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Main Board Listing – Research

富豪房地產投資信託基金
Regal Real Estate Investment Trust [Stock Code: 1881]
Joint Global Coordinators, Joint Bookrunners and Joint Lead Underwriters : Merrill Lynch Deutsche Bank AG Goldman Sachs

Sole Listing Agents & Sole Financial Adviser : Merrill Lynch

Sector : Financials

Business : Real estate investment trust (REIT)

Total unit offer: <u>869,289,000</u> units (28% of the enlarged share capital) Public Offer: 86,930,000 shares (10%) Placing: 782,359,000 shares (90%) Greenshoe: 130,393,000 shares (15%)	<u>Business of Regal REIT</u> Regal REIT is formed to own an investment portfolio of 5 hotels ("Initial Hotel Properties") in Hong Kong with a total of 3,348 rooms, which is equivalent to 7.3% market share in HK's hotel industry. The hotels are located in both core and non-core districts. Two are High Tariff A hotels (30% of total by number of rooms) and three are High Tariff B hotels (70% of total by number of rooms). Average occupancy rate for these hotels was 81.2% and the average room rate was HK\$786.9 in 2006. Regal REIT is the first hotel REIT in HK. The primary objective of Regal REIT is to provide unitholders with stable distributions and long-term capital growth in NAV per unit. The REIT Manager intends to achieve these objectives through asset enhancement opportunities and operational improvements, external growth through potential acquisitions and financing through an appropriate capital structure. The Manager's policy is to distribute to unitholders 100% of Regal REIT's total distributable income for each financial year. From the listing date to 31 December 2007, the forecasted total distributable income is HK\$420.32 million. The forecast distribution per unit is HK\$0.1488 – HK\$0.1527, representing an annualized distribution yield after tax of 5.80% to 7.51%.
Price: HK\$2.68 – HK\$3.38 per unit Market Cap.: HK\$8.32 billion – HK\$10.49 billion FY2007E Distribution Yield: 5.80% - 7.51% Adjusted NTA per unit: HK\$3.73 Manager: Regal Portfolio Management Limited	
HK Public Offer period: 19 th March 2007 – 22 nd March 2007 noon Receiving bank: The Bank of East Asia Hang Seng Bank HSBC ICBC (Asia) Standard Chartered Unit registrar: Computershare Hong Kong Investor Services Limited Listing date: 30 th March 2007	

Major unitholders after Listing (Assuming the over-allotment option is not exercised)

Regal	72.0%
Public unitholders	28.0%
	<u>100.0%</u>

Use of Proceeds

Total proceeds from the offer are estimated to be HK\$8,320 million – HK\$10,494 million. (Assuming the over-allotment option is not exercised.)

In addition to the funds raised from the offer, a HK\$4.35 billion term loan facility is to be drawn on or before the listing date and a revolving credit facility of HK\$150 million is available for drawdown during the first 24 months after the listing date. This brings the total funds available to be HK\$12,670.3 million – HK\$14,843.6 million.

(HK\$ million)	Based on the Minimum Offer Price of HK\$2.68	Based on the Maximum Offer Price of HK\$3.38
The acquisition of the Initial Hotel Properties	12,500.0	14,658.0
Costs and expenses of the Global Offering and debt related costs	170.3	185.6
Total	12,670.3	14,843.6

Financial Highlights

HK\$ million	Year ended 31 Dec			Nine months ended 30 Sep	
	2003	2004	2005	2006	
Turnover	718.2	993.5	1,077.2	841.5	
Gross profit	189.9	391.5	456.8	387.2	
Operating profit before depreciation & amortization	821.4	1,533.0	1,433.9	380.5	
Operating profit	681.9	1,386.4	1,259.3	230.7	
Profit for the year	620.4	1,297.4	1,182.2	69.8	

Breakdown of turnover

HK\$m	Year ended 31 Dec						Nine months ended 30 Sep	
	2003	%	2004	%	2005	%	2006	%
Gross hotel income								
Room	399.0	55.6	636.7	64.1	700.9	65.1	546.3	64.9
Food and Beverage	256.3	35.7	290.1	29.2	307.6	28.6	235.9	28.0
Others	37.8	5.3	43.8	4.4	42.7	4.0	35.0	4.2
Gross rental income from hotel properties	25.1	3.5	22.9	2.3	26.0	2.4	24.4	2.9
Turnover	718.2	100.0	993.5	100.0	1,077.2	100.0	841.5	100.0

Description of the Initial Hotel properties

	HK Tourism Board Rating	Opening year	No of rooms	Average occupancy rates FY06 (%)	Gross Floor Area (sq. ft.)
Regal Airport Hotel, HK International Airport	High Tariff B	1999	1,104	64.1	774,445
Regal Hongkong Hotel, Causeway Bay	High Tariff A	1993	424	90.1	215,736
Regal Kowloon Hotel, Tsim Sha Tsui	High Tariff A	1982	600	85.6	341,714
Regal Oriental Hotel, Kowloon City	High Tariff B	1982	390	90.0	243,167
Regal Riverside Hotel, Shatin	High Tariff B	1986	830	92.2	519,046
Total			3,348		2,094,108

