Grainger 28/02/2013 **FAT-UK-477**

GRI GBP £1.365 Core **MED.** **B**

Britain's biggest listed landlord

Grainger plc offers investors exposure to the strong rental sector in the UK as well as German property. The business also invests in residential assets that it is able to sell when they fall vacant. With a good track record of outperformance and a discount to net asset value per share we initiate Grainger as a buy.

Grainger plc started just over 100 years ago in Newcastle and today owns £2.23bn of residential properties. In terms of value 84% of this is located in the UK with the rest in Germany.

It is a similar picture on the management side with 18,500 UK properties managed and 6,500 in Germany. The group achieves income from three sources which are property sales, rents and fees.

Looking at the trading side of the business and Grainger buys regulated tenancies or retirement properties which it is able to sell when they fall vacant. The group also does some new development with a build to rent scheme recently started.

Grainger's current strategy is to 1) maintain the leading position in residential property 2) locate assets in areas of high economic activity 3) increase the proportion of non-trading income 4) reduce financial and operational gearing.

The investment case is that Grainger's risk profile is falling while future returns are supported by rising rents and a tight housing market. The group also has a history of outperformance within the sector which, in our view, is set to continue.

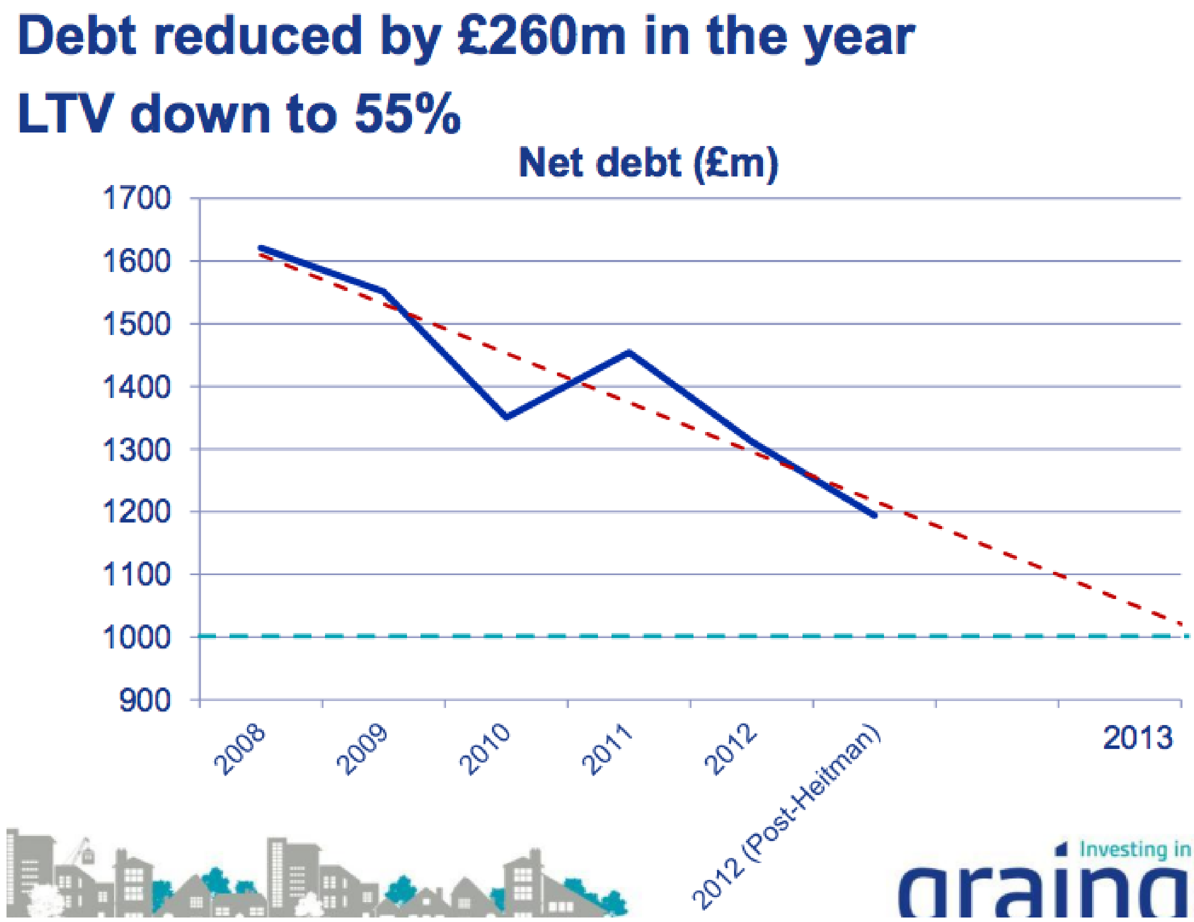
Following the 2008 lows, Grainger's share price has traced out a significant ascending triangle pattern marked by the upward sloping trend line, and horizontal resistance, at 150.58p. With upward momentum building, we believe a re-test of the upper boundary is a strong possibility over the coming months.

