Progressive EQUITY RESEARCH

WATKIN JONES

HOME CONSTRUCTION

27 January 2023

WJG.L

110p

Market Cap: £280.8m

SHARE PRICE (p)

12m high/low	277p/80p

Source: LSE Data (priced as at prior close)

KEY DATA

Net (Debt)/Cash	£82.6m *(at 30/09/22)*
Enterprise value	£198.2m
Index/market	AIM
Next news	AGM, Feb 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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Rising rents attract investors back to market

Residential-for-rent developer and manager Watkin Jones on 25 January delivered FY22 results that were broadly in line with our expectations. Continuing strong demand for its core rental developments, as highlighted in October, was hampered by delays in investment decisions following the mini-budget. We believe recovery has begun, albeit on a slightly shallower trajectory, and current market conditions may offer the group opportunities. Surveys show continuing rental growth, attracting back investors but stretching affordability – we see WJG as 'part of the solution'.

- **Results in-line.** FY22 adjusted PBT slipped by 4.5% to £48.8m, in line with our £49.0m estimate. Revenue declined by 5.4% with record forward sales of £900m, including an increased contribution from build-to-rent (BTR) developments, but impacted by two anticipated forward sales being deferred because of the market volatility in September. The slight decline in profits also reflected some pricing and margin softness on sales concluded in H2, offset by a higher-than-expected profit of £18.3m from the sale of two purpose-built student accommodation (PBSA) assets. Year-end net cash, pre-IFRS16, was £82.6m, better than our £75.0m estimate.

- **Steady recovery now evident.** The October trading update highlighted the deferral of forward-funding decisions by WJG's institutional investors because of volatility in the cost of capital. Wednesday's outlook statement – and our own market soundings – suggests that stability in the financial markets is attracting back investors. However, the group assumes that this will more H2-weighted in FY23E. We have maintained our FY23E PBT estimate, backed by the secure PBSA and BTR development pipeline (maintained at £2.0bn) and have introduced FY24E estimates, implying 5% Y/Y growth in adjusted PBT (pages 2 - 3).

- **Under-supply feeds rental growth.** Today's Rightmove survey backs up the latest RICS data, which shows continuing rental growth driven by under-supply. This is attractive for investors currently and, longer term, stretched affordability means that there needs to be more supply, maintaining demand for developments (page 4 - 5).

- **Unique capital-light, low-risk model.** WJG develops BTR, PBSA and urban regeneration assets, forward-funded by institutions, which in our view reduces risk and cyclicality with low capital tie-up. The accommodation management division has relatively sustainable revenues (page 6).

FYE SEP (£M)	2020	2021	2022	2023E	2024E
Revenue	354.1	430.2	407.1	560.4	618.7
Fully Adj PBT	45.8	51.1	48.8	50.1	52.7
Fully Adj EPS, dil (p)	14.7	16.3	14.8	15.2	15.4
Dividend per share (p)	7.4	8.2	7.4	7.6	7.7
PER (x)	7.5x	6.7x	7.4x	7.2x	7.1x
Dividend yield (%)	6.7%	7.5%	6.8%	7.0%	7.0%
EV/EBITDA (x)	3.2x	3.0x	3.1x	3.1x	2.9x

Source: Company Information and Progressive Equity Research estimates.

