

Rural Funds Group (ASX:RFF)

The domestic listed REIT space heats up

29 May 2018

Market commentators believe that the recent A\$33bn scrip-and-cash takeover of Westfield Corp (ASX:WFD) - the largest takeover in Australia's corporate history - is likely to impact other stocks listed in the domestic REIT sector. The question is how much of the A\$7bn cash component of the consideration - paid to WFD investors on 7 June - will find its way back into the market? Factoring in the proportion of global investors on the Westfield register who will simply repatriate their cash component and investors who take some profits off the table, analysts estimate that between A\$1.5bn-A\$2bn could be left to reinvest. Predicated on investors maintaining asset allocation, the bulk of this could flow into the domestic listed REIT space. While REIT plays with offshore retail exposure (mirroring WFD) such as Goodman Group (ASX:GMG) and Lendlease Group (ASX:LLC) are likely to be the main beneficiaries, we suggest that non-retail REIT plays - like Rural Funds Group - could also benefit from the overall investment reallocation process.

On 29 May, US fund manager Blackstone announced a \$3.1bn bid to buy out commercial property investor Investa Office Fund (ASX:IOF). Although, one tenth the size of the Westfield deal, the delisting of Investa will result in additional cash looking for a new home in the domestic REIT space.

RFF's A\$15.7m acquisition in May 2018 of a 7,600ha cattle property in central Queensland falls into the group's strategy of identifying investment opportunities in Australia's fragmented and capital constrained agricultural sector. With some A\$60m remaining in available debt facilities (following the recent debt-funded acquisition), RFF is well positioned, we believe, to take advantage of additional acquisition and development opportunities over the medium-to-long term.

Target price: A\$2.21ps (unchanged). Recommendation: Hold

We have kept our full-year earnings forecast unchanged and maintain our 50:50 weighted dividend discount model (DDM) and price-to-book (P/B) valuation at A\$2.21ps. At current share price levels of A\$2.12, RFF offers some 4% upside potential. Including a one-year rolling dividend yield of 5%, we calculate RFF offers a total one-year return of 9%. We maintain a Hold (Medium Risk) recommendation

Key Financials

Year-end June	FY17A	FY18E	FY19E	FY20E	FY21E
Adjusted income generating assets - average (A\$m)	469	627	703	747	788
Rental income as %	8.5%	8.0%	8.0%	8.0%	8.0%
Rental income (A\$m)	39.8	49.9	56.0	59.5	62.8
Plant & Equip rental (A\$m)	1.80	1.80	1.89	1.98	2.08
Revenue (A\$m)	41.6	51.7	57.9	61.5	64.8
Reported profit (A\$m)	43.3	43.9	61.0	53.2	53.5
AFFO (A\$m)	25.6	32.9	37.6	40.1	42.5
EPS Reported (A\$c)	17.0	17.2	23.9	20.9	21.0
AFFO per share (A\$c)	12.5	12.9	14.7	15.7	16.7
DPS (A\$c)	9.6	10.0	10.4	10.8	11.3
Dividend yield (%)	4.5%	4.7%	4.9%	5.1%	5.3%
PE on AFFO (x)	17.0	16.5	14.5	13.5	12.8
Net (debt) / cash (A\$m)	(164)	(268)	(274)	(289)	(300)
Capex (A\$m)	(162)	(95)	(17)	(25)	(20)

Source: IRESS, Company Data, State One Stockbroking. Share price: \$ 2.130 May 29, 2018

Share Price: A\$2.13

Target Price: A\$2.21

Recommendation
Hold

Risk Assessment
Medium

REIT - Agriculture

David Brennan, CFA

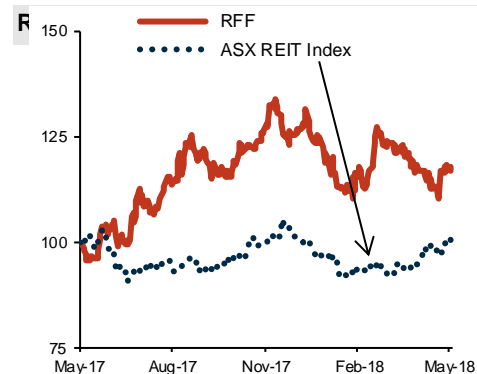
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Rural Funds Group