Investment Case: Grainger risk profile

The investment case is best explored by looking at the risks the business faces and secondly the return potential. This helps generate an idea of the risk to reward ratio on the stock.

The key risks for Grainger are the availability of debt, debt finance costs and how property values and rents affect loan covenants. On the operational side risks include the resilience of property sales and rents.

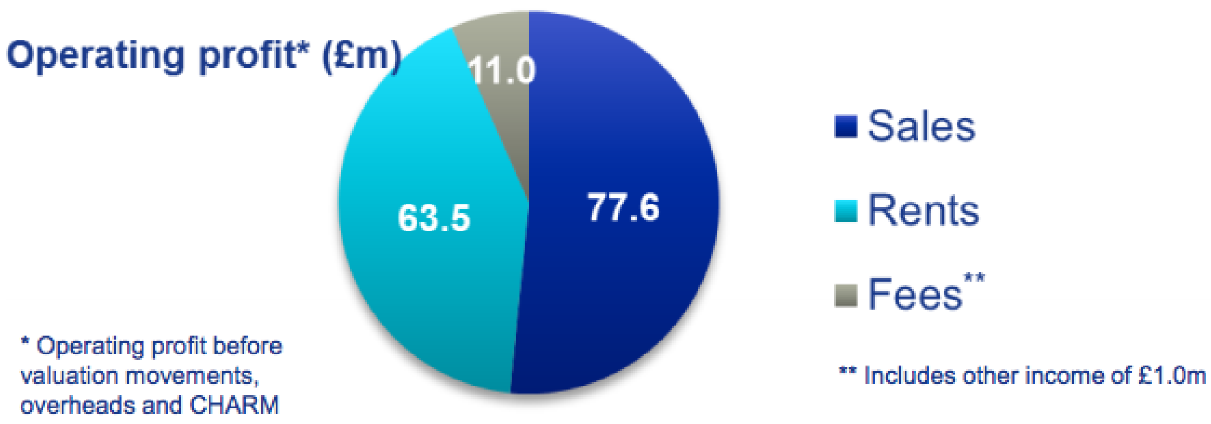
Grainger is focusing on reducing debt to £1bn by the end of 2013 and during the 2012 financial year it fell 18% to £1.2bn (including German assets sold after year end). Similarly the loan to value (LTV ratio fell from 61% to 55% during 2012.



Interest cover on the core facility was 3X at the end of September 12 which compares to an interest covenant of 1.35X. The average cost of debt was 6.1% in 2012 versus 5.4% the year but the interest rate should fall over time.

Meanwhile, the group is focusing on increasing rental assets and its third part property management business. In the 2012 financial year 49% of operating profits came from both areas which compares to 46.5% in 2011.

Grainger 2012 operating profit by area



The group's CEO, Andrew Cunningham, said in 2011 that a long-term shift into a high yielding real estate investment trust is "inevitable". This would mean almost a full shift to lower risk rental properties.

Thus Grainger is becoming less dependent on property sales which makes its profitability more resilient. This is as the below graphic shows that rental income and management fees held up during the downturn while property sales suffered.