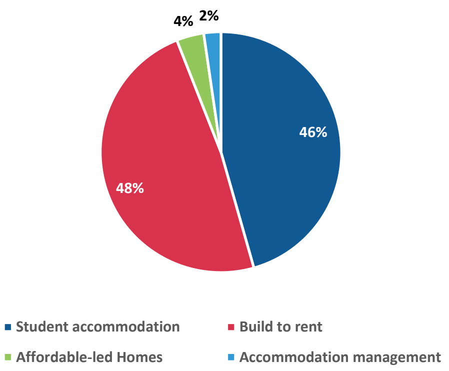
Results and forecast highlights

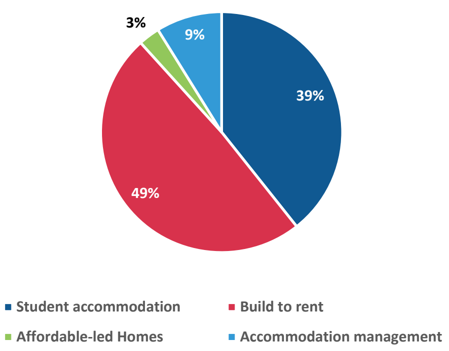
- Adjusted PBT slipped by 5% to £48.8m, in line with our estimate.
- Revenue declined by 5% because of the impact of two forward sales not closing in September due to market disruption, as previously disclosed.
- The gross margin fell from 19.7% to 16.6% due to higher land sales, which normally carry lower margins than developments.
- Operating profit of £54.7m included £18.3m from the sale of two PBSA leased assets, leaving four leased properties remaining.
- Adjusted EPS declined by 10% to 14.8p, 4.3% below our forecast, due to a prior-year tax adjustment. The dividend declined by 10% to 7.4p, in line with WJG's 2x cover policy.
- Net cash, pre-leases, moved from £124.3m in FY21 to £82.6m in FY22, ahead of our estimate of £75.0m.
- An exceptional charge of £30.4m was made due to the previously announced provision for remedial works under the Building Safety Act.
- Operational highlights include: a growing contribution from BTR; drop in PBSA due to a scheme deferral; transition effects and build delays in Affordable-led; and a 10% increase in units under management at Fresh, boosting revenue and margins.
- The secured development pipeline was maintained at £2bn, including £0.7bn forward sold and a £0.8bn secured consented pipeline.

Our PBT estimate for FY23E is unchanged and introduce a FY24E forecast opposite.

- We have increased our revenue estimate for FY23E by 2.8% and reduced our gross margin assumption from 16.1% to 15.2%, in line with guidance in the group's outlook statement that development gross margins would trend to 12%-14% in the short term, before new, cheaper land would build this back up to 15% in the medium term.
- Our FY22E EPS estimate now includes six-months of the 25% Corporation Tax rate.
- The group has identified costs savings of £3-4m pa and is already seeing good land opportunities. In our view, WJG's small, urban sites do not face the same competition as in mainstream housebuilding, and commercial owners are facing pressure to sell.

Revenue, LHS, and gross profit, RHS, by division, FY22 (%)





Source: Company Information

Figure 1: Watkin Jones – Key performance highlights (£m unless stated)