Strengths/Opportunities

- ✓ **Asset enhancement program (AEP)** The program will convert some of the floor space into hotel rooms and adding new rooms to existing hotels. The expansion increases the total number of rooms by 14% to 3,816. The target completion dates range from Sept 2007 to Dec 2008. The construction costs, including any overruns, are estimated to be HK\$320 million and will be incurred by Regal Hotels (0078). Regal will subscribe for the AEP units (295.9 million – 373.1 million units), which is the amount representing the appraised value of the AEP. Distribution from the AEP units will be locked up and Regal will not be entitled to receive distributions in respect of the AEP units until a certain time after the corresponding AEP is completed. The AEP units will represent 9.5%-12% of total units in issue (depending on the offer price). We think the arrangement shows Management's commitment in enhancing asset value of the REIT, which is a more sustainable way to improve yield through enhancing the fundamental yield-generating ability of the properties.
- ✓ Stripping out the financial engineering measures commonly used in enhancing other REIT's yield, Regal REIT's distribution yield is among the highest. For instance, Prosperity REIT (0808)'s FY06 distribution yield was about 7%. After taking out the cash-flow from financial engineering, the underlying yield was about 3.5%. Sunlight REIT (0435)'s yield would be at about 2.5%. Comparing with other hotel REITs in Asia, CDL Hospitality Trust in Singapore has a yield of about 3.7%.
- ✓ The REIT Manager is entitled to base fee and variable fee. Part of the structure is to be paid in the form of units. For instance, from the listing date to the end of FY2010, the base and variable fees referable to the Initial Hotel Properties (i.e. before the AEP), are to be paid to the REIT Manager in the form of units. The maximum number of units that may be issued to the REIT Manager in a fiscal year as payment of the fees is limited to less than 3% of the units outstanding.
- ✓ **Long term lease agreements** The REIT is to collect rent from the lessee, a Regal's subsidiary, rental income in the form of fixed rent plus variable rent. The fixed rent is set at HK\$630, 700, 750, 780 million for the years from 2007 – 2010. The variable portion is 100%, 70%, 60% and 50% of the excess of the net property income over the annual base rent for the years from 2007 – 2010. The fixed rent structure provides stable yield while the variable portion allows for profit sharing from growth in rental income. This acts as a cushion to the relatively more volatile nature of hotel rental income.

Weaknesses/Threats

- × **Pure hotel REIT – more volatile rental income** Regal REIT is the first hotel REIT listed in HK. Hotel industry is very competitive and highly cyclical. Although industry forecasts suggest that increase in supply is in-line with growth in visitors arrival and availability of new hotel rooms is tight in the coming few years, any economic downturn or shocks could hurt tourism extensively. The underlying portfolios of other REITs in HK are mostly office, retail, and industrial properties, of which rental reversions are typically in cycles of 2-3 years. Hotel room rates can fluctuate on a daily basis, so rental income for hotel REIT tends to be more volatile than office/retail REITs.
- × Including the HK\$4.35 billion term loan facility to be drawn on or before the listing date, the debt-to-equity ratio is about 42.0% assuming the maximum offer price.
- × The AEP units, representing 9.5%-12% of total units outstanding, pose some dilutions to the FY07E distribution yield. Assuming all the AEP units would be entitled to distributions during FY07, the annualized distribution yield would be 5.25% to 6.61%.

Recommendation: Subscribe

**Appendix: Details of Asset Enhancement Program (AEP)**

	Existing No. of rooms	No. of rooms after AEP	Existing GFA (sq. ft.)	GFA after AEP (sq. ft.)	Target completion date	Estimated construction cost (HK\$m)	Work to be done
Regal Airport Hotel	1,104	1,171	774,445	775,000	30 Sep 2007	38	Conversion of about 27,730 sq. ft. unutilized GFA into 67 additional rooms
Regal Hongkong Hotel, Causeway Bay	424	474	215,736	269,911	30 Sep 2007	90	Addition of new floor areas to the top of the building; conversion of existing space into 50 guest rooms & a new swimming pool
Regal Kowloon Hotel, Tsim Sha Tsui	600	600	341,714	341,714	-	-	-
Regal Oriental Hotel, Kowloon City	390	439	243,167	243,203	30 Sep 2007	30	Conversion of unutilized area into 49 additional rooms; refurnishing the existing 4 room floors
Regal Riverside Hotel, Shatin	830	1,132	519,046	639,292	2 phases: 30 Sep 07 / 31 Dec 08	162	Conversion of 27 suites into 55 rooms; addition of 3 new floors (274 additional rooms) to the top of the building
Total	3,348	3,816	2,094,108	2,269,120		320	

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