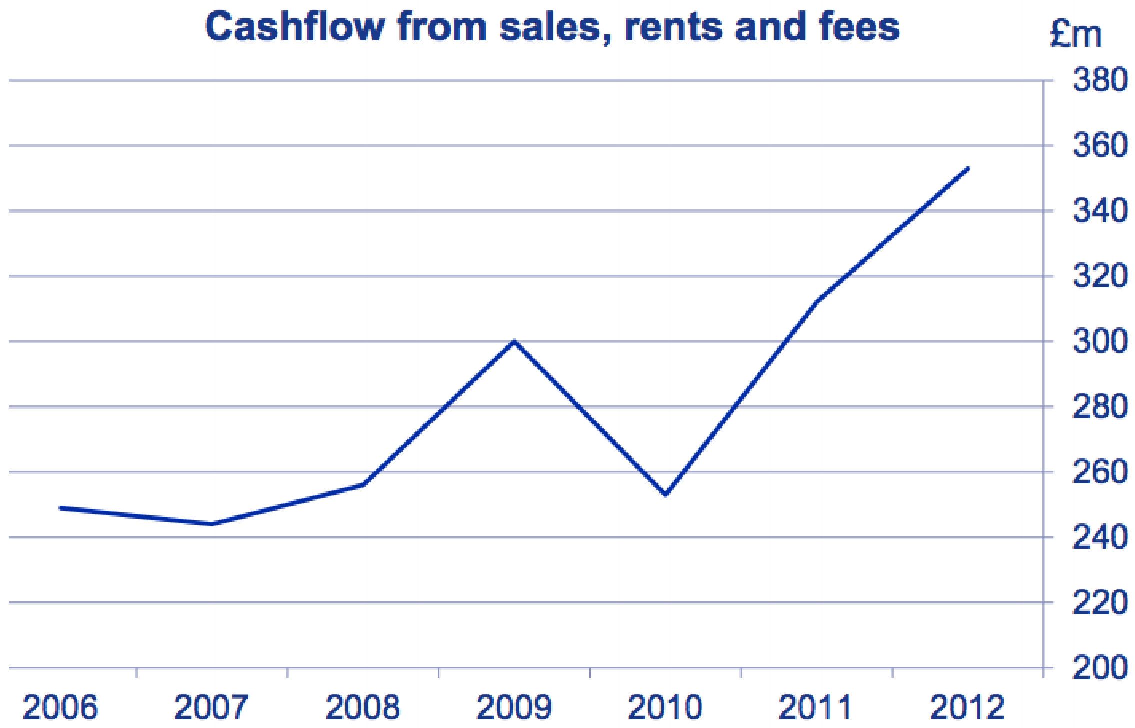
Grainger's 5 year rental income versus property sales

Regular, resilient cash flows £m

Financial years ended 30 September

	2012	2011[1]	2010[2]	2009[3]	2008[4]
Gross rents					
UK residential	58	51	39	41	42
Retirement solutions	5	5	6	6	6
Development	–	1	1	1	1
Germany	27	30	30	30	22
Total	90	87	76	78	71
Property Sales net of sales fees					
UK residential	172	148	118	139	137
Retirement solutions	38	27	29	27	27
Development	18	22	19	46	10
Germany	24	21	4	3	2
Total	252	218	170	215	176
Fees/other income	11	8	7	7	9
Overall total	353	313	253	300	256
Group overheads	(31)	(32)	(29)	(30)	(30)
Net Interest Payable	(91)	(76)	(77)	(79)	(89)

We would also note that cash generated by the business has also been relatively resilient throughout the downturn. The volatile component is clearly property sales but the housing market currently looks set to remain robust in our view.



