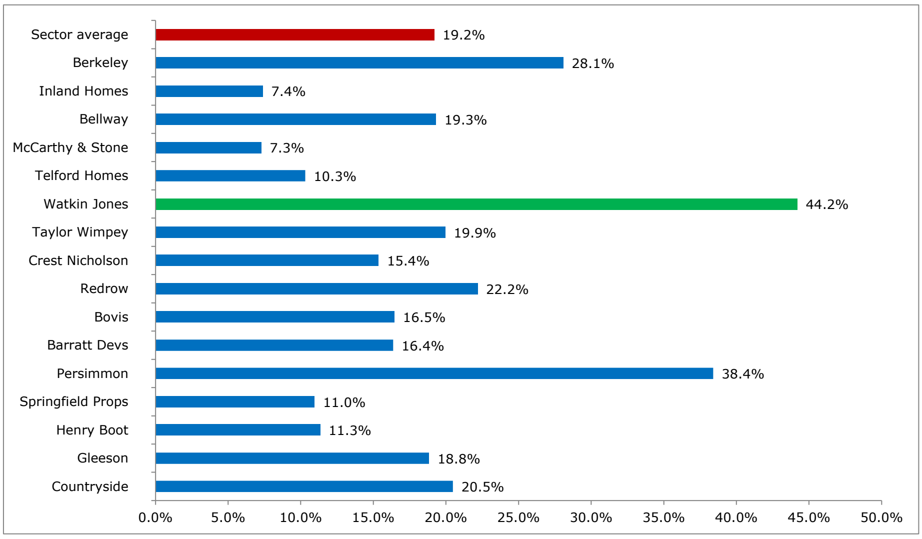
Watkin Jones plc

Upbeat H1 & in line with FY19 estimates

21st May 2019

One of the most reliable gauges of a company's 'competitive moat', is (not surprisingly) the amount of money it generates. Not solely profits, but the return on invested capital after adjusting for financial gearing. On this measure **Watkin Jones ranks as the industry's #1 player** (see below), **delivering an anticipated FY19 unlevered Return on Equity of 44.2%** (see below).

Ungeared Return on Equity



Source: Equity Development. Ungeared ROE = (EBIT – tax - minorities)/(net assets +/- net debt/cash)

Superior performance however doesn't happen by magic. Thanks to a **4 year pipeline, new growth engines**, **a forward funded model and tight cost control**, all the bricks are lining up. Carefully building one of the UK's top developers/managers of large scale, multi occupancy accommodation. A message which once again came through 'loud & clear' at this morning's upbeat H1'19 results.

Double digit adjusted PBT and dividend growth

Here, **gross margins climbed 1.9% to 23.7% on sales up 0.5% to £159.1m**, reflecting improved mix (re more premium PBSA sites), augmented by higher contributions from BtR and residential housebuilding.

Likewise this pushed **adjusted PBT up 10.0% to £26.0m** (£23.6m LY) and **EPS +7.7% to 8.11p** (7.53p LY) - with **net cash closing March at a comfortable £18.3m** (vs £38.4m LY). The latter decline being simply a function of planned investment, BtR/PBSA WIP and the temporary impact a delayed £14m customer payment (now collected), which slipped over the period end.

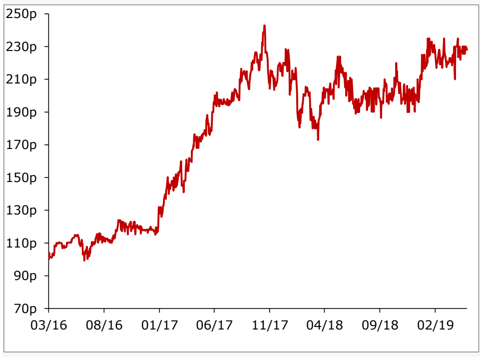
Trading in line with expectations

All told, leaving the firm **on track to hit our FY19 turnover, EBIT and EPS estimates of £390m, £51.7m and 16.0p** respectively, alongside **lifting the interim dividend 11.3% to 2.75p** (2.47p).

Company Data

EPIC	AIM:WJG
Price (last close)	229p
52 week Hi/Lo	249p/178p
Market cap	£585m
ED valuation/share	250p
Net cash (est. Sept'19)	£90.5m
Sharecount	255.3m
Daily volume	300k

Share Price (p)



Source: Share Cast

Company Description

Watkin Jones is a tier 1 developer & manager of large scale, multi occupancy accommodation, focusing on purpose built student accommodation (PBSA) and residential build to rent (BtR).

Both areas are expanding, supported by strong fundamentals – enabling the firm to leverage its reputation & industry expertise, along with operating a forward sale, low risk, cashflow positive and capital light model.

Residential property & agency lettings businesses are also set to become growth engines.

Next news: Trading update Oct'19

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In fact, optically PBT could have risen even further YoY (+£613K, or 2.5%), had the company decided to restate H1'18 comparatives for the adverse effect of IFRS15. Granted there was a £2.6m exceptional item concerning compensation paid to the group's new CEO, Richard Simpson for the loss of bonuses/LTIPs at his former employer (re Unite). Equally though, the vast majority (£2.2m) of the charge relates to SBPs with just £0.4m paid in cash.

Robust visibility coupled with predictable earnings

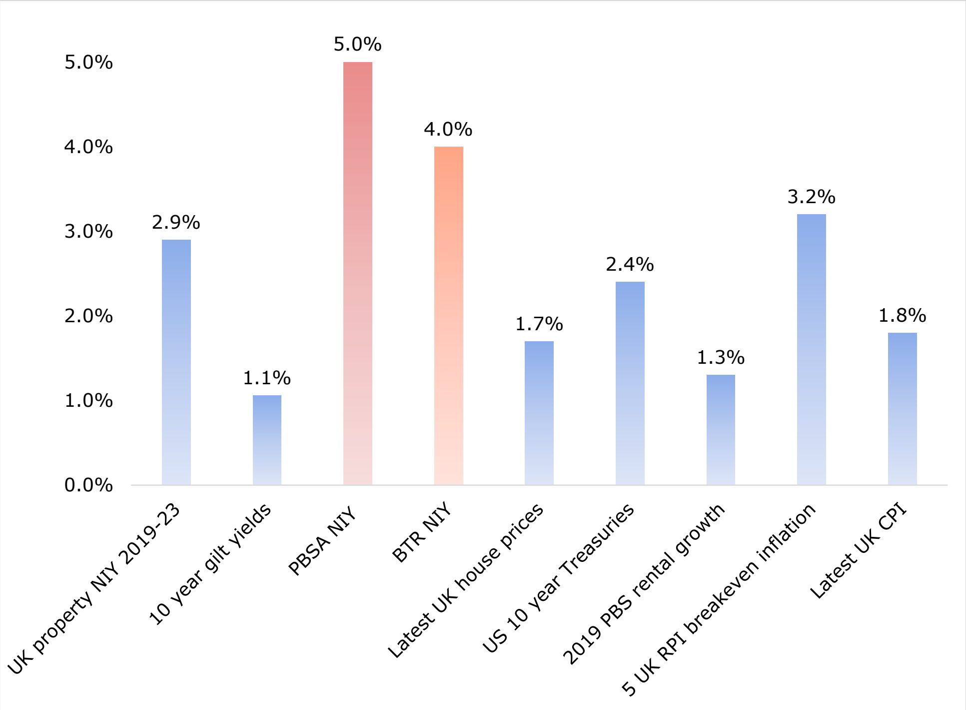
Mr Simpson commenting "*We are pleased to report* ***another strong set of results, in-line with our expectations…*** *underpinned by* ***robust student accommodation activity*** *and …****increased contribution from the Group's other operating divisions****.*

