GRIT REAL ESTATE INCOME GROUP (LON:GR1T)

REAL ESTATE INVESTMENT & SERVICES

01/10/2018

Big yields, blue-chip asset base

UNIQUE DIVERSIFIED REAL ESTATE PLAY

Grit Real Estate Income Group (LON:GR1T) is a multi-listed (LSE, JSE, SEM) property company with a focus on selected African countries with a combination of economic growth, investment friendly policies and political stability. Rental income is underpinned by a blue-chip multinational tenant base, hard currency leases, and high occupancy rates.

Grit has a strong management team, with more than 59 years' African experience cumulatively. The portfolio has grown to US$642mln from US$210ln in 2015, and the company achieved its LSE main board listing in July 2018.

HIGH INCOME YIELD – AN OUTLIER VERSUS PEERS

Grit offers a dividend yield of 8.7%, which is among the very best in class compared with LSE-listed property stocks or with the global peer group. In this report we examine the financial dynamics behind this strong dividend yield.

The Grit property portfolio produces a Weighted Average Capitalisation rate of 8.3% compared with typical figures 3-6% for the London listed peer group. Grit operates a lean administrative cost base and maintains a high pay-out ratio of rental income into dividends.

RISK/REWARD PROFILE

Stocks delivering an 8.7% dividend yield in the London market would typically be companies perceived as facing financial distress and a dividend at risk. Grit, by contrast, has delivered nine consecutive income distributions in line with guidance, and has just achieved an LSE main board listing and a well-supported capital raise.

In terms of managing risks and therefore sustaining the dividend, Grit has a multi-tiered strategy. The company maintains a diverse portfolio in terms of geography and property sector, as well as a strong and diverse tenant base, and tightly manages currency risk and capital repatriation risk – some 93% of rental income is in hard currency or pegged currency. In this report we examine the risk management strategy in some detail. We conclude that Grit offers a compelling risk/reward profile.

Y/E June 30, $US-mln	2017a	2018a	2019e	2020e
Income producing assets	488.5	642.3	763.4	785.6
Adj. EPRA net income	5.6	22.8	37.2	38.9
Adj. EPRA EPS (cents)	5.1	11.3	12.5	13.1
DPS (cents)	12.1	12.2	12.7	13.1
Dividend yield	8.3%	8.3%	8.7%	8.9%
EPRA NAV/share (cents)	137.4	145.7	149.7	153.5
Price/NAV (x)	1.06	1.00	0.98	0.95

Source: Company data and Capital Network forecasts

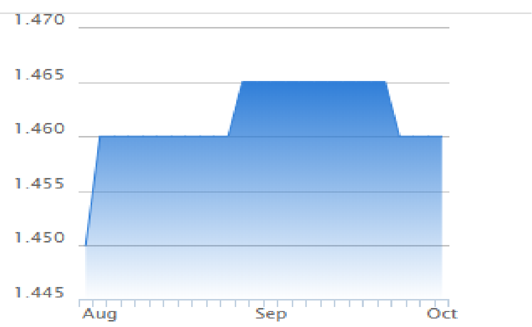
SHARE PRICE	52 WEEK LOW
US$1.45	US$1.45
MARKET CAP	52 WEEK HIGH
$444mln	US$1.48
NET DEBT	NAV
$303mln	$276mln

MAJOR SHAREHOLDERS

1) Government Employees Pension Fund: 28%
2) UK Institutional Investors: 12%
3) Drive In Trading Limited: 8%

Shares in Issue	306.4m
Avg Volume Daily	28,016
Primary index	FTSE AS
EPIC	LON:GR1T
Next Key Announcement	AGM Expected November 2018
Sector	Real Estate Investment & Services

