Progressive EQUITY RESEARCH

WATKIN JONES

HOME CONSTRUCTION

13 October 2022

WJG.L

80.1p

Market Cap: £205.2m

SHARE PRICE (p)

12m high/low	277p/83p

Source: LSE Data (priced as at prior close)

KEY DATA

Net (Debt)/Cash	£75.0m *(at 30/09/22)*
Enterprise value	£130.2m
Index/market	AIM
Next news	FY results, Jan 2023
Shares in Issue (m)	256.2
Chairman	Alan Giddins
CEO	Richard Simpson
CFO	Sarah Sergeant

COMPANY DESCRIPTION

Watkin Jones develops large-scale residential-for-rent properties in the build-to-rent & student accommodation markets.

www.watkinjones.com

WATKIN JONES IS A RESEARCH CLIENT OF PROGRESSIVE

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RICS survey highlights strong rental market

Today's RICS housing market survey, in our view, paints a much brighter picture of Watkin Jones's rental sector than that in the sales market. Surveyors expect strong growth in rents to continue, driven by strong tenant demand and constricted supply. We believe that part of the reason for the arguably excessive reaction of the share price to last week's trading update may be the weakness of the national housebuilders, but they operate in the currently more challenged sales market.

- **Stronger rental market data.** The monthly RICS Residential Market Survey is widely view as among the best leading indicators of trends in the sales market. The quarterly lettings report, out this morning (see over), shows that a +36% 'balance' of agents (% seeing a rise less those seeing a fall) reported rising tenant demand in Q3. Meanwhile, new landlord instructions continued their five-year-long decline. This widening imbalance led to a +57% balance expecting rents to rise further over the next three months. The monthly sales survey shows -36% and -18% balances for the equivalents of buyer enquiries and price expectations.

- **Higher funding costs.** WJG's share price has fallen by 47% since the 4 October FY22E trading update (see Strong rental market offset by margin pressure), despite management buying over 72,000 shares the following day (see Board's share purchases highlight confidence). We reduced our estimates due to pricing softness on sales in H2, with institutions facing higher funding costs. Two forward sales that were planned to close in September are now planned to transact in FY23E due to market volatility.

- **Long-term rental demand offers land prospects.** We believe that WJG's build-to-rent (BTR) and student accommodation markets offer long-term growth opportunities, driven by the rising demand among tenants and the attractive income characteristics for institutional investors of BTR, highlighted in today's RICS survey. The group's £75m net cash could offer major opportunities in a now possibly less competitive land market.

- **Unique capital-light, low-risk model.** WJG develops BTR, student and urban regeneration assets, forward-funded by institutions, which in our view reduces risk with low capital tie-up. The accommodation management division has relatively sustainable revenues (page 4).

- **Valuation.** Following the steep fall in the shares, the cash-rich group is trading at a FY23E PER of 5.1x and dividend yield of 9.9%.

FYE SEP (£M)	2019	2020	2021	2022E	2023E
Revenue	374.8	354.1	430.2	421.3	545.4
Fully Adj PBT	50.4	45.8	51.1	49.0	50.0
Fully Adj EPS, dil (p)	16.1	14.7	16.3	15.5	15.8
Dividend per share (p)	8.4	7.4	8.2	7.8	7.9
PER (x)	5.0x	5.5x	4.9x	5.2x	5.1x
Dividend yield (%)	10.4%	9.2%	10.2%	9.7%	9.9%
EV/EBITDA (x)	2.0x	2.1x	2.0x	2.0x	2.0x

Source: Company Information and Progressive Equity Research estimates.

Rents to rise further as demand outstrips supply

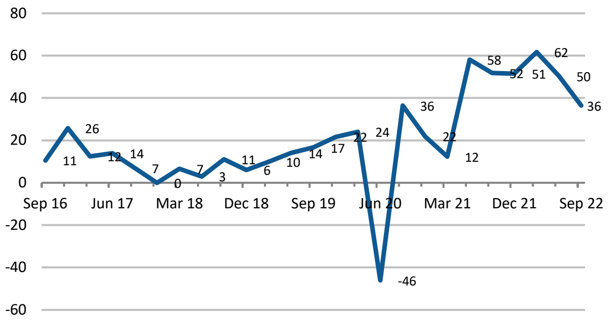
The RICS report indicates a continuing trend of rising demand and falling supply pushing up rental expectations (link). Note that it refers to the latest monthly figures while our database is based on quarterly data, which we believe are more statistically representative.