ASX Code	RFF
52-week range (A\$)	1.74-2.45
Fully diluted Market Cap (A\$m)	547
Fully diluted no. of shares (m)	256
Av Daily Turnover (shares)	464k
ASX All Ordinaries	6,132
FY18E BV per share (A\$)	1.47
FY18E AFFO per share (A\$c)	12.9c
FY18E Net (Debt)/Cash (A\$m)	(268)



Source: Iress



Financial Statements

Rural Funds Group

Year ending June

Profit & Loss Statement (A\$M)	FY17A	FY18E	FY19E	FY20E	FY21E
Revenue	41.6	51.7	57.9	61.5	64.8
Raw materials / rental / lease	(4.4)	(5.4)	(6.0)	(6.3)	(6.6)
Employee	(1.5)	(1.8)	(2.1)	(2.2)	(2.3)
Other	(2.5)	(3.1)	(3.4)	(3.5)	(3.6)
EBITDA	33.2	41.4	46.5	49.5	52.3
Depreciation & Amortisation	(1.6)	(2.2)	(2.2)	(2.3)	(2.3)
Operating profit	31.6	39.2	44.2	47.2	50.0
Asset fair value adjustments	20.0	14.3	27.3	18.1	19.2
EBIT	51.7	53.5	71.5	65.3	69.2
Interest income+ investment income	1.4	1.4	1.4	1.4	1.4
Interest expense	(7.9)	(9.9)	(10.3)	(10.7)	(11.2)
Tax expense	(1.8)	(1.1)	(1.6)	(2.8)	(5.9)
Reported NPAT	43.3	43.9	61.0	53.2	53.5
Adjusted FFO	25.6	32.9	37.6	40.1	42.5
EBITDA Margin (%)	80%	80%	80%	80%	81%
Operating profit margin (%)	76%	76%	76%	77%	77%
Reported EPS (A\$C)	17.0	17.2	23.9	20.9	21.0
AFFO per share (A\$C)	12.5	12.9	14.7	15.7	16.7
AFFO payout ratio (%)	77%	78%	71%	69%	68%
DPS - Declared (A\$C)	9.6	10.0	10.4	10.8	11.3
Avg. no. of fully-diluted shares (m)	205	255	255	255	255
YE no. of fully-diluted shares (m)	255	255	255	255	255

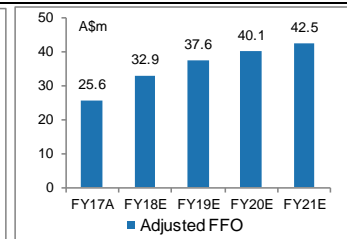
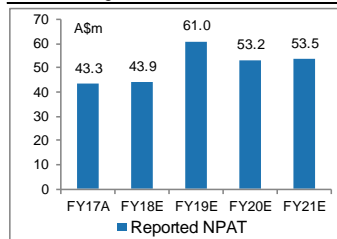
Cash Flow Statement (A\$M)	FY17A	FY18E	FY19E	FY20E	FY21E
EBITDA	33.2	41.4	46.5	49.5	52.3
Investment in working capital	4.0	0.1	0.7	0.7	0.8
Tax expense	(0.7)	(1.1)	(1.6)	(2.8)	(5.9)
Operating Cash Flow	36.5	40.4	45.6	47.4	47.1
Capex	(162.3)	(95.2)	(16.5)	(25.2)	(20.0)
Other investments	(4.8)	(15.0)	0.0	0.0	0.0
Investing Cash Flow	(167.1)	(110.2)	(16.5)	(25.2)	(20.0)
Net interest received / (paid)	(6.5)	(8.5)	(8.9)	(9.3)	(9.8)
Debt draw down / (repayment)	18.2	105.0	6.0	15.0	11.0
Dividends	(24.6)	(25.6)	(26.6)	(27.6)	(28.8)
Equity raised / (repaid)	142.1	0.0	0.0	0.0	0.0
Financing Cash Flow	129.2	70.9	(29.5)	(22.0)	(27.5)
Non-operating & Other	2.2	0.0	0.0	0.0	0.0
Inc/(Dec) in Cash	0.8	1.1	(0.4)	0.2	(0.4)