SHARE PRICE CHART



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OVERVIEW

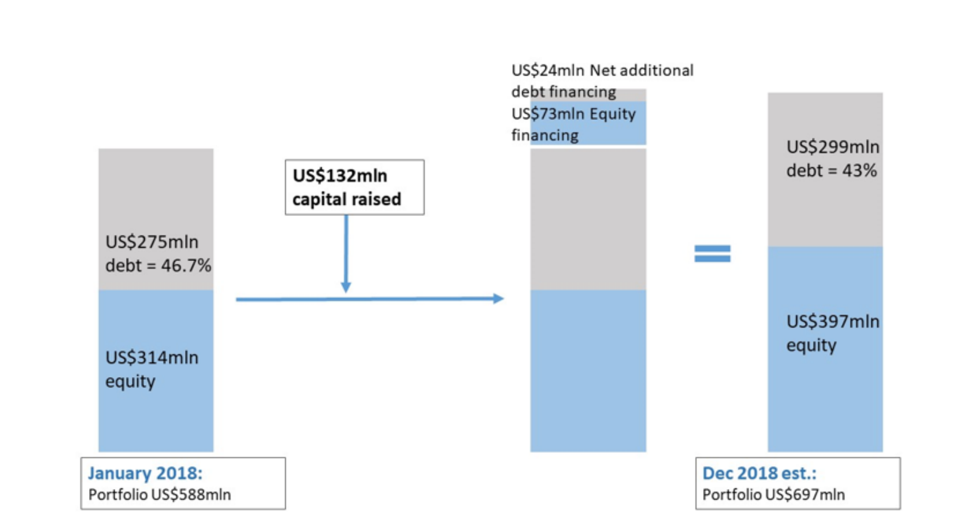
Grit Real Estate Income Group is a property company investing in African properties across diversified non-residential sectors including retail, office, hospitality and others.

Background and capital raising

The company was founded in 2014 and listed on the Johannesburg Stock Exchange (JSE) ALT-X board. In 2015 the company made an additional listing on the Stock Exchange of Mauritius (SEM) and moved from the ALT-X to the Johannesburg main board. The company raised additional capital in 2017 and grew the property portfolio to US$588mln by January 2018, from US$210mln at year-end June 2015.

In July 2018, the company listed on the LSE main board, in addition to the JSE and SEM listings, raising US$132mln in additional capital. The following schematic illustrates the use of the new funds.

Equity capital raising, July 2018

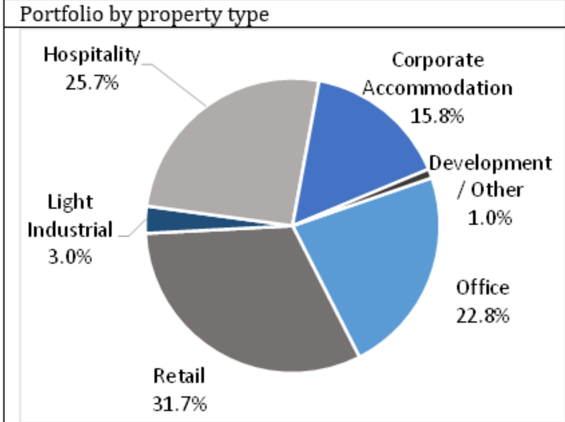


Source: Company data

The US$132mln equity raising gave rise to net proceeds of US$121mln, of which US$73mln was earmarked for acquisition of new properties already close to deal completion, with the remainder used to pay down group-level debt.

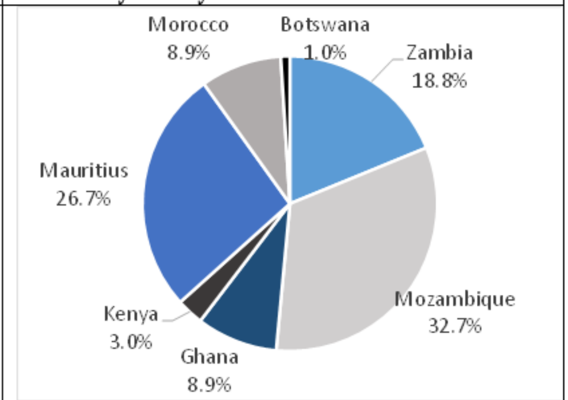
The following charts show the expanded property portfolio by value, in terms of the sectoral and geographic split.