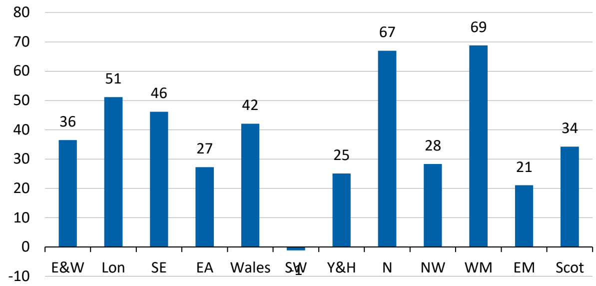
Tenant demand: still rising as many are priced out of buying

Demand continues to rise, albeit at a lower rate of growth and widely spread regionally

Tenant demand continued to rise in Q3, with a balance of +36% reporting an increase over the prior three months, seasonally-adjusted (SA), down from a peak of +62% in Q1 22. This signifies that demand has continued to rise but at a slower rate of growth. The positive trend has been apparent since 2018, in our view reflecting stretched affordability and more demanding mortgage offer terms, but also lifestyle changes. Growth in demand has been fairly widespread regionally, with the highest being in the North and West Midlands.

Tenant demand over past three months, SA (% balance*)





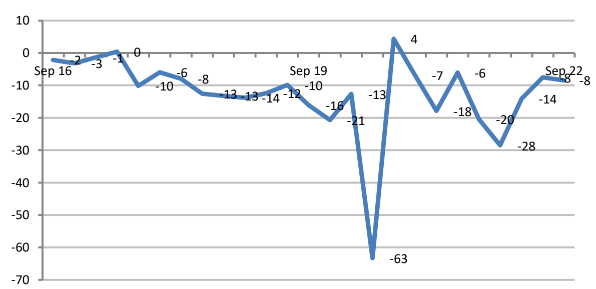
*Source: RICS * Balance = % of surveyors reporting a rise minus % reporting a fall*

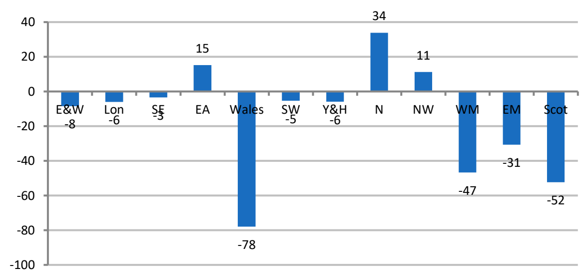
Landlord instructions: still falling as many sell up due to taxes

2015 Budget was a turning point, with many buy-to-let landlords selling up due to higher taxes

New lettings have been going the other way, largely because of private landlords selling up due to tax rises by then-chancellor George Osborne in his 2015 Budget, greater regulatory burdens and a trend, possibly reversing, of landlords freezing rents to reduce voids.

New landlord instructions over past three months, SA (% balance*)





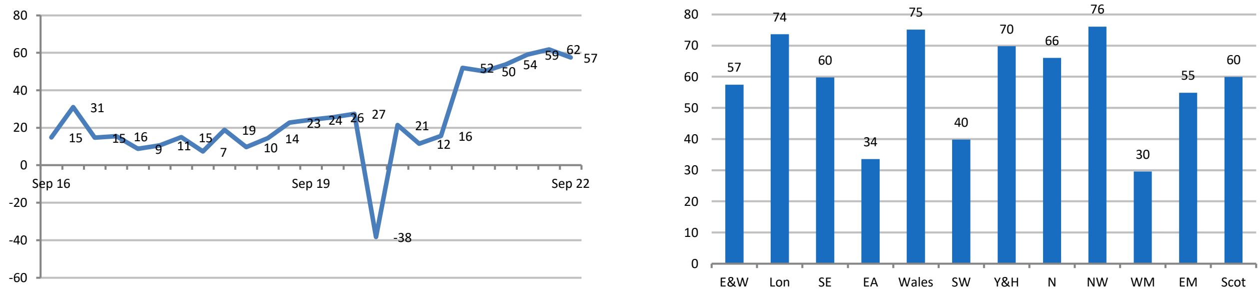
*Source: RICS * Balance = % of surveyors reporting a rise minus % reporting a fall*

Rent expectations: London leads the way

Trend is widespread but London, a target market for WJG, has seen the strongest growth in recent months after a long decline

The widening gulf between demand and supply has been pushing rents and expectations of future rises for several years. In Q3, the balance fell to +57% from a high of +62% in the previous quarter, signifying an only slight softening in strong growth. London has, in recent months, been the fastest growing region, after the capital had seen weaker growth or actual falls in rents since 2015, largely due to over-supply of apartments; this was reversed as many landlords sold up, since Osborne's tax rises particularly hit more expensive regions.