Institutional investor demand for our PBSA is strong and we continue to see quality new investors entering the market, such as DWS *(asset manager)* ***at Wembley****. Similarly, investor* ***momentum is growing in BtR****, with a* ***significant increase in reported transaction volumes in Q1'19****.*

PBSA and BtR offer attractive risk adjusted returns

So what's triggering this institutional interest? Well first and foremost, in light of the positive 'real' Net Initial Yields (NIY), **PBSA and BtR are both becoming the real-estate assets of choice for many property, pension or alternative fund managers** - who are seeking long term returns above sovereign / investment grade debt, coupled with lower levels of volatility than from equities (see below).

PBSA and BtR generating positive real-returns



Source: Bank of England, CBRE and JLL. NIY = Net initial yield (post running costs)

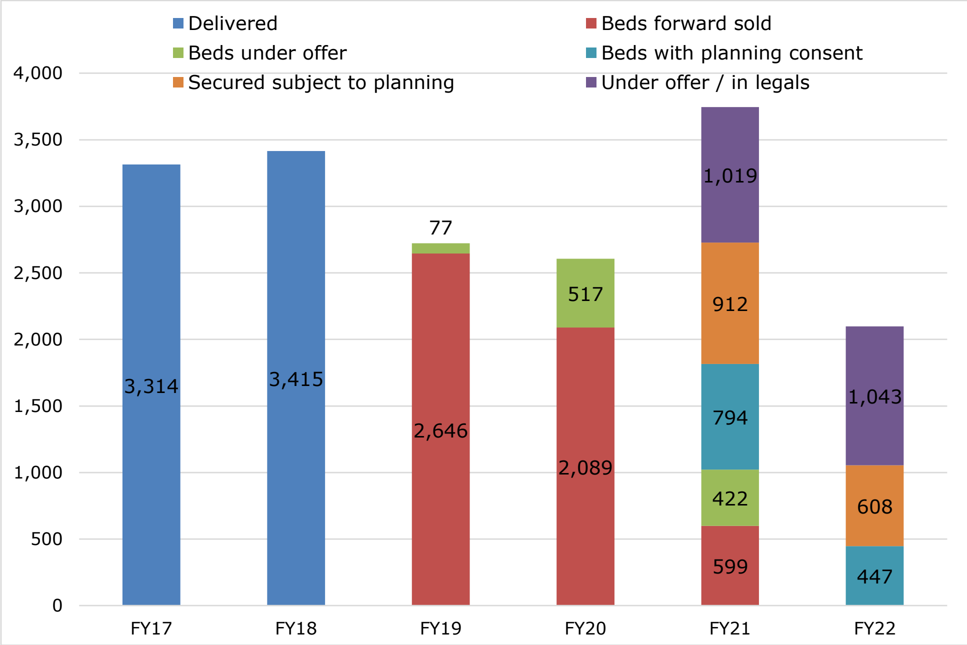
Enhanced student pipeline with greater visibility

With regards to divisional splits, the more mature **PBSA division continues to tick along**. In fact, despite revenues declining 9.5% to £128.8m (vs £142.2m LY), gross margins rose 3.0% to 23.7%, due primarily to profitable land buying in premium locations where robust investor demand exists.

The PBSA pipeline (see below) comprises 20 sites from which it is targeting to deliver over 9,100 beds between FY19-22, with a combined development value of c. £850m. This includes a new site purchased in Selly Oak, Birmingham for 608 units (subject to planning) with delivery set for FY22.

A total of 11 developments (5,334 beds) have been forward sold between FY19-21, whilst another 3 (594) are in legals. Only 77 rooms (<3%) that are earmarked for FY19 remain under offer. Whilst 80% of the 2,606 beds slated for FY20 have been forward funded, thus providing **robust visibility**. For FY19, 6 schemes (2,723 beds) are scheduled for completion vs 10 (3,415) LY.

PBSA delivery pipeline (beds – March 2019)



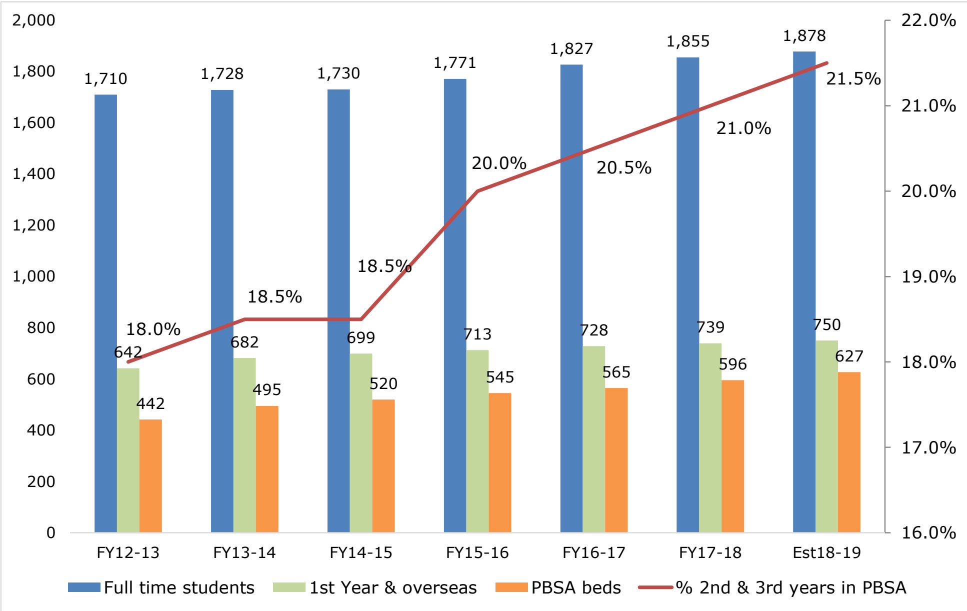
Source: Company. NB: sales/profits track 'cost to complete' contract accounting not just deliveries. Secure = Beds forward sold and/or with planning permission.