Year-end September	2017	2018	2019	2020	2021	2022	2023E	2024E
Revenue								
Student accommodation	256.1	312.7	246.1	226.0	259.9	180.0	275.0	345.0
Change (%)	*8.0%*	*22.1%*	*-21.3%*	*-8.2%*	*15.0%*	*-30.7%*	*52.7%*	*25.5%*
Build-to-rent	1.2	3.8	77.4	94.0	138.6	191.2	245.0	235.0
Change (%)		*na*	*na*	*21.4%*	*47.4%*	*38.0%*	*28.1%*	*-4.1%*
Affordable-led Homes	18.1	30.0	34.3	26.3	22.7	14.5	27.4	24.7
Change (%)	*-31.3%*	*65.8%*	*14.4%*	*-23.4%*	*-13.7%*	*-36.1%*	*89.3%*	*-10.0%*
Accommodation management	6.1	7.3	7.5	7.6	7.8	9.1	13.0	14.0
Change (%)	*116.6%*	*19.2%*	*2.2%*	*1.7%*	*2.3%*	*16.9%*	*43.3%*	*7.7%*
Corporate	20.4	9.3	9.5	0.3	1.3	12.3	-	-
Group revenue	**301.9**	**363.1**	**374.8**	**354.1**	**430.2**	**407.1**	**560.4**	**618.7**
Change (%)	*-5.5%*	*21.5%*	*-2.1%*	*29.4%*	*-3.9%*	*49.5%*	*37.7%*	*10.4%*
Gross profit								
Student accommodation	56.6	60.7	54.9	54.3	50.5	26.4	49.5	55.2
Margin (%)	*22.1%*	*19.4%*	*22.3%*	*24.0%*	*19.4%*	*15.0%*	*18.0%*	*16.0%*
Build-to-rent	0.7	1.0	13.8	14.9	29.8	32.8	24.5	21.2
Margin (%)	*56.3%*	*27.1%*	*17.8%*	*15.8%*	*21.5%*	*17.0%*	*10.0%*	*9.0%*
Affordable-led Homes	3.0	4.4	7.2	4.0	2.6	1.9	3.3	3.0
Margin (%)	*16.7%*	*14.6%*	*20.9%*	*15.4%*	*11.3%*	*12.0%*	*12.0%*	*12.0%*
Accommodation management	3.8	4.5	4.6	4.5	4.1	5.9	7.8	8.4
Margin (%)	*61.9%*	*61.8%*	*61.5%*	*59.8%*	*52.6%*	*50.0%*	*60.0%*	*60.0%*
Corporate	(0.5)	1.8	(0.3)	(1.8)	(2.1)	0.6	-	-
Gross profit	**63.5**	**72.4**	**80.0**	**75.9**	**84.8**	**67.6**	**85.1**	**87.7**
Margin (%)	*21.0%*	*20.0%*	*21.4%*	*21.4%*	*19.7%*	*16.6%*	*15.2%*	*14.2%*
AM admin	(1.7)	(3.2)	(3.2)	(3.4)	(4.2)	(5.8)	(5.0)	(5.0)
Group admin	(19.1)	(19.6)	(21.3)	(20.8)	(23.3)	(25.4)	(25.0)	(25.0)
Profit on sale of leasehold properties	-	-	-	-	-	18.3	-	
EBIT, group only	**42.7**	**49.6**	**55.6**	**51.7**	**57.3**	**54.7**	**55.1**	**57.7**
Share in op profit of JVs	1.4	1.1	0.3	0.2	(0.1)	-	-	-
Total operating profit	**44.1**	**50.8**	**55.9**	**51.9**	**57.2**	**54.7**	**55.1**	**57.7**
Exceptionals	-	4.3	(2.6)	(20.4)	-	(30.4)	-	-
Net interest	(0.9)	(0.7)	(5.4)	(6.1)	(6.0)	(5.9)	(5.0)	(5.0)
PBT	**43.3**	**54.3**	**47.9**	**25.3**	**51.1**	**18.4**	**50.1**	**52.7**
Add back exceptionals	-	(4.3)	2.6	20.4	-	30.4	-	-
Adj PBT	**43.3**	**50.1**	**50.4**	**45.8**	**51.1**	**48.8**	**50.1**	**52.7**
EBITDA	**43.8**	**50.9**	**64.8**	**61.1**	**65.9**	**63.1**	**64.8**	**67.5**
Adj EPS, dil (p)	**14.0**	**16.0**	**16.1**	**14.7**	**16.3**	**14.8**	**15.2**	**15.4**
DPS (p)	**6.6**	**7.6**	**8.4**	**7.4**	**8.2**	**7.4**	**7.6**	**7.7**
Net debt, post-IFRS 16	41.0	80.2	(60.7)	(39.6)	(4.9)	33.5	32.2	28.5
Net cash, pre-IFRS 16	na	na	**88.4**	**94.8**	**124.3**	**82.6**	**81.3**	**77.6**

Source: Company Information and Progressive Equity Research estimates.

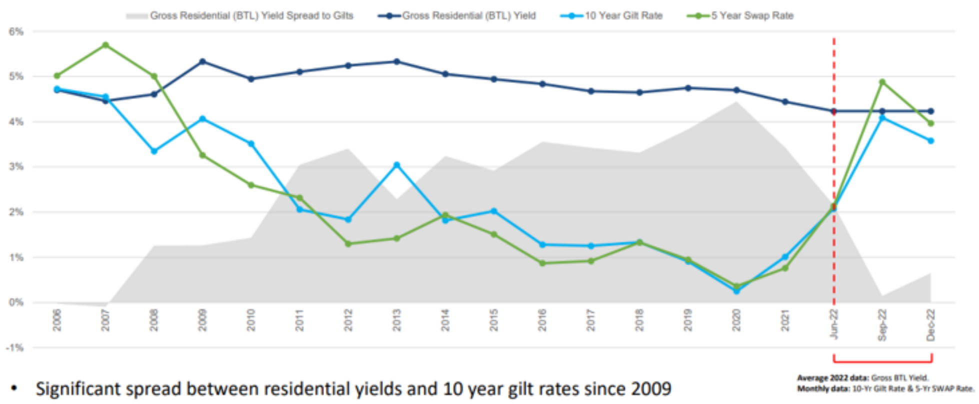
Settling down in borrowing costs attracting back investors