Balance Sheet (A\$M)	FY17A	FY18E	FY19E	FY20E	FY21E
Cash & Equivalents	3.8	5.0	4.6	4.8	4.3
Receivables	4.6	5.7	5.8	5.6	5.2
Inventories	0.0	0.0	0.0	0.0	0.0
Other Current Assets	1.8	1.8	1.8	1.8	1.8
Property / bearer plants/ water rights	504	611	653	694	730
Deferred tax asset	0.0	0.0	0.0	0.0	0.0
Other Non Current Assets	29	44	44	44	44
Total Assets	543	668	709	750	786
Payables and other current Liabilities	11.5	12.8	13.5	14.0	14.4
Short Term Debt	3.2	3.2	3.2	3.2	3.2
Long Term Debt	165	270	276	291	302
Other Non Current Liabilities	6.1	6.1	6.1	6.1	6.1
Total Liabilities	185	292	298	314	325
Total Equity	358	376	410	436	461
Net Cash/(Debt)	(164)	(268)	(274)	(289)	(300)

Substantial Shareholders	%	Date
JP Morgan Nominees	15.3	
HSBC Custody Nominees (Australia)	7.6	Sep-17
Netwealth Investments Ltd	5.8	

Source: Company, IRESS, State One Stockbroking forecasts

Asset calculation (A\$m)	FY17A	FY18E	FY19E	FY20E	FY21E
Adjusted income generating assets - beginning of year	366	572	682	725	769
Additions	93	42	17	25	20
Acquisitions	64	53	-	-	-
Fair value adjustments	49	14	27	18	19
Adjusted income generating assets - end of year	572	682	725	769	808
Fair value adjustments as % prior year asset value	n/c	2.5%	4.0%	2.5%	2.5%
<i>Note: Asset values pre-depreciation. Includes property/plants/water rights/financial assets</i>					
Revenue calculation (A\$m)	FY17A	FY18E	FY19E	FY20E	FY21E
Average asset base	469	627	703	747	788
Effective rental income as % average asset base	8.5%	8.0%	8.0%	8.0%	8.0%
Rental income	39.8	49.9	56.0	59.5	62.8
Plant & equipment rental	1.8	1.8	1.9	2.0	2.1
Total rent / revenue	41.6	51.7	57.9	61.5	64.8
YoY % change in revenue	nm	24.4%	12.0%	6.2%	5.5%



Leverage	FY17A	FY18E	FY19E	FY20E	FY21E
Net Debt/Equity	46%	71%	67%	66%	65%
Gearing (ND/ND+E)	30%	40%	39%	39%	38%
Interest Cover on EBITDA (x)	5.1	4.9	5.2	5.3	5.3
Debt as % Total assets	31%	41%	39%	39%	39%
=> room to max loan to value ratio	19%	9%	11%	11%	11%

Valuation Multiples (x)	FY17A	FY18E	FY19E	FY20E	FY21E
P/E on reported earnings	12.5	12.4	8.9	10.2	10.2
P/E on AFFO	17.0	16.5	14.5	13.5	12.8
Price/OP Cash Flow	14.9	13.4	11.9	11.5	11.5
EV/EBITDA	21.4	19.7	17.7	16.9	16.2

Book value per share	FY17A	FY18E	FY19E	FY20E	FY21E
Book value per share (A\$C)	1.40	1.47	1.61	1.71	1.81
Price / book value multiple (x)	1.52	1.44	1.32	1.25	1.18

Return on Equity and Assets	FY17A	FY18E	FY19E	FY20E	FY21E
AFFO ROE (%)	7.2%	8.7%	9.2%	9.2%	9.2%
AFFO ROA (%)	4.7%	4.9%	5.3%	5.4%	5.4%
Reported profit ROE (%)	12.1%	11.7%	14.9%	12.2%	11.6%
Reported profit ROA (%)	8.0%	6.6%	8.6%	7.1%	6.8%

Dividends	FY17A	FY18E	FY19E	FY20E	FY21E
Annual % change in DPS	-	4.0%	4.0%	4.0%	4.0%
Dividend yield (%)	4.5%	4.7%	4.9%	5.1%	5.3%

Weighted Target Price					
Valuation method	Target (A\$)	Weighting (%)	Share price (A\$)		Capital gain (%)
			Target	Current	
DDM	2.01	50%	2.01	2.13	4%
P/B multiple	2.00	50%	2.01		
New acquisitions / additions upside (10%)			0.20		
Total			2.21		

Target price and recommendation

Attaching a 50% weighting to our DDM and P/B multiple valuations, we calculate a target value for RFF of A\$2.01ps. Because of the lack of visibility on the timing or quantum of acquisitions, we have not factored in new acquisitions beyond the current financial year (FY18E). However – as illustrated in the slide below - RFF believe that there are numerous acquisition opportunities in the Australian agricultural sector. As a result, we suggest that our forecast revenue / rent stream and asset profile is understated. To compensate for this, we escalate our DDM/PB valuation by 10% to A\$2.21ps. At current share price levels, we believe that RFF offers some 4% upside potential.