Outlook for PBSA remains supportive

More broadly too, **we think the outlook for PBSA is favourable**, with demand underpinned by the UK's world-renowned University sector, the internationalisation of higher education and the shortage of good quality housing. For instance, the UK continues to be the 2nd most popular destination for international students, and has 12 out of the world's top 100 and 59 of Europe's top 200 universities.

Moreover, according to Cushman & Wakefield there were 627k PBSA beds in the UK in Sept'18 - split 53% university vs 47% privately owned - compared to an estimated 750k 1st year and international students. Approx. 36k new units (vs 31.3k LY) are predicted to come on stream this academic year, which we believe should be absorbed relatively easily, in light of an increasing proportion of 2nd and 3rd year students opting for PBSA in preference to traditional student digs.

UK student numbers and PBSA beds

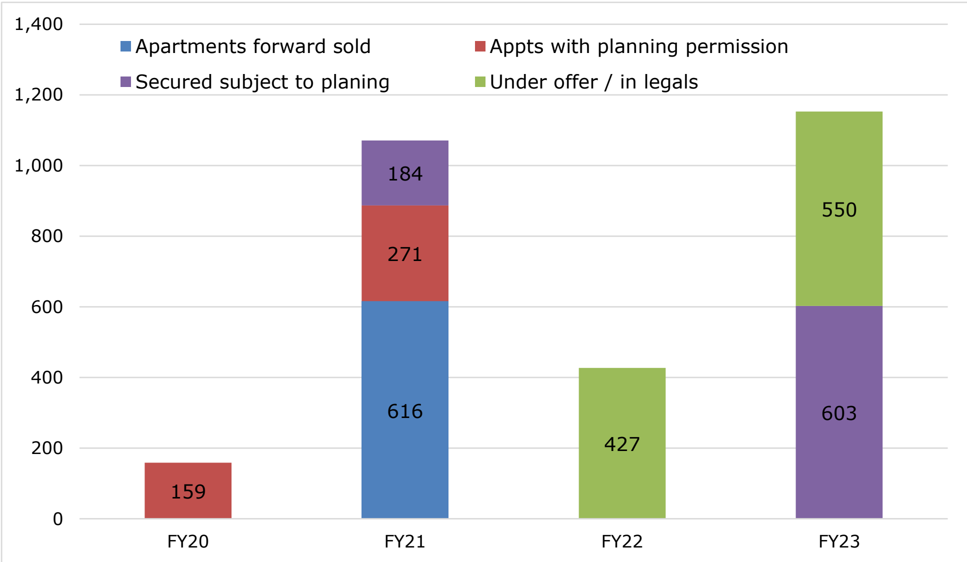


Source: UCAS, HESA, Unite estimates

Strong investor demand continues for BtR

Elsewhere, **BtR revenues jumped to £8.8m** (£0.6m LY), mirroring new developments at Reading (315 apartments worth c. £68.5m, with completion FY21) and Wembley (300) - producing 21.7% gross margins, well ahead of WJG's 15% medium term target.

Total BTR delivery pipeline (apartments – March 2019)



Source: ED estimates. NB: sales/profits track 'cost to complete' contract accounting not just deliveries

All told, the pipeline (see below) now includes 8 BtR sites, from which approx 1,800 apartments are scheduled to be built FY20-23. 5 of these already have planning consent

(1,031 apartments), 6 are self-owned and the other 2 are being constructed for 3rd parties (M&G and Singaporean investors).

Separate BtR investment vehicle provides upside

Additionally, the Board continues to explore the opportunity of creating a discrete entity for BtR investments. Here we suspect WJG would retain a minority stake, but could nonetheless generate attractive returns, acting as either the fund manager and/or lettings agent. Additionally the Newco would provide a logical home and forward funding source for WJG's interests to be agreed on an arms' length basis.

Finally from a macro standpoint, by moving more students/young professionals into institutionally owned/managed accommodation - this frees up Buy-to-Let & other rented properties, which can then be renovated and re-provisioned to provide much-needed housing to families in areas that may be short of affordable places to live. A win-win for councils, developers and politicians alike.

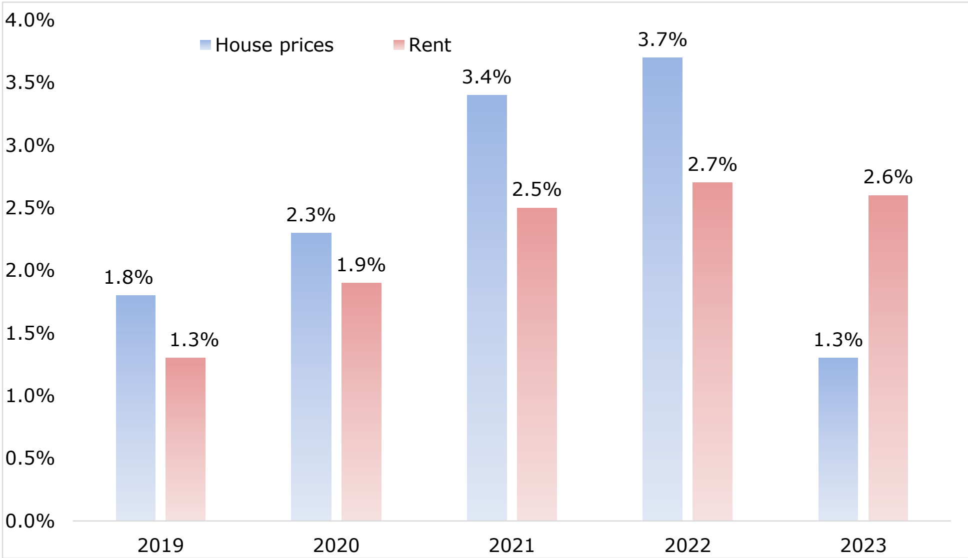
Fresh singing off the same hymn sheet

But that's not all. There was **an encouraging performance from Fresh lettings too**, which increased turnover 3.5% to £3.9m, sporting gross margins of 62.6% vs 61.8% FY18. At the start of FY19, the division managed 15,421 student beds and BtR apartments across 56 schemes. Looking ahead this is expected to rise to 21,018 units across 73 schemes by FY22.