'Broader and deeper' range of investors looking to capitalise on rental market strength

The results statement referred to recovering interest in forward-funding among institutional investors, although cautioning that this should take until H2 23 to start feeding through to results. During the results presentation, management said the group is now "talking to a broader and deeper range" of potential investors.

The institutional investment market was disrupted by the sharp rise in the cost of capital that followed the mini-budget, in particular 10-year gilts and five-year swaps. But Wednesday's results presentation (link) provided further evidence that both are falling (see below).

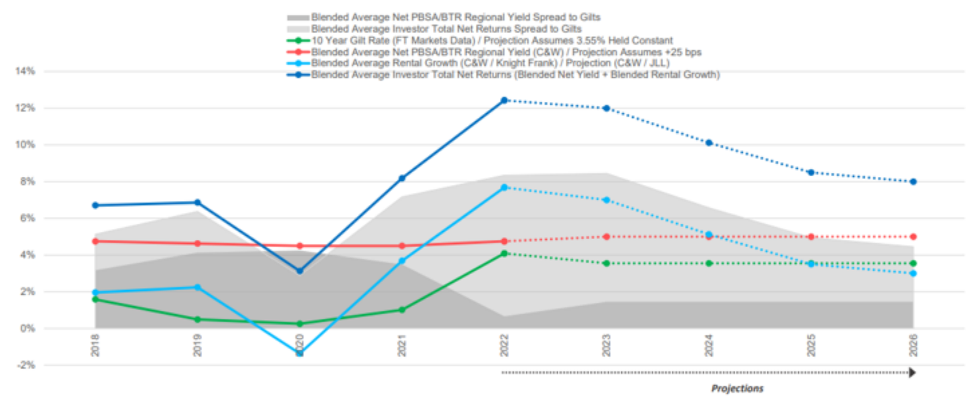
Residential yields v risk free rate (%)



Source: Company presentation, based on Savills and Chatham Financials research

Management argued that strong demand and rental growth prospects still provide attractive long-term total property returns (see below) in a market that is still clearly under-supplied, according to a swathe of surveys, including from RICS.

Forecast total property return (%)



Source: Company presentation, based on WJ management analysis

Surveys highlight continuing demand-supply inbalance

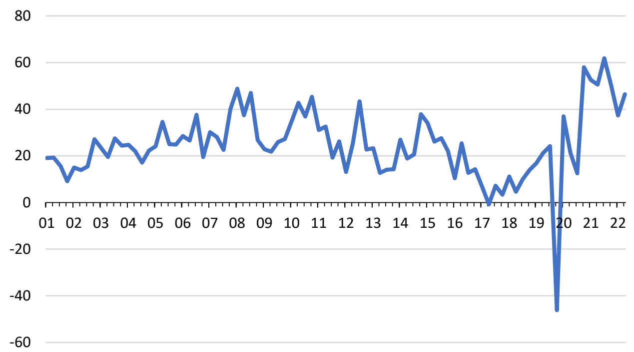
Tenant demand continues to rise but supply keeps falling