Portfolio by property type



Source: Company data

Portfolio by country



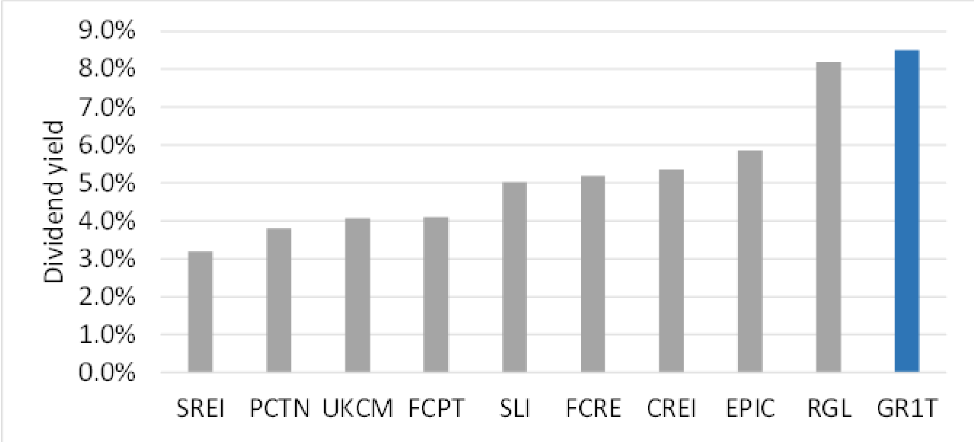
Source: Company data

Grit generates exceptionally high rental returns on its property portfolio and delivers commensurately high-income returns to its shareholders.

The company essentially operates as a REIT (real estate investment trust), although the REIT legal/tax structure is currently not applicable in some of the jurisdictions where Grit operates, and therefore the company is not incorporated as a REIT. Nonetheless, we find it instructive to compare Grit's dividend yield with a REIT peer group.

The following chart shows Grit's dividend yield compared with a selection of LSE-listed REITs (identified by their ticker symbols).

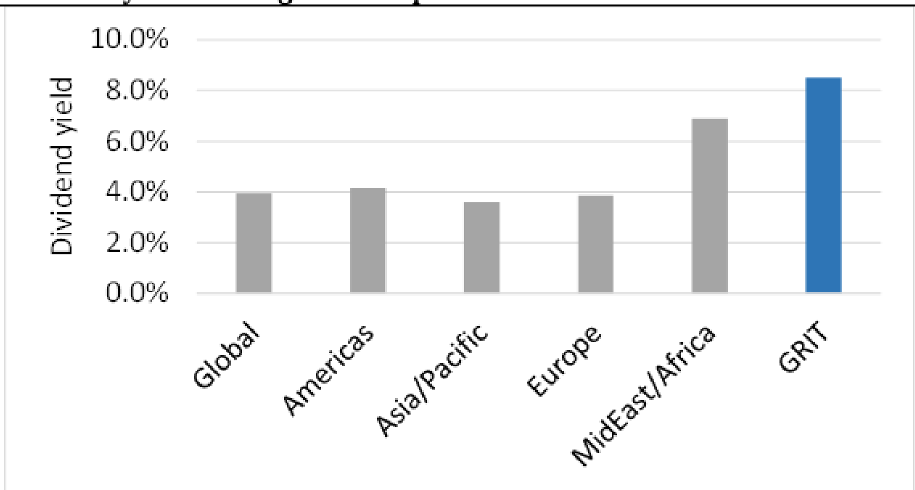
Dividend yield versus diversified LSE-listed property stocks



Source: LSE data

The dividend yield also compares strongly against a global peer group. The following chart shows the Grit dividend yield compared with global peers, as measured by the FTSE EPRA/Nareit indices.

Dividend yield versus global comparators



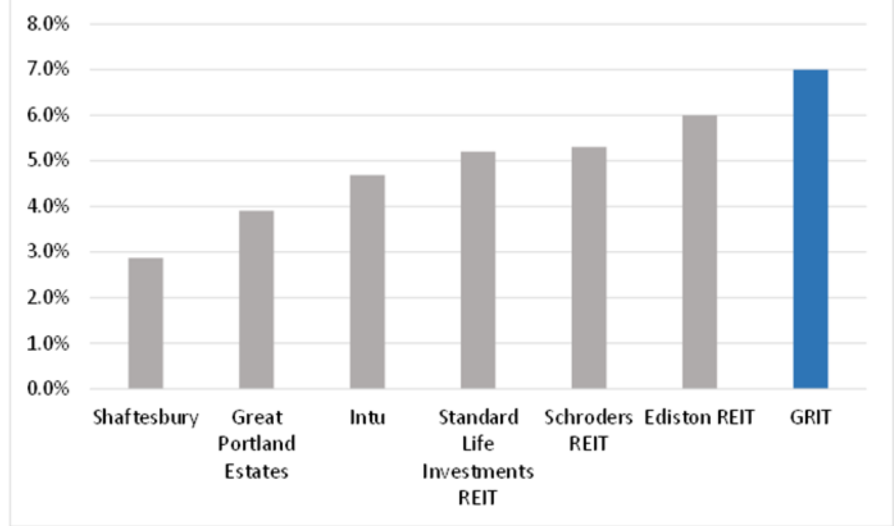
Source: Annualised yields from FTSE EPRA/Nareit indices

The strong dividend yield has a simple explanation:

- Grit shares currently trade close to 1x NAV
- Assets are mostly income generating properties
- African non-residential property offers a strong rental yield compared with other geographies

The following chart shows the rental income yield on Grit's portfolio compared with some of the UK-listed peers, in terms of net initial yield (see the glossary).