Lastly, the **residential housing business** achieved 53 completions in its North West heartland vs 28 in H1'18, reflecting solid buyer interest, as well as the phasing of developments. In tandem, the Group sold the 22 affordable apartments that form part of its mixed-use development at Stratford, London. Consequently, turnover came in at £17.4m vs £5.3m LY, producing a gross margin of 16.7% (10.1% LY), or 19.5% excluding £2.5m of sales from the legacy Droylsden site at nil margin.

More broadly, the UK housing sector is being assisted by low unemployment, rising wages, generous government support (Help-to-Buy), low interest rates and the availability of competitive mortgages. Whilst the private rented sector should remain supply constrained, with modestly improving rental growth pencilled in for the next 4-5 years (see below).

Forecasts for UK residential property

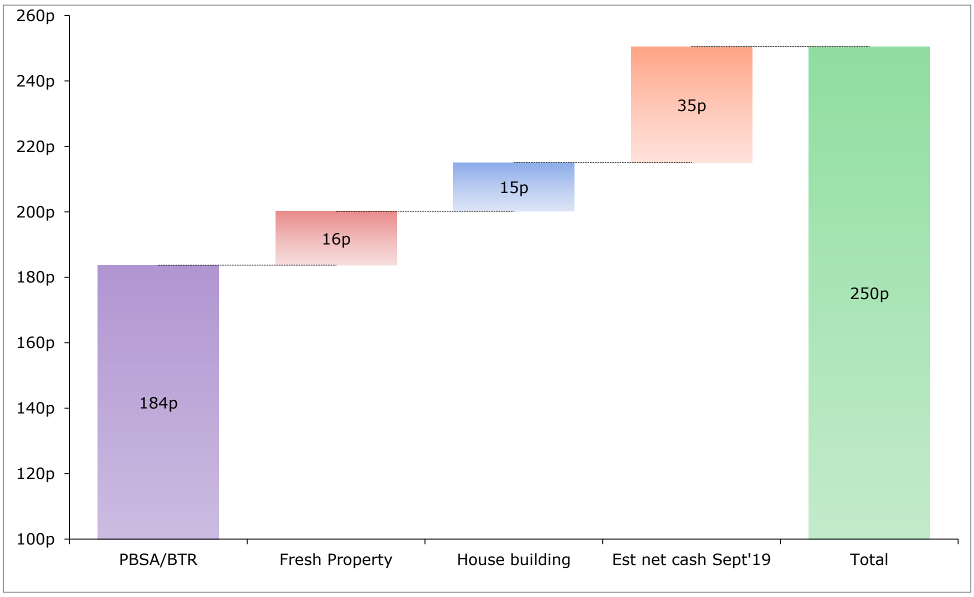


Source: CBRE

No change to forecasts and reiterate 250p valuation

Going forward, we make no change to our numbers, and reiterate the 250p/share SOTP valuation.

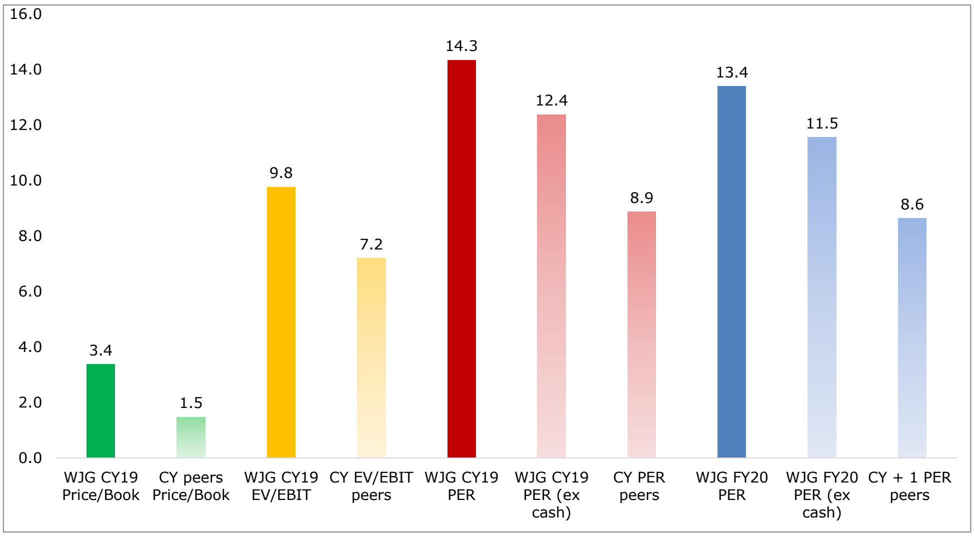
Sum of the parts valuation (pence/share)



Source: Equity Development

At 229p, the stock offers **an earnings yield of 8.2%** (ex cash), which is set to expand in the high single or low double digits for the foreseeable future on the back of predictable revenues and profits. Meaning that in our view, **WJG continues to trade at a deserved premium to peers in light of its superior cash generation, asset efficiency, sales visibility and risk profile**.

Summary valuation benchmarks vs UK homebuilders



Source: Equity Development

Material potential upside

The potential upside is not insignificant either. In fact, if one pushes the clock forward 5 years, then we think (hypothetically) there is little reason why the stock can't trade at north of 350p/share, based on a modest 12x PER and 61p in net cash. Which together with 48p of dividends along the way, equates to an annualised 11.8% compound return - or almost 50% above WJG's estimated 'cost of capital' of 8.0%. Plus this could actually end up much better, given the stock has generated c. 30% pa returns since listing in March 2016 on AIM at 100p.

CEO Richard Simpson adding "***I continue to be very excited by the opportunities in this business, seeing the market dynamics for both PBSA and BtR so strongly supportive of the Group's forward sale model***. *Together with our pipeline of forward sold and secured development sites, this will continue to provide* ***excellent visibility on future earnings and cash flow****.Consequently,* ***the Board remains confident in the prospects for the Group***."