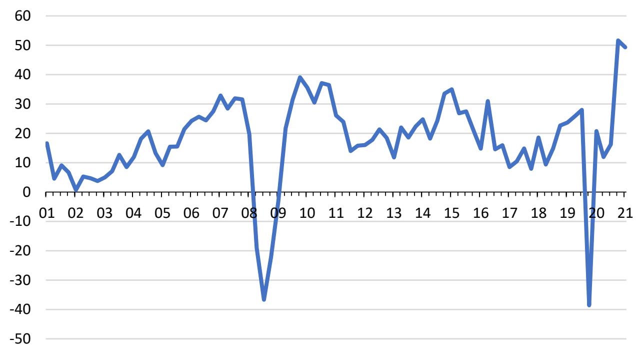
In our 13 October note RICS survey highlights strong rental market, we highlighted the continuing trend of very strong tenant demand and restricted supply pushing up rent expectations in Q3 2022. The latest RICS Residential Market Survey for Q4 (link) reinforces the theme. The survey balance for tenant demand in England & Wales rebounded from +37% in Q3 to +46% in Q4, indicating accelerated growth but at not quite the pace of last year's first quarter, which registered a peak of +62% (below, left).

New landlord instructions declined for the ninth consecutive quarter (Q3 2020, was a 'blip' interrupting a seamlessly downwards trend that stretches to 2016, as tax and regulatory changes have forced many landlords to sell up). Q4 22 showed an accelerating trend: -14% following -8% then -10% in the preceding two quarters.

This imbalance has had the inevitable effect of pushing rents up, with the latest balance of +52% just short of +61% in Q1 22. In absolute rather than 'balance' terms, RICS calculates that this equates to expectations for actual rents, 12 months ahead, of around +3%, down from the high of +4.5% earlier in 2022 (below, right).

Tenant demand over past three months, SA, LHS; Price expectations, next three months, RHS (% balance*)





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

Rental affordability now a pressing political imperative – with WJG 'part of the solution'

Affordability – the reason, along with lifestyle choices, for many households previously looking to rent rather than buy – is now becoming a pressing cost-of-living and political issue regarding the rental sector. In this morning's Rightmove Rental Tracker (link), the pace of growth nationally slowed from +3.2% Q/Q (Y/Y, +11.0%) in Q3 to +0.9% in the three months to December (Y/Y, +9.7%), taking the average monthly rent to £1,172. However, in London the trend accelerated: +5.8% to £2,480, from +3.8% in the previous quarter, pulling the annualised rate to +15.7%.

High rents have a double benefit for WJG, in our view: they are attractive for institutional investors currently, with the clear implication from this stretched affordability that there simply has to be more supply in the longer term. We see WJG as 'part of the solution'. Its core BTR product has always been aimed at median earners, and also includes 'affordable BTR' in the case of pipeline developments in Edinburgh and Belfast.