Target price:

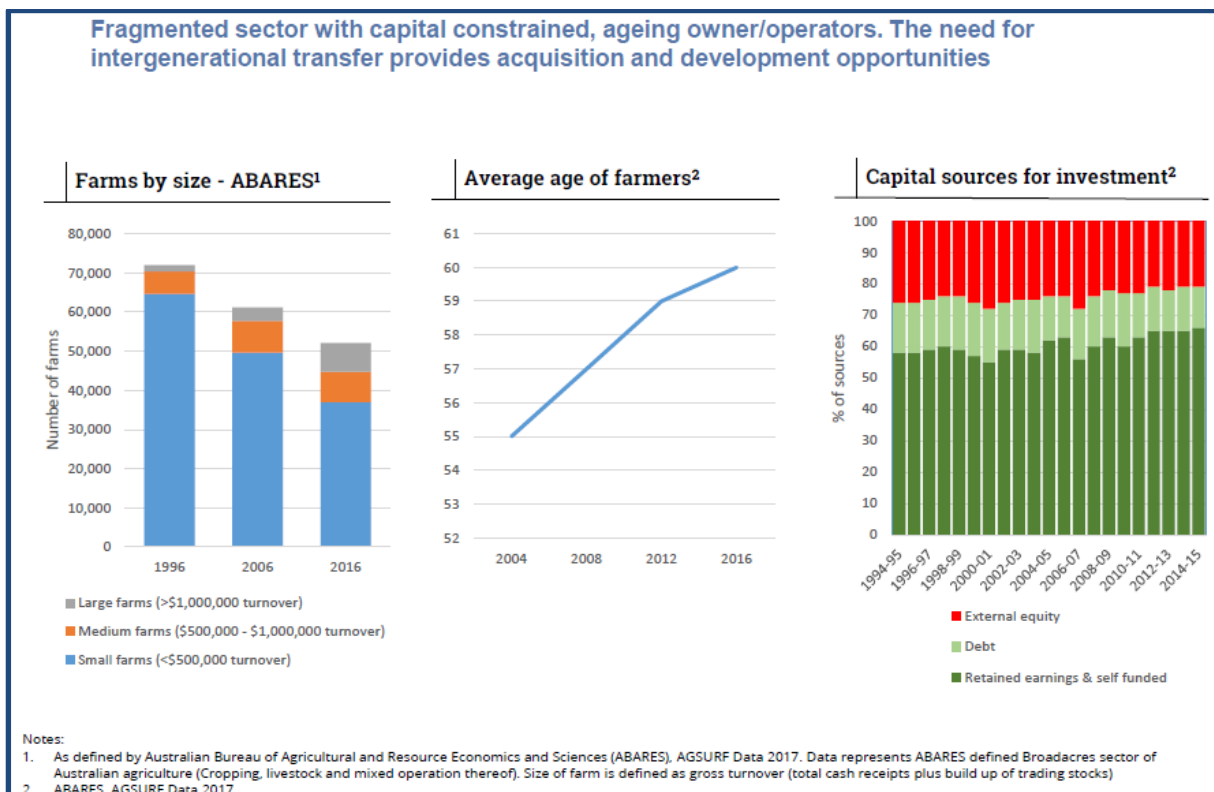
A\$2.21 per share

Figure 1: Target price calculation

Valuation method	Target value (A\$)	Weighting (%)	Target price (A\$)	Current share price (A\$)	Capital gain / (loss)
DDM	2.01	50%	2.01	2.13	4%
P/B multiple	2.00	50%			
New acquisitions / additions upside (10%)			0.20		
Total			2.21		

Source: IRESS, State One Stockbroking forecasts

Figure 2: Acquisition environment



Source: Company (November 2017 presentation)