Rent expectations three months ahead, SA (% balance*)



*Source: RICS * Balance = % of surveyors reporting a rise minus % reporting a fall*

New tenancies achieving higher rents – Zoopla

Zoopla data shows actual prices and they are rising strongly

The RICS pricing data involves balances rather than actual prices. Zoopla's quarterly UK Rental Market Report provides these, and reported a 12.3% increase in rents to £1,015 a month in Q3 (link). London's rents rose by 17.8% to £1,818, reflecting a rebound after the travel bans evident in the pandemic and the falling supply already referred to. This has been particularly evident in new lets vs the overall stock of existing homes, reinforcing the view that landlords may now be moving from keeping existing tenants at frozen rents to seeking new tenancies, despite the cost of void periods (below).

Rental growth on new lets vs all homes (%)

Source: Zoopla Rental Index, ONS Rental Index

WJG in brief: low-risk, capital-light, in growth markets

Unique model addresses growing rental market, with low exposure to development risk and capital tie-up

The group, admitted to AIM in 2016, in our view offers a unique low-risk, capital-light development and asset management model for private and student rental. It develops BTR and PBSA schemes, largely forward-funded by institutional investors, which acquire sites from WJG with the benefit of planning and then pay for the works monthly as development progresses, thus reducing capital tie-up for WJG. The group also provides an accommodation management service through its Fresh Property Group (FPG) business, which manages both WJG and third-party developed assets, and operates a more traditional housebuilding business focused on the North West, with the intention signalled to pivot this into affordable housing. We believe the group should benefit from continuing growth opportunities in new student accommodation, has 'early mover advantage' in BTR, and this is all tied together by FPG in what we have defined as a 'virtuous circle'. For more details, see our 9 June 2020 initiation, *Build-to-rent 'comes of age'*.

Key current themes: addressing growing rental markets

- **Institutional investment resilient.** Institutional investors have underpinned the group's capital-light growth model by acquiring developments on a forward-sales basis, in which they pay for the land and the development works as they progress. Despite the repricing referred to in the recent trading statement due to higher funding costs, demand has remained robust for both BTR and PBSA because of long-term visibility of rental income.
- **Build-to-Rent.** As we argued in our initiation note, we expect long-term growth in BTR, fuelled by demand from renters, either economically or for 'life-style', and from investors, attracted by income prospects while other sources of yield are diminishing.
- **Student demand remains high despite Covid challenges.** Despite worries that Brexit and Covid may deter university entries, particularly from overseas students, UCAS registered a new record in the number of applications from both home and abroad. While remote teaching by universities and uncertainty during the pandemic could reduce the number of students choosing to study away from home in the current year, in our view it remains the preference of the majority to study at their university of choice, and so we expect lettings to recover to normal levels post-Covid.
- **Opportunities in land market – boosted by strong balance sheet.** Any slowdown in investment decisions could, in our view, open up new opportunities for WJG to buy land at reduced prices, given the group's net cash of c.£75m. We believe WJG could exploit significant opportunities from landowners in challenged sectors such as retail and leisure. WJG could also benefit from recent changes to planning rules, allowing vacant office and retail properties to be fast-tracked for residential use.
- **House building arm pivoting into the affordable homes market.** The largely stand-alone Residential division, which historically operated a private-focused housebuilding model mainly in the North West of England, is piloting a move into affordable housing, which will operate through a capital-light forward-sale model. This will be led by affordable housing and include BTR as well as private housing for sale. The group has announced its first affordable homes site
- **Fresh accommodation management: tying the group together.** We see Fresh as not only providing a stable income stream from its regular management fees but also using its insight and 'brand' to tie together student accommodation, BTR and possibly co-living as graduates move into work.

Financial Summary: Watkin Jones

Year end: September (£m unless shown)