Rental yields



Source: Company data

We believe that Grit's rental yield is more accurately reflected in the weighted average capitalisation rate (see the glossary), which currently stands at 8.3%, but the net initial yield gives us comparability with the peer group.

Clearly, as an income investment Grit offers returns that are among the best in class; we believe there are two main questions that investors then need to ask:

• Does the African real estate risk demand a dividend yield as high as 8.7%? We argue that in fact, the yield is generous relative to the level of risk
• Does Grit have the right portfolio and the right structure operationally and financially?

We examine these issues in the remainder of this report. We conclude that Grit screens favourably on a risk/reward basis.

MARKET POSITIONING - SECTORS

A key pillar of Grit's strategy is sector diversification. The property portfolio comprises five main verticals (see chart p2). We consider the three biggest segments in more detail.

Office

In the office sector, Grit owns office buildings in Mozambique, Ghana, and Mauritius. The focus is purely on the blue-chip or multinational tenants, and rental payments are in $US (for Ghana and Mozambique) or Euros (for Mauritius).

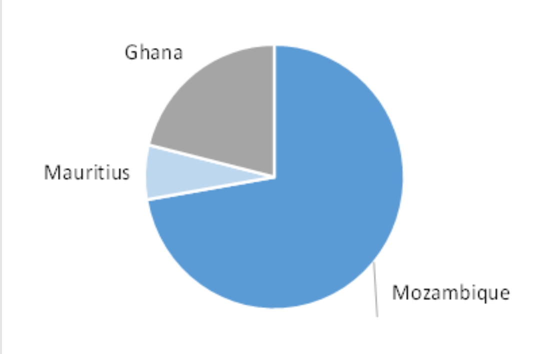
The following image shows a typical representative of the office portfolio.

KPMG Hollard building - Mozambique

Source: Company image

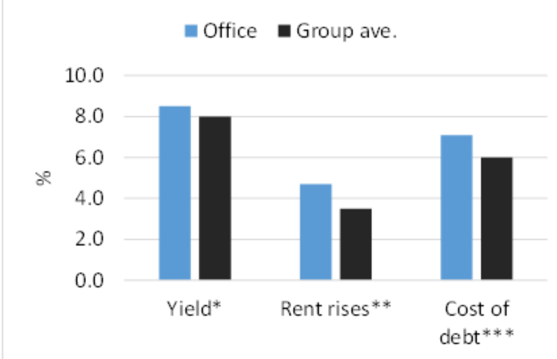
The following charts outline the main characteristics of the portfolio in the office sector, based on the expanded portfolio as per p2.

Geographic split – Expanded portfolio



Source: Company data

Financial characteristics



Source: Company data
*Yield = Weighted average capitalisation rate
**Rent rises = Weighted average annual rent escalations
***Cost of debt = Weighted average cost of property debt

The office sector has a number of attractive characteristics in terms of risk mitigation. In addition to the blue-chip tenant base, the segment also benefits from the use of offshore guarantees on some rental agreements, meaning a global corporate tenant guarantees the lease contract at the corporate level rather than at the local subsidiary level. Despite the attractive risk profile, the office segment actually generates a rental yield slightly higher than the group average.

In terms of cost of debt, we believe that the higher cost for the commercial sector, versus group average, reflects the geographic base of the office segment.

Going forward, Grit has negotiations underway to acquire further commercial property in Ghana and could consider additional geographies in the future.