Recommendation and risks

At current share price levels, we calculate that RFF offers some 9% total return (incl. a one-year rolling dividend yield of 5%)

Recommendation: Hold (Medium risk)

Risks to our earnings profile and target price include, but are not limited to:

- **Counterparty:** All land and infrastructure assets owned by RFF are leased and as such Unitholders are not directly exposed to agricultural operational risk. There is a risk that a counterparty may default on its financial or operational lease obligations to RFF. RFF has several lessees, with the largest lessee (with ~25% of group rental income) being RFM Poultry.
- **Timing of productivity capex:** Some 80% of capex over the next three years is allocated to the development of the 2,500ha Kerarbury almond orchard (lessee Olam Orchards). Project development delays may result in a reduction or deferral of rent received.
- **Suspension event:** Suspension events for all chicken growing contracts include: act of God, epidemics / diseases, fires, industrial disputes, livestock husbandry issues, chicken meat importation. A suspension event if triggered could lead to the suspension of payments to RFM Poultry from Bartter Enterprises.
- **Acquisition risk:** There is no guarantee that RFM will be able to acquire additional acquisitions in the future.
- **Gearing and refinancing:** RFF maintains a gearing range of 30%-40%. RFF has secured a debt facility limit of up to A\$250m to end 2019. Beyond this, there is the risk that the debt providers (Rabobank, ANZ) could reduce the gearing limit. Depending on underlying asset value momentum, this may require RFF to sell assets and/or reduce or suspend distributions to retire debt.
- **Asset valuations:** The asset value (and associated rental income) of RFF's land, water, and infrastructure assets may rise or fall due to general economic conditions, local and global agricultural conditions, demand for end-market products (i.e., chicken meat, beef, almonds, wine), and changes in discount rates / independent valuation methodologies.
- **Water entitlements:** Lease terms with Treasury Wines, RFM Almonds, and Olam require the supply of water to vineyards. A reduction in RFF water entitlements may result in higher water costs and/or rent abatements.
- **Distributions:** Our Dividend Discount Model (DDM) valuation is dependent on next year's forecast dividend and a constant 4%pa dividend growth rate. RFF must meet its operating expenses, capital commitments, and debt servicing obligations before distributions can be made to Unitholders. Consequently, distributions may vary.
- **Other:** Destruction or damage of property, property illiquidity, climate risk and climate change risk, environmental management, change in political and regulatory environment, key management / personnel risk.

Recommendation:
 Hold (Medium risk)

Board (Source: Company)



Guy Paynter

Non-Executive
Chairman



Guy Paynter is a former director of broking firm JB Were. Guy brings to RFM more than 30 years of experience in corporate finance. Guy is a former member of the Australian Securities Exchange (ASX) and a former associate of the Securities Institute of Australia (now known as the Financial Services Institute of Australasia). Today, Guy is chair of Bill Peach Group Limited (previously known as Aircruising Australia Limited).



David Bryant

Managing Director



David Bryant established RFM in February 1997 and since that time has led the team that is responsible for the acquisition of large-scale agricultural property assets and associated water entitlements. As of 30 June 2017, RFM manages over \$640 million of agricultural assets.

On a day-to-day level, David is responsible for leading the RFM Executive, maintaining key commercial relationships and sourcing new business opportunities.



Michael Carroll

Non-Executive
Director



Michael Carroll serves in a board and advisory capacity for a range of agribusiness entities. Michael is a Director of Tassall Group Ltd, Select Harvests Limited, Paraway Pastoral Company and Sunny Queen Ltd. Former board positions include the Australian Farm Institute, Warrnambool Cheese and Butter Factory Company Holdings Limited, Queensland Sugar Limited, Rural Finance Corporation of Victoria, the Gardiner Dairy Foundation and Meat and Livestock Australia. Michael's advisory clients include government, major banks, institutional investors, and successful family owned agribusinesses.



Julian Widdup

Non-Executive
Director



Julian Widdup is a former executive of infrastructure investment management companies, Palisade Investment Partners and Access Capital Advisers (now Whitehelm Capital) where he was responsible for the acquisition and asset management of major infrastructure assets, risk management, portfolio construction, institutional client management and overseeing all aspects of investment operations.

Previously Julian had worked with Towers Perrin (now Willis Towers Watson) as an asset consultant, the Australian Bureau of Statistics and the Insurance and Superannuation Commission (now APRA).

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