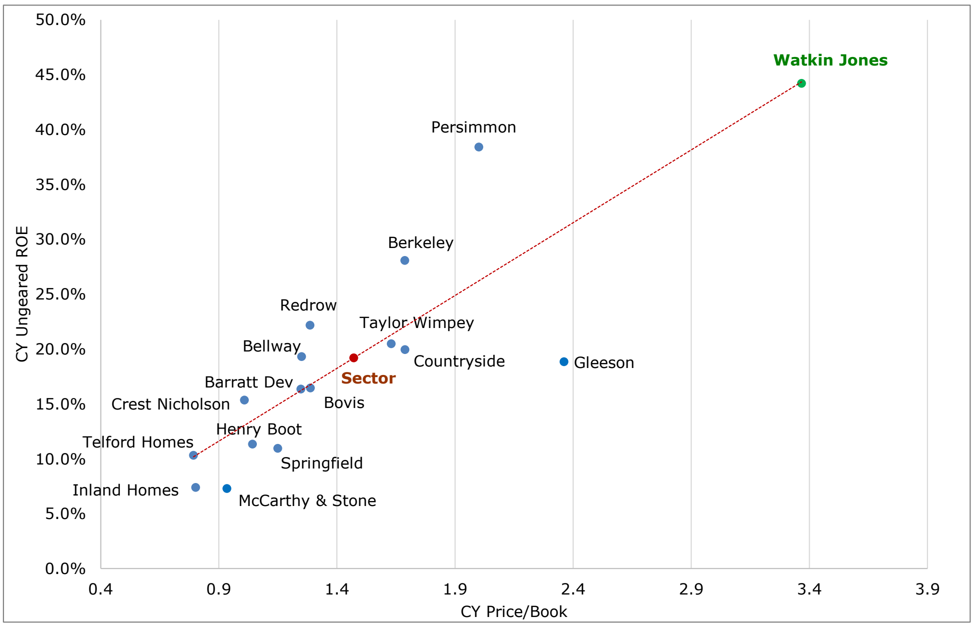
Summary financial projections

Watkin Jones (continuing) (Sept yearend)	2015 Act £'ms	2016 Act £'ms	2017 Act £'ms	2018 Act £'ms	2019 Est £'ms	2020 Est £'ms	2021 Est £'ms	2022 Est £'ms	2023 Est £'ms	2024 Est £'ms
Turnover										
Student (PBSA) accommodation	228.2	237.2	256.1	312.7	285.0	295.0	300.0	300.0	300.0	300.0
Build to Rent (BTR)	0.0	0.0	1.2	3.8	60.0	90.0	125.0	170.0	210.0	250.0
Residential development	15.9	26.3	18.1	30.0	38.0	40.0	45.0	50.0	55.0	60.0
Fresh property management		2.8	6.1	7.3	7.0	8.1	8.9	9.7	10.7	11.8
Other / construction	0.2	0.7	20.4	9.3	0.0	0.0	0.0	0.0	0.0	0.0
Total	**244.2**	**267.0**	**301.9**	**363.1**	**390.0**	**433.1**	**478.9**	**529.7**	**575.7**	**621.8**
Group revenue growth % YoY	*73.5%*	*9.3%*	*13.1%*	*20.3%*	*7.4%*	*11.0%*	*10.6%*	*10.6%*	*8.7%*	*8.0%*
Student (PBSA) accommodation		*3.9%*	*8.0%*	*22.1%*	*-8.9%*	*3.5%*	*1.7%*	*0.0%*	*0.0%*	*0.0%*
Build to Rent (BTR)				*209.5%*	*1494.0%*	*50.0%*	*38.9%*	*36.0%*	*23.5%*	*19.0%*
Residential development	*-12.6%*	*65.3%*	*-31.3%*	*65.8%*	*26.8%*	*5.3%*	*12.5%*	*11.1%*	*10.0%*	*9.1%*
Fresh property management			*116.6%*	*19.2%*	*-4.1%*	*15.0%*	*10.0%*	*10.0%*	*10.0%*	*10.0%*
Student (PBSA) accommodation	41.5	48.6	56.6	60.7	55.6	55.1	54.0	54.0	54.0	54.0
Build to Rent (BTR)	0.0	0.0	0.7	1.0	7.8	11.7	16.3	22.1	27.3	32.5
Residential development	2.7	3.0	3.0	4.4	7.6	8.0	9.0	10.0	11.0	12.0
Fresh property management	0.0	1.7	3.8	4.5	4.2	4.8	5.3	5.8	6.4	7.1
Other	-0.1	0.5	-0.5	1.8	0.0	0.0	0.0	0.0	0.0	0.0
Group gross profit	**44.0**	**53.8**	**63.5**	**72.4**	**75.2**	**79.6**	**84.6**	**91.9**	**98.7**	**105.6**
Group % margin	***18.0%***	***20.2%***	***21.0%***	***20.0%***	***19.3%***	***18.4%***	***17.7%***	***17.4%***	***17.1%***	***17.0%***
Student (PBSA) accommodation	*18.2%*	*20.5%*	*22.1%*	*19.4%*	*19.5%*	*18.7%*	*18.0%*	*18.0%*	*18.0%*	*18.0%*
Build to Rent (BTR)			*56.3%*	*27.1%*	*13.0%*	*13.0%*	*13.0%*	*13.0%*	*13.0%*	*13.0%*
Residential development	*16.6%*	*11.5%*	*3.8%*	*14.6%*	*20.0%*	*20.0%*	*20.0%*	*20.0%*	*20.0%*	*20.0%*
Fresh property management		*58.9%*	*49.4%*	*61.8%*	*60.0%*	*60.0%*	*60.0%*	*60.0%*	*60.0%*	*60.0%*
Admin	-10.6	-14.6	-20.8	-22.8	-23.5	-24.9	-26.1	-27.4	-28.4	-29.5
Distribution / other	-1.0	-1.4	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Adjusted EBIT	**32.5**	**37.9**	**42.7**	**49.6**	**51.7**	**54.7**	**58.5**	**64.6**	**70.3**	**76.1**
% margin	***13.3%***	***14.2%***	***14.1%***	***13.7%***	***13.3%***	***12.6%***	***12.2%***	***12.2%***	***12.2%***	***12.2%***
EBITDA (incl JV profits)	**33.6**	**41.5**	**45.2**	**50.9**	**52.9**	**55.9**	**59.7**	**65.9**	**71.6**	**77.4**
% margin	*13.8%*	*15.6%*	*15.0%*	*14.0%*	*13.6%*	*12.9%*	*12.5%*	*12.4%*	*12.4%*	*12.5%*
Profit from JVs	1.2	3.0	1.4	1.1	0.0	0.0	0.0	0.0	0.0	0.0
Net interest	-0.7	-1.0	-0.9	-0.7	-0.7	-0.7	-0.7	-0.7	-0.7	-0.7
Adj profit before Tax	**32.9**	**39.8**	**43.3**	**50.1**	**51.0**	**54.0**	**57.7**	**63.8**	**69.6**	**75.4**
Effective tax rate	*-19.1%*	*-20.5%*	*-17.3%*	*-18.6%*	*-20.0%*	*-19.0%*	*-19.0%*	*-19.0%*	*-19.0%*	*-19.0%*
Adjusted EPS (pence)	**10.4**	**12.4**	**14.0**	**16.0**	**16.0**	**17.1**	**18.3**	**20.2**	**22.0**	**23.9**
EPS growth rate	*138.5%*	*19.2%*	*13.1%*	*13.8%*	*0.1%*	*7.1%*	*6.9%*	*10.6%*	*8.9%*	*8.3%*
Net assets per share (p)	*44*	*40*	*49*	*60*	*68*	*76*	*86*	*96*	*107*	*119*
Net tangible assets per share (p)	*44*	*34*	*44*	*54*	*62*	*71*	*80*	*90*	*101*	*113*
Dividend (p)		***4.0***	***6.6***	***7.6***	***8.0***	***8.6***	***9.1***	***10.1***	***11.0***	***11.9***
Valuation benchmarks										
P/E ratio	*22.0*	*18.5*	*16.3*	*14.3*	*14.3*	*13.4*	*12.5*	*11.3*	*10.4*	*9.6*
P/E ratio (excluding Sept'18 net cash)				*12.4*	*12.4*	*11.5*	*10.8*	*9.8*	*9.0*	*8.3*
Price/Tangible book	*5.2*	*6.7*	*5.3*	*4.2*	*3.7*	*3.2*	*2.9*	*2.5*	*2.3*	*2.0*
Price/Book	*5.2*	*5.7*	*4.6*	*3.8*	*3.4*	*3.0*	*2.7*	*2.4*	*2.1*	*1.9*
EV/EBIT	*15.5*	*13.3*	*11.8*	*10.2*	*9.8*	*9.2*	*8.6*	*7.8*	*7.2*	*6.6*
Return on Equity (EPS/NA)	*23.5%*	*30.8%*	*28.4%*	*26.6%*	*23.5%*	*22.4%*	*21.4%*	*21.2%*	*20.7%*	*20.1%*
Dividend yield		*1.7%*	*2.9%*	*3.3%*	*3.5%*	*3.7%*	*4.0%*	*4.4%*	*4.8%*	*5.2%*
Net cash/(debt)	**39.1**	**32.2**	**41.0**	**80.2**	**90.4**	**101.3**	**113.0**	**125.9**	**140.0**	**155.3**
Net cash / share (p)	15.3	12.6	16.1	31.4	35.4	39.6	44.2	49.2	54.7	60.7
Sharecount (Ks)	255,269	255,269	255,269	255,269	255,369	255,469	255,569	255,669	255,769	255,869
Shareprice	**229**									