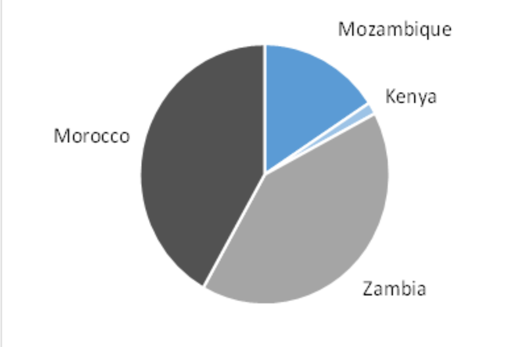
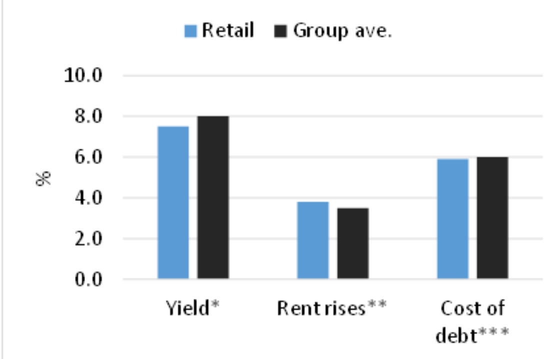
Retail

In the retail space, Grit owns shopping malls in Morocco, Zambia, Mozambique, and Kenya. The focus is on convenience retail, as opposed to luxury malls which can be more cyclical in an emerging market environment. The following image shows a typical example of the retail portfolio.

Mukuba Mall, Zambia

Source: Company image

The following charts outline the main characteristics of the portfolio in the retail sector, based on the expanded portfolio as per p2.

Geographic split – expanded portfolio	Financial characteristics
	
Source: Company data	Source: Company data *Yield = Weighted average capitalisation rate **Rent rises = Weighted average annual rent escalations ***Cost of debt = Weighted average cost of property debt

The rental yield on the retail portfolio is slightly lower than the group average; however, there is a favourable tax regime in Zambia for income repatriation, which means that in net terms the retail segment matches the group average. In terms of rent escalations and cost of debt, the retail segment is similar to the group average.

Looking forward, the company has received an offer for the Buffalo Mall in Kenya and is considering this disposal. There are no other acquisitions or disposals in the retail segment within Grit's publicly disclosed pipeline.

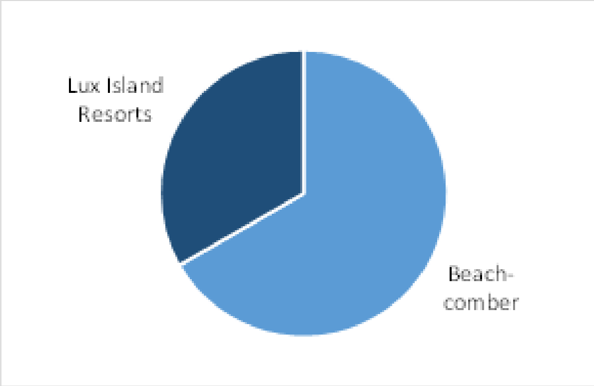
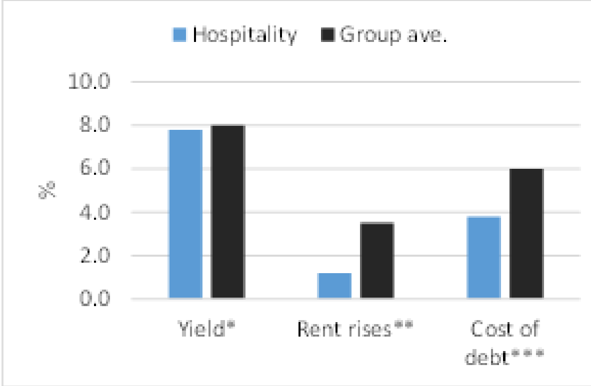
Hospitality

In the hospitality segment, Grit has property ownership (no operational management responsibility) of four resorts in Mauritius, operated by Beachcomber (3 resorts) and Lux Island Resorts (1 resort). The following image shows a typical example of the hospitality portfolio.

Canonnier resort and spa - Mauritius

Source: Company image

The following charts outline the main characteristics of the portfolio in the hospitality sector, based on the expanded portfolio.

Customer split	Financial characteristics
	
Source: Company data	Source: Company data

The hospitality portfolio attracts a lower cost of debt financing than the group average due to the investment grade status of Mauritius and the euro-denominated funding. Rent escalations have been lower than the group average due to the long lease durations (weighted average lease expiry 12.6 years).

Going forward in the hospitality sector, Grit has negotiations ongoing to acquire further properties in Mauritius and also in the Seychelles and in Senegal.

Other sectors

The other property sectors for Grit are light industrial (3.3% of group portfolio) and corporate accommodation (11.0% of portfolio). The assets comprise industrial warehouses in Kenya and Mozambique and a corporate housing estate in Mozambique.