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

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 over £80m. 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 indicated at the results that growth would slow down slightly in the near term.
- **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	**2020**	**2021**	**2022**	**2023E**	**2024E**
Revenue	354.1	430.2	407.1	560.4	618.7
Adj EBITDA	61.1	65.9	63.1	64.8	67.5
Adj EBIT	51.7	57.3	54.7	55.1	57.7
Reported PBT	25.3	51.1	18.4	50.1	52.7
Fully Adj PBT	45.8	51.1	48.8	50.1	52.7
NOPAT	37.6	41.9	38.0	39.1	39.5
Reported EPS (p)	8.2	16.4	5.2	15.2	15.4
Fully Adj EPS (p)	14.7	16.3	14.8	15.2	15.4
Dividend per share (p)	7.4	8.2	7.4	7.6	7.7
CASH FLOW & BALANCE SHEET	**2020**	**2021**	**2022**	**2023E**	**2024E**
Operating cash flow	54.9	76.3	(19.6)	16.8	16.5
Free Cash flow	38.0	61.3	(15.3)	16.8	15.9
FCF per share (p)	14.9	23.9	(6.0)	6.5	6.2
Acquisitions	0.8	0.1	0.0	0.0	0.0
Net cash flow	18.9	1.8	(25.5)	(1.3)	(3.7)
Overdrafts / borrowings	174.1	141.2	77.4	77.4	77.4
Cash & equivalents	134.5	136.3	110.8	109.6	105.8
Net (Debt)/Cash, pre-IFRS 16	94.8	124.3	82.6	81.3	77.6
IFRS 16 Lease liabilities	(134.5)	(129.3)	(49.1)	(49.1)	(49.1)
Net (Debt)/Cash post-IFRS 16	(39.6)	(4.9)	33.5	32.2	28.5
NAV AND RETURNS	**2020**	**2021**	**2022**	**2023E**	**2024E**
Net asset value	167.8	184.8	176.5	197.5	217.4
NAV/share (p)	65.5	72.1	68.8	77.0	84.8
Net Tangible Asset Value	154.6	172.1	164.3	185.9	206.4
NTAV/share (p)	60.3	67.2	64.1	72.5	80.5
Average equity	164.5	176.3	180.9	187.2	207.4
Post-tax ROE (%)	12.8%	23.8%	7.4%	20.9%	19.1%
METRICS	**2020**	**2021**	**2022**	**2023E**	**2024E**
Revenue growth	(5.5%)	21.5%	(5.4%)	37.7%	10.4%
Adj EBITDA growth	(5.7%)	7.9%	(4.3%)	2.8%	4.0%
Adj EBIT growth	(7.1%)	10.8%	(4.5%)	0.7%	4.8%
Adj PBT growth	(9.3%)	11.7%	(4.6%)	2.7%	5.2%
Adj EPS growth	(8.5%)	11.2%	(9.4%)	2.7%	1.2%
Dividend growth	(12.0%)	11.6%	(9.8%)	3.0%	1.2%
Adj EBIT margins	14.6%	13.3%	13.4%	9.8%	9.3%
VALUATION	**2020**	**2021**	**2022**	**2023E**	**2024E**
EV/Sales (x)	0.6	0.5	0.5	0.4	0.3
EV/EBITDA (x)	3.2	3.0	3.1	3.1	2.9
EV/NOPAT (x)	5.3	4.7	5.2	5.1	5.0
PER (x)	7.5	6.7	7.4	7.2	7.1
Dividend yield (%)	6.7%	7.5%	6.8%	7.0%	7.0%
FCF yield	13.6%	21.8%	(5.4%)	6.0%	5.7%

Source: Company information and Progressive Equity Research estimates

27 January 2023

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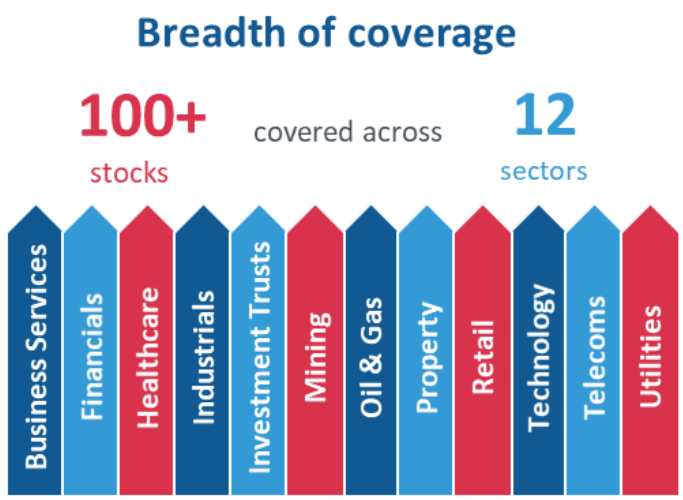

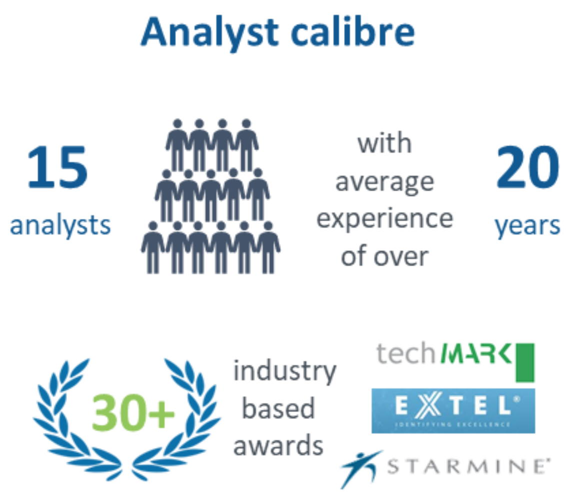

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