Source: Company historic data, Equity Development estimates.

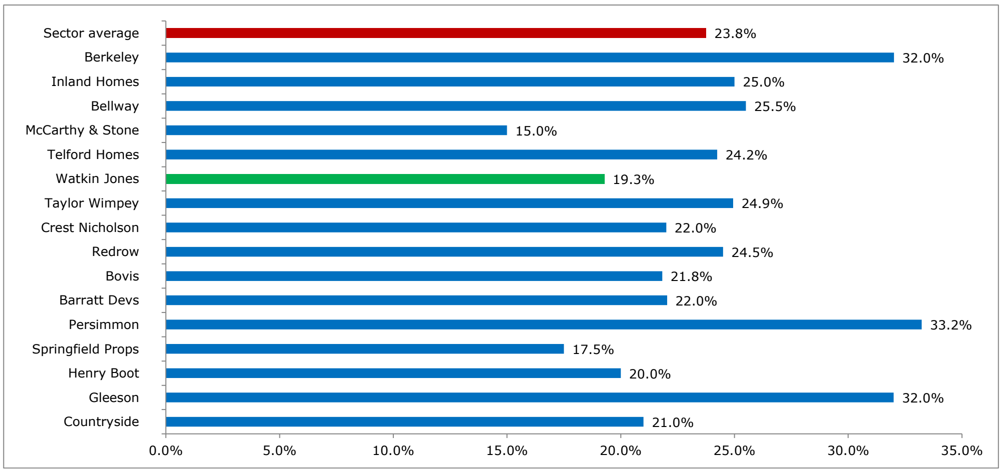
Appendices - sector valuation metrics and KPIs

Ungeared Return on Equity vs Price:Book valuation



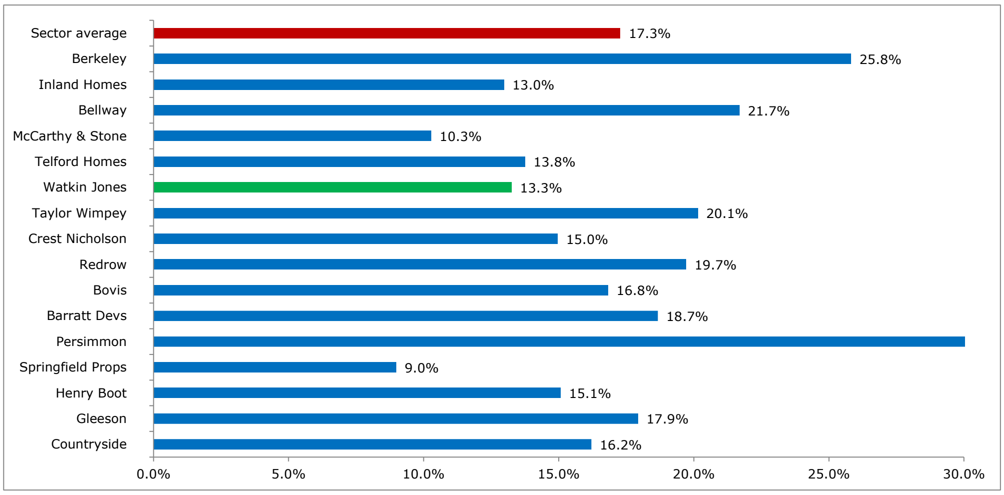
Source: Equity Development. Ungeared ROE = (EBIT – tax - minorities)/(net assets +/- net debt/cash)