The company is in negotiations for further light industrial properties in Kenya and Ghana.

ECONOMIC DRIVERS

In addition to diversification by property sector, Grit also seeks to maintain diverse portfolio exposure in terms of underlying economic drivers. The strategic aim of maintaining balanced economic exposure follows several key parameters:

- Maintaining <25% portfolio exposure to any individual country
- Achieving a geographic spread around Africa – North, Southern, East, West
- Exposure to investment grade countries as well as higher growth developing economies
- Avoiding over-exposure to any one economic sectoral driver

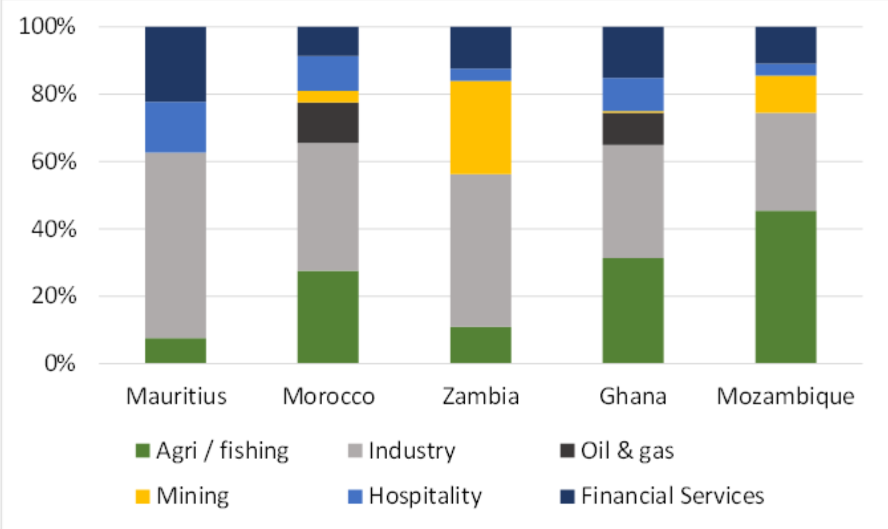
The following table summarises the general economic characteristics of the countries in Grit's portfolio.

	% of Grit's portfolio	Moody's sovereign rating	Annual GDP growth since 2010	GDP per capita
Mauritius	23.4	Baa1	3.7	11,948
Morocco	12.1	Ba1	3.6	3,304
Mozambique	32.9	Caa3	6.2	543
Zambia	11.8	Caa1	5.3	1,333
Ghana	16.0	B3	6.7	1,183
Kenya	3.3	B2	5.8	1,777

Source: African Development Bank

The following chart shows GDP breakdown for the main countries in Grit's portfolio. For these purposes we have excluded the government and transport & general services sectors, which make up about 50% of each country's GDP by do not reveal much about what differentiates the countries. We have focussed instead on the sectors which really drive GDP.

Economic growth drivers



Source: National accounts, intergovernmental agencies, US government agencies

We believe that the chart and table together demonstrate that Grit is well aligned with its target of balanced investment grade against emerging economies and balancing sectoral drivers.

RISK MANAGEMENT

We have demonstrated that Grit generates strong returns on its portfolio. The next natural question is to examine how the attendant risks are managed.

The company mitigates risks in its business model by maintaining a set of standards called its "margins of safety". These can be summarised as follows:

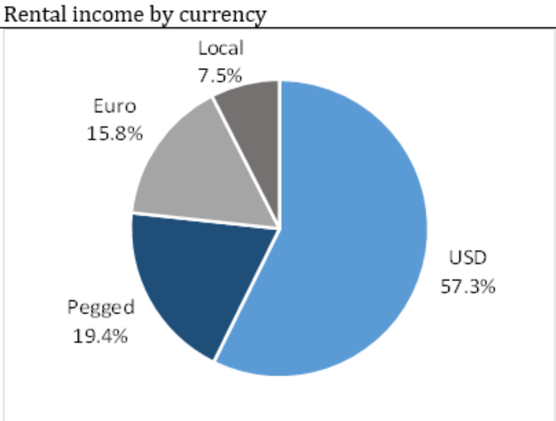
- Preference for hard currency – 93% of income in $US, euro, or pegged currency
- Securing the ability to repatriate funds – political risk insurance cover is applied
- Limiting political & macro risk – balancing high growth economies with investment grade
- Understanding land tenure – comprehensive legal due diligence
- Maintaining the ability to raise debt funding – multi-bank strategy
- A focus on counterparty strength in tenants – "Forbes 2000" or other global corporations account for 67% of rental income

We consider the underpinnings of some of the risk mitigation measures.