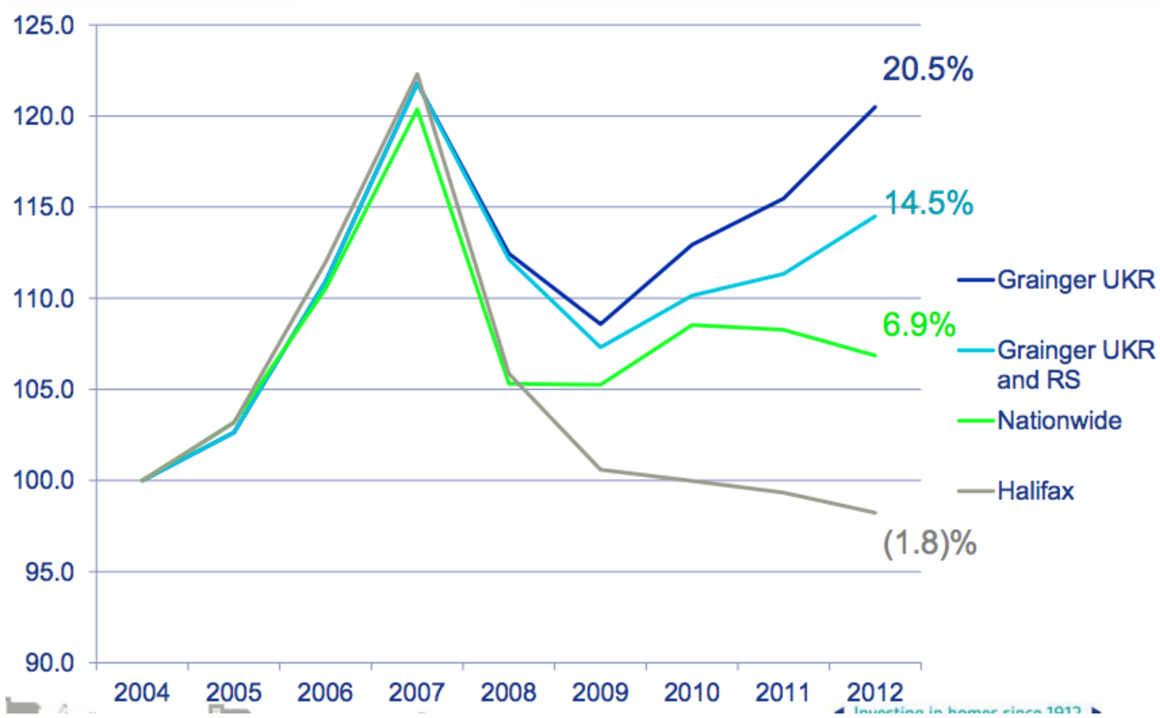
Geographically Grainger has also increased its focus on economically strong areas. Over the last three years the proportion of assets in London and the South East has increased from 54% to 62%.

Thus the level of risk in Grainger's business has fallen and is set to fall further over time. A more conservative approach is clearly warranted as in 2009 Grainger needed to raise £250m to reduce the debt in the business.

Investment case: Grainger return profile

Turning to the return side of the equation and Grainger has a strong history of creating value in the property sector. The below graphic highlights the property outperformance in the key UK market.