Current Year gross profit margins



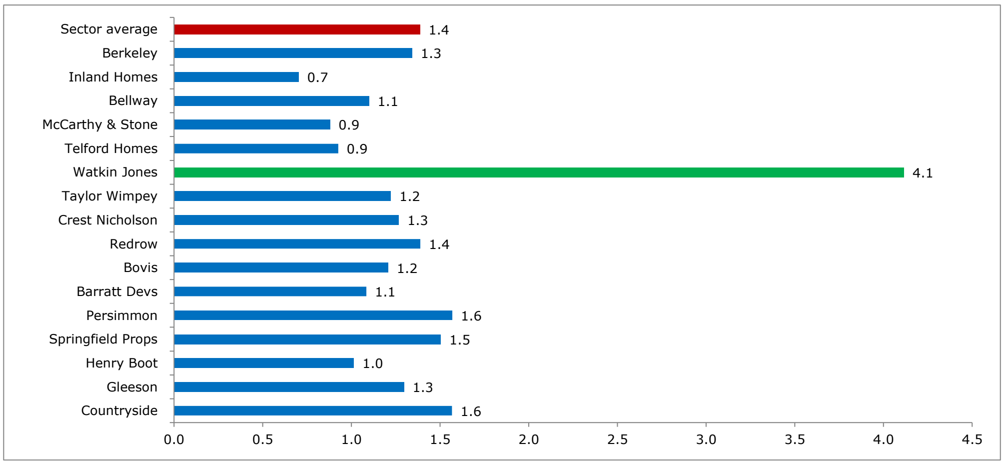
Source: Equity Development : arithmetic average for sector

CY EBIT margins



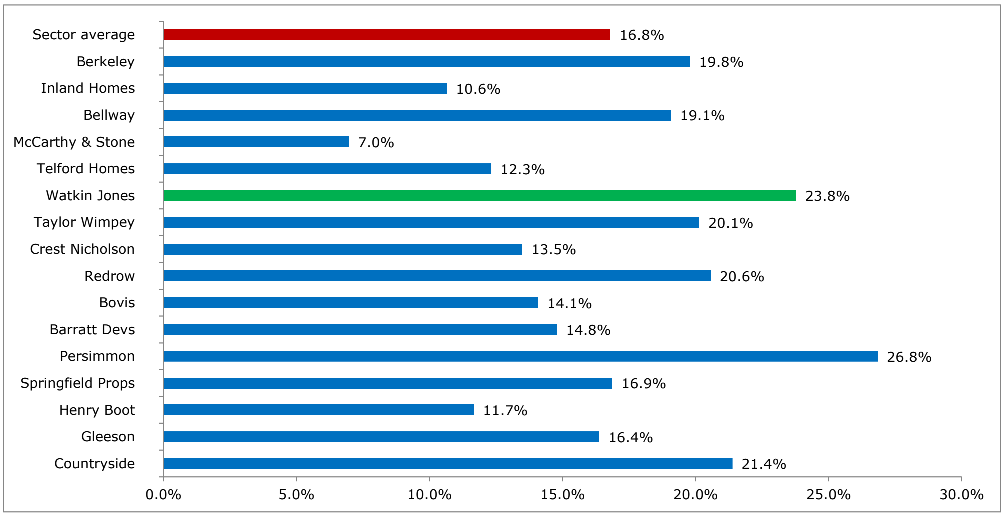
Source: Equity Development, arithmetic average for sector

CY ungeared net asset turns



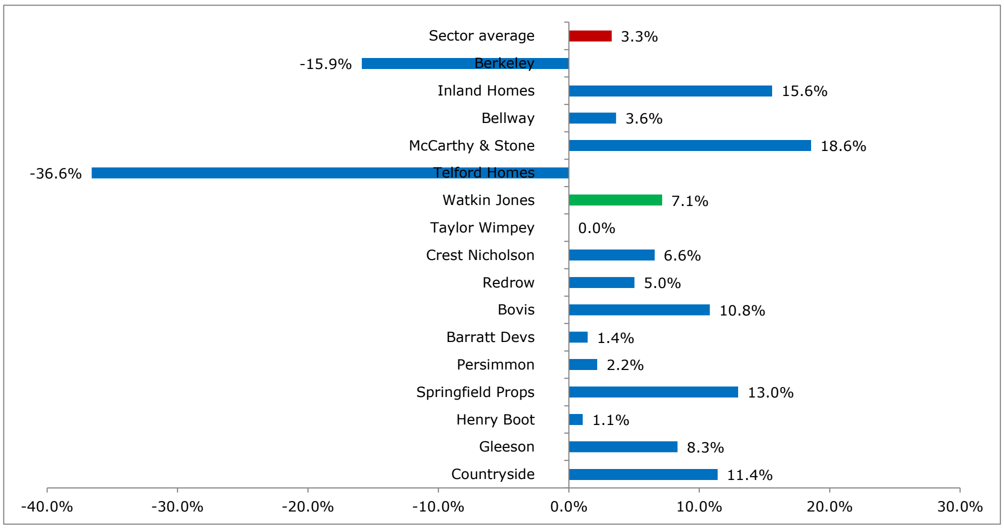
Source: Equity Development : arithmetic average for sector

CY ROE (reported)



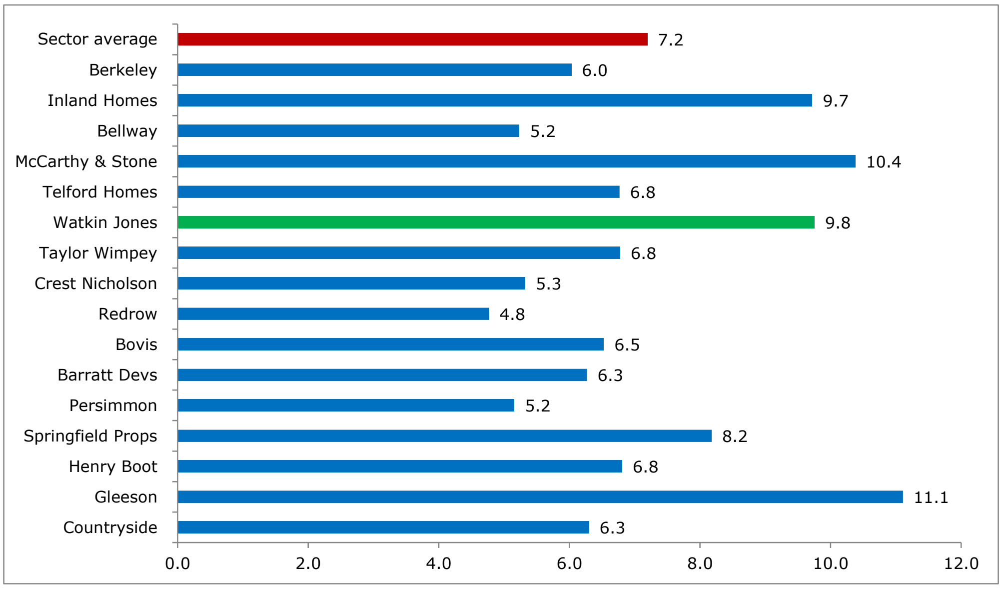
Source: Equity Development, arithmetic average for sector

