)	9.04%
The Conygar Investment Company (certified 20 September 2017)	8.76%
Old Mutual (notified 16 December 2016)	5.76%

Companies named in this report

Assura (AGR), Big Yellow (BYG), British Land (BLND), Capital & Regional (CAL), Custodian REIT (CREI), Derwent London (DLN), Ediston (EPIC), Empiric Student Property (ESP), Great Portland Estates (GPOR), Hammerson (HMSO), Hansteen (HSTN), Land Securities (LAND), Londonmetric (LMP), McKay Securities (MCKS), Mucklow (MKLW), NewRiver Retail (NRR), Primary Health Properties (PHP), Real Estate Investors (RLE), Redefine (RDI), Safestore (SAFE), Schroder REIT (SREI), Segro (SGRO), Shaftesbury (SHB), Town Centre Securities (TOWN), Tritax Big Box (BBOX), Workspace (WKP).

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