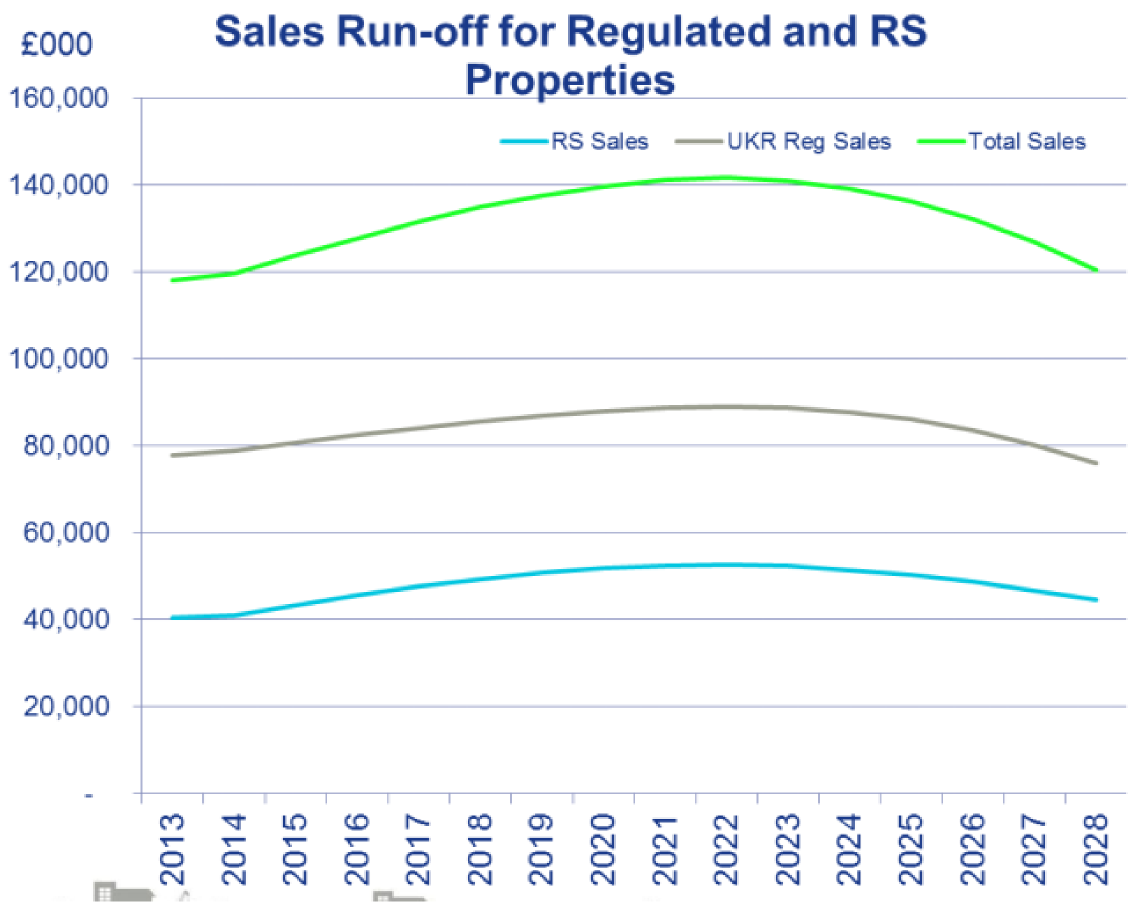
Grainger UK Residential & Retirement Solutions versus the market



On the property sales side Grainger has expertise in an area which other property groups generally don't. Thus it should be able to get good buy prices for regulated tenancy properties and possibly also retirement properties.

These can be given a makeover on becoming vacant for a further uplift in value when sold. Grainger therefore has a profitable niche which takes time to realize value from but is low risk versus outright development.

A further key aspect of the property sales element is that Grainger can roughly forecast when properties will become vacant. As such it has a profile of future sales which is set to increase over the next ten years as illustrated below:



Looking at the rental side and the group is looking to "innovative transactions" to increase its exposure. These include building to rent and creating a registered social landlord which is attractive given that rents can be 80% of market levels.

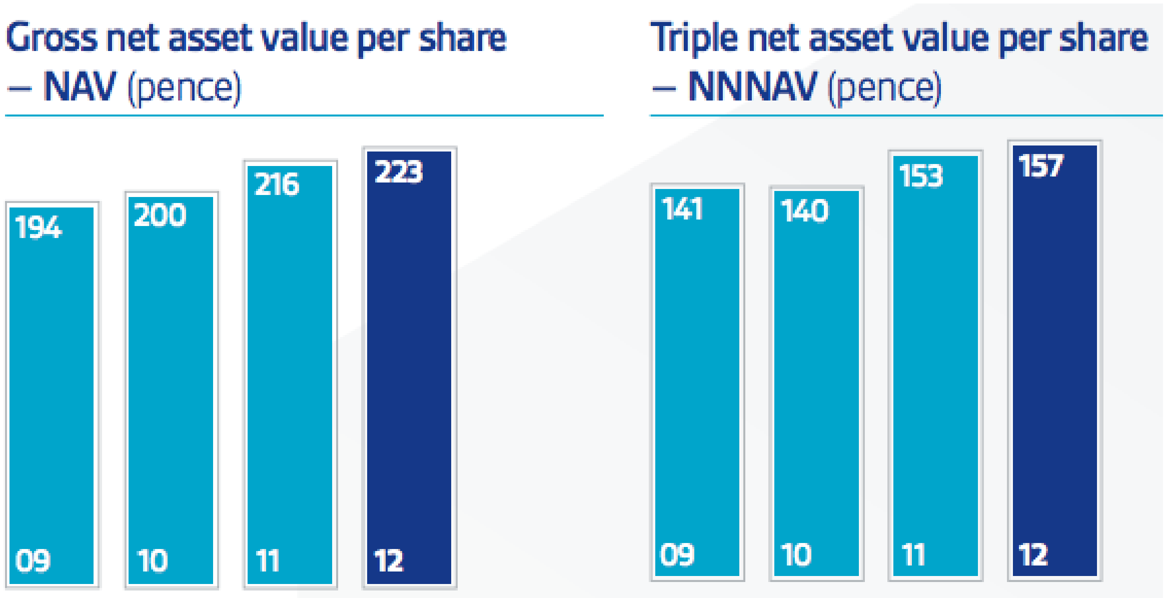
A recent focus has also included boosting the low risk property management side which saw fees rise by 45% to £10m in the 2012 financial year. The group points to "continuing demand from new high quality players".