Currency risk management

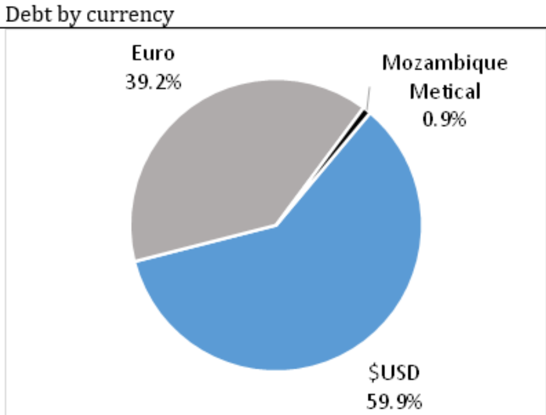
The following charts show Grit's currency exposure in terms of income and in terms of debts owed.

Rental income by currency



Source: Capital Network estimates

Debt by currency



Source: Company data, June 30 2018

The main US dollar (USD)-pegged currency is the Moroccan Dirham. Revenues from Ghana, Mozambique and Zambia are primarily in $US, while Mauritian revenues are in euros.

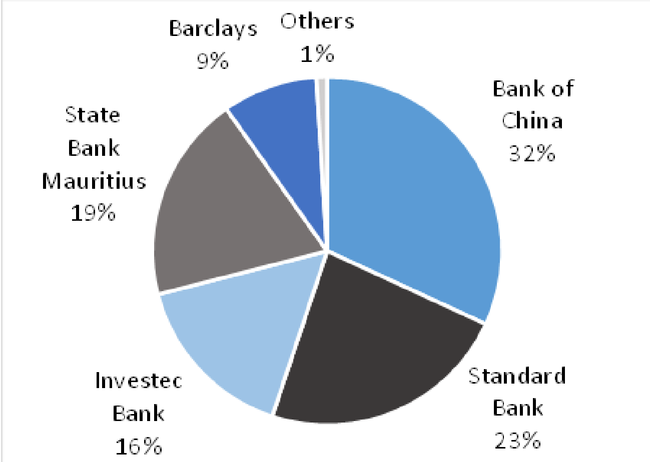
Debt financing is broadly matched against revenues.

We argue that overall Grit has a well-balanced FX exposure.

Financing risk management

The following chart shows Grit's borrowings by institutional lender.

Debt financing by institution

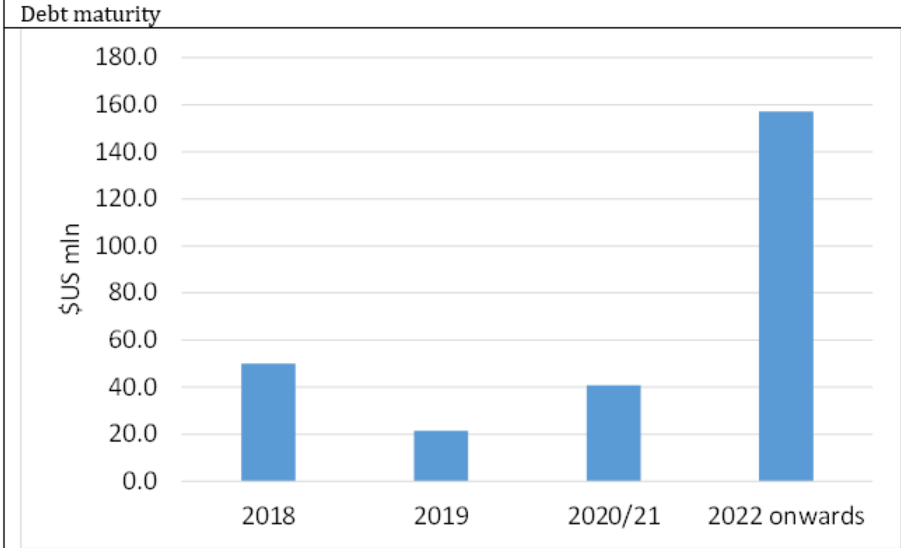


Source: Company data

The debt finance base is balanced between African and global lenders, with the global lenders being from Asia and Europe. The company avoids over-exposure to any one lender or jurisdiction.