CY + 1 EPS growth rates



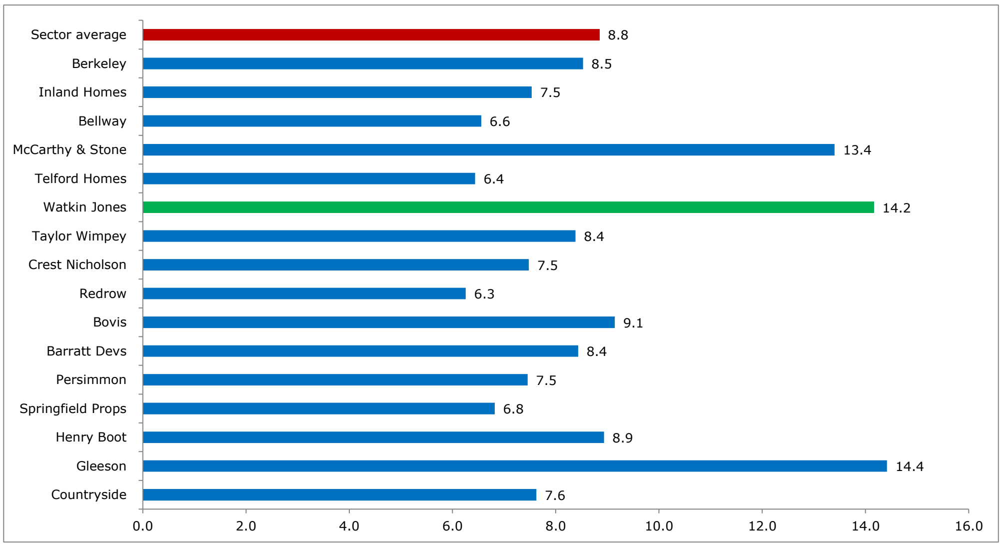
Source: Equity Development : arithmetic average for sector

CY EV/EBIT multiples vs peers



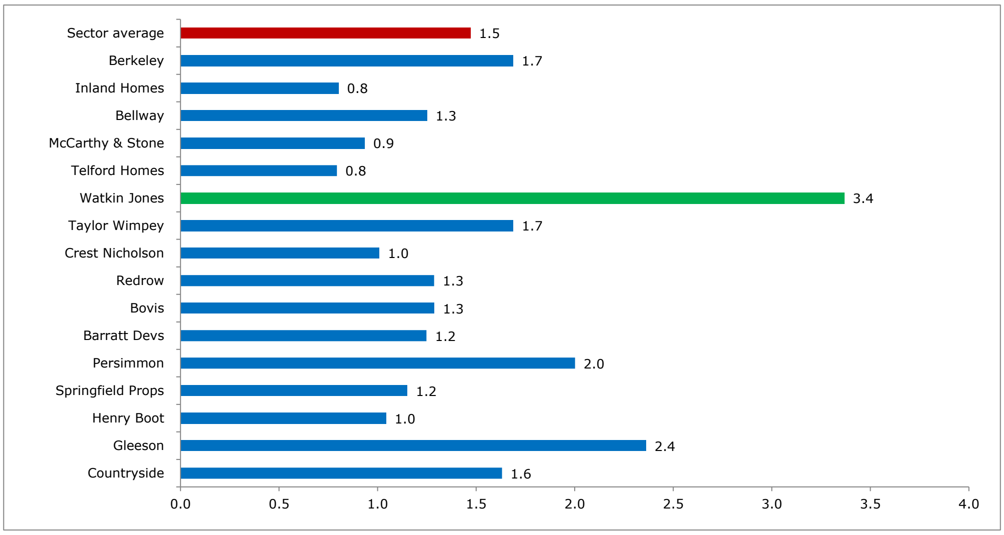
Source: Equity Development : arithmetic average for sector

CY PER multiples vs peers



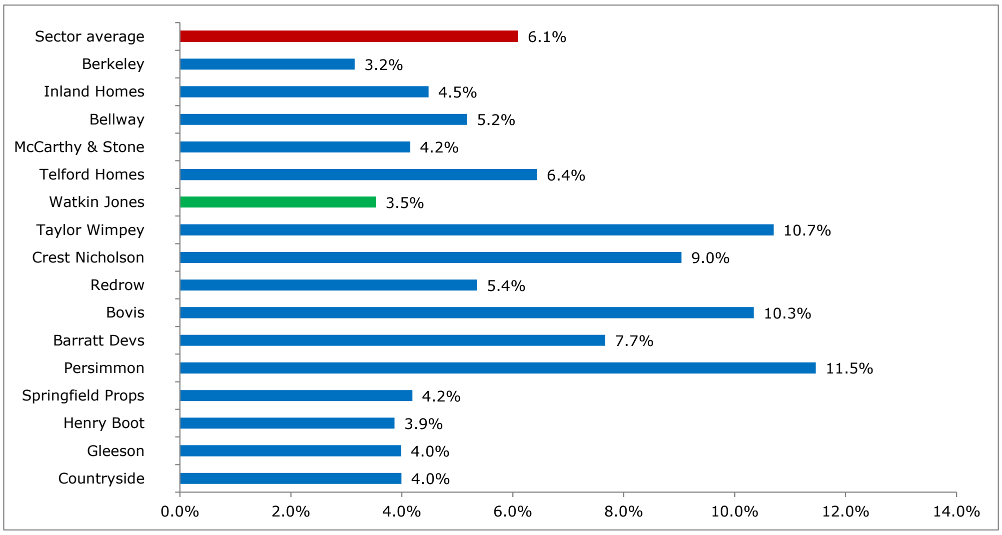
Source: Equity Development : arithmetic average for sector

CY Price : Book



Source: Equity Development, arithmetic average for sector

CY dividend yield vs peers



Source: Equity Development : arithmetic average for sector

Key risks

- Impact of a substantial jump in UK interest rates and/or a recession. This seems unlikely though, given that even the most pessimistic economic forecasts are for >1.5% GDP growth through to 2022.
- Protracted delays in obtaining planning consent, which traditionally has plagued the whole sector.
- Availability of skilled labour and associated resources at desired cost levels.
- Foreign exchange fluctuations could impact demand from international investors, from say Singapore, Hong Kong and China.
- Being relatively small in BTR, Watkin Jones could get squeezed by larger rivals, partners and customers.
- Future access to funding at commercial rates, perhaps in the unlikely event of another banking crisis.
- Generic risks of retention/recruitment of key staff, etc.
- Acquiring land at affordable rates.
- Withdrawal of government support for house-building (eg H2B, FTBs, stamp duty, etc).
- Brexit, and other possible legislative changes, say concerning building regulations, affordable housing, ground rents, etc
- Less demand from institutional money, if for example bond/gilt yields were to rise materially.

Investor Access

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