Looking at the overall gross net asset value (NAV) and this has increased in each of the last three years with a 3.2% rise in 2012. Since 2009 the gross net asset value is up 15% from 194p to 223p per share.

The gross NAV uses property estimated at market value and adds back deferred tax on property valuations and derivatives. By way of illustration the NNNAV includes the contingent tax on the property uplift and deferred tax.

Clearly Grainger stands at a discount to both figures and has been increasing its net asset value successfully over time. We view the discount to assets and history of value creation in the property field as providing a good return profile.

Asset value as of the year-end of September



We would also note that Grainger tests the value of its assets, in contrast to some other property companies, with continued property sales. Typically the sales value also exceeds the book value by as much as 6%.

Trading update.

Since announcing the financial results for the year to 30th September Grainger has given a trading update for the four months to the 31st January. This has shown completed sales up to £64.6m from £62.4m last year.

Of this figure £32.4m was from 201 vacant UK sales at a margin of 41.1% which was up on the 39.9% of last year. Tenanted and other sales came in at £26.6m with sale values above book value.

Fee income has continued to gain strongly with £4.6m seen in the period which compares to £2.9m last year. However, rental income fell to £27.3m from £30.4m due to a disposal in part of Grainger's German assets.

On 9th November Grainger sold 75% of its ownership in a German rented residential portfolio (the Hietnam sale). The rationale is to make more efficient use of the balance sheet while continuing to manage the underlying assets.

Summary and valuation

Grainger increased its dividend in the last financial year by 4.9% to 1.92p which is an historic yield of only 1.4%. This is as much of the group's capital is tied up in retirement reversions and regulated tenancies which generate little income.

However, when net debt reaches £1bn at the end of 2013 the dividend policy is likely to be reviewed. The forecast yield for the current year is nearly 1.5% while the group's market value comes in at £560m.

In our view, Grainger is attractive as its trading business has a low risk way of adding value. This is by purchasing regulated tenancies and retirement assets and then selling, after refurbishment, when they become vacant.

The rental side also provides the future strategic direction and as such the dividend income will increase over time. Lastly, the business looks set to growth its management arm which provides a less capital intensive way to grow profits.

Thus Grainger is an attractive long-term risk/reward play on the UK residential sector which is seeing strong demand. The stock is likely to be a slow burner but should re-rate overtime as the group's focus shifts to rentals.

Accordingly, we recommend Grainger as a buy for all members. The shares are somewhat illiquid and so buying a position is appropriate.

Snapshot GRI

Grainger

Grainger plc is a holding company operating in five segments: UK residential, Retirement solutions, Fund and third party management, UK and European development; and German residential. The UK residential business primarily consists of properties subject to a regulated tenancy. Grainger is the UK's largest listed landlord managing 18,500 properties in the UK as of September 12. The three income streams for Grainger are property sales, rents and management fees.

Market Capitalisation:£450m

	FY1	FY2

Price to Earnings	22.7	20.4
Dividend Yield (%)	1.5	1.6
Price to Book	0.6	0.7
Return on Equity (%)	12.9	