PROFIT & LOSS	**2019**	**2020**	**2021**	**2022E**	**2023E**
Revenue	374.8	354.1	430.2	421.3	545.4
Adj EBITDA	64.8	61.1	65.9	63.8	64.8
Adj EBIT	55.6	51.7	57.3	54.0	55.0
Reported PBT	47.9	25.3	51.1	21.0	50.0
Fully Adj PBT	50.4	45.8	51.1	49.0	50.0
NOPAT	41.1	37.6	41.9	39.7	40.5
Reported EPS (p)	15.2	8.2	16.4	4.6	15.8
Fully Adj EPS (p)	16.1	14.7	16.3	15.5	15.8
Dividend per share (p)	8.4	7.4	8.2	7.8	7.9
CASH FLOW & BALANCE SHEET	**2019**	**2020**	**2021**	**2022E**	**2023E**
Operating cash flow	38.9	54.9	76.3	(9.6)	45.2
Free Cash flow	23.8	38.0	61.3	(24.1)	30.4
FCF per share (p)	9.3	14.9	23.9	(9.4)	11.9
Acquisitions	0.2	0.8	0.1	0.0	0.0
Net cash flow	9.0	18.9	1.8	(45.1)	10.4
Overdrafts / borrowings	176.3	174.1	141.2	141.2	141.2
Cash & equivalents	115.7	134.5	136.3	91.2	101.6
Net (Debt)/Cash, pre-IFRS 16	88.4	94.8	124.3	75.0	80.4
IFRS 16 Lease liabilities	(149.0)	(134.5)	(129.3)	(125.0)	(120.0)
Net (Debt)/Cash post-IFRS 16	(60.7)	(39.6)	(4.9)	(50.0)	(39.6)
NAV AND RETURNS	**2019**	**2020**	**2021**	**2022E**	**2023E**
Net asset value	161.1	167.8	184.8	175.6	196.1
NAV/share (p)					
Net Tangible Asset Value	147.3	154.6	172.1	163.4	184.5
NTAV/share (p)					
Average equity	157.1	164.5	176.3	180.2	185.8
Post-tax ROE (%)	28.1%	23.6%	12.0%	23.3%	6.3%
METRICS	**2019**	**2020**	**2021**	**2022E**	**2023E**
Revenue growth	3.2%	(5.5%)	21.5%	(2.1%)	29.4%
Adj EBITDA growth	27.2%	(5.7%)	7.9%	(3.2%)	1.6%
Adj EBIT growth	12.1%	(7.1%)	10.8%	(5.6%)	1.8%
Adj PBT growth	0.8%	(9.3%)	11.7%	(4.1%)	2.0%
Adj EPS growth	0.7%	(8.5%)	11.2%	(5.3%)	2.0%
Dividend growth	9.9%	(12.0%)	11.6%	(5.5%)	2.0%
Adj EBIT margins	14.8%	14.6%	13.3%	12.8%	10.1%
VALUATION	**2019**	**2020**	**2021**	**2022E**	**2023E**
EV/Sales (x)	0.3	0.4	0.3	0.3	0.2
EV/EBITDA (x)	2.0	2.1	2.0	2.0	2.0
EV/NOPAT (x)	3.2	3.5	3.1	3.3	3.2
PER (x)	5.0	5.5	4.9	5.2	5.1
Dividend yield (%)	10.4%	9.2%	10.2%	9.7%	9.9%
FCF yield	11.6%	18.6%	29.9%	(11.8%)	14.8%

Source: Company information and Progressive Equity Research estimates

13 October 2022

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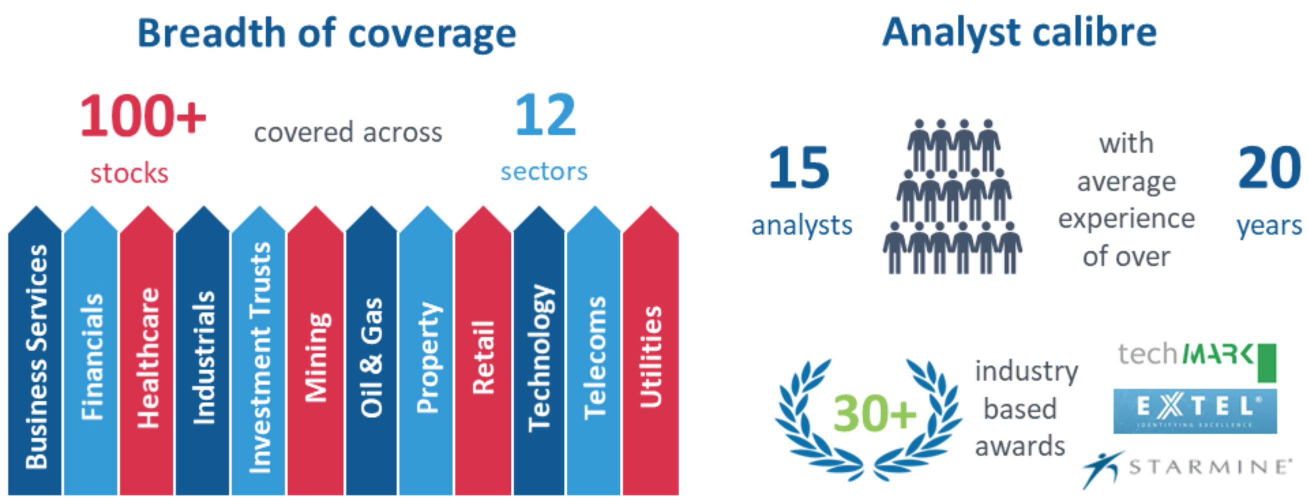

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