The next chart shows the debt maturity profile.

Debt maturity



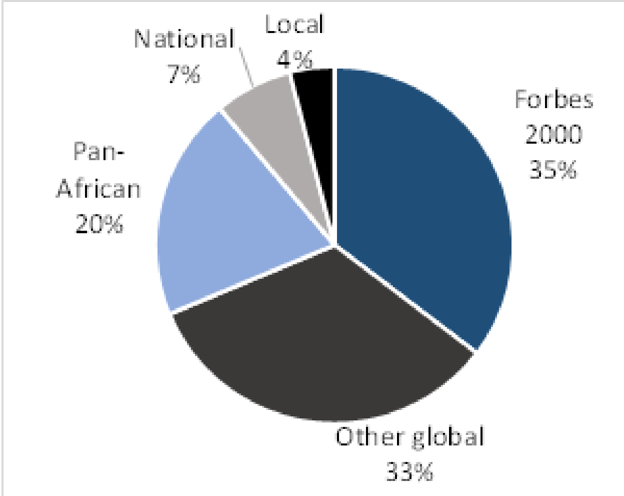
Source: Company data

Debt maturity is weighted towards the outer years, which minimises liquidity risk. Furthermore, via the July 2018 capital raise, the company has reduced its loan-to-value ratio to 43% from 51.4% at June 30, 2018 and has managed down its weighted average cost of debt from 5.78% at June 30, 2017 to 5.75% at present. Going forward the company is exploring entering the debt market with a note programme, which would further diversify the debt financing base.

Tenant profile

The final risk parameter that we consider is tenant grading. Grit targets global corporate clients, with 67% of the tenant base consisting of Forbes 2000 companies or other global players, weighted by rental income.. The following chart shows the composition of the tenant base, weighted by rental income, based on the expanded portfolio.

Tenancy grading



Source: Company data

Tenant concentration is another important measure of risk. Grit has no individual tenant exceeding 10% of group property income. The following table summarises the top 10 tenants.

Tenant	Industry	Tenant type	Contribution to group income (%)	Currency
Beachcomber	Hospitality	Other global	9	EUR
Vodacom	Telecom	Forbes 2000	8	$US
Lux Resorts	Hospitality	Other global	8	EUR
Vale	Mining	Forbes 2000	6	$US
A global petroleum corporation	Oil & Gas	Forbes 2000	4	$US
Edcon	Retail	Pan African	4	$US/ZMW
Game	Retail	Pan African	3	$US
Shoprite	Retail	Pan African	3	$US
Imperial Logistics	Logistics	Pan African	3	$US
Barclays	Financial	Forbes 2000	3	$US/MUR

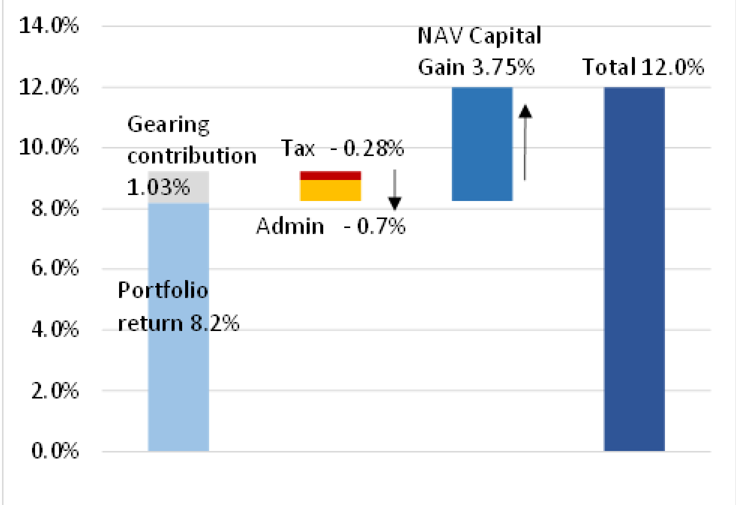
Source: Company data

We argue that Grit has a well-diversified and high quality tenant base, which serves as another risk limiting factor for the group.

FINANCIALS

Grit targets a return on net asset value (NAV) of 12%, based on 8.2% rental income return on properties, plus gearing effect, plus capital gains, minus costs and taxes. The following chart illustrates how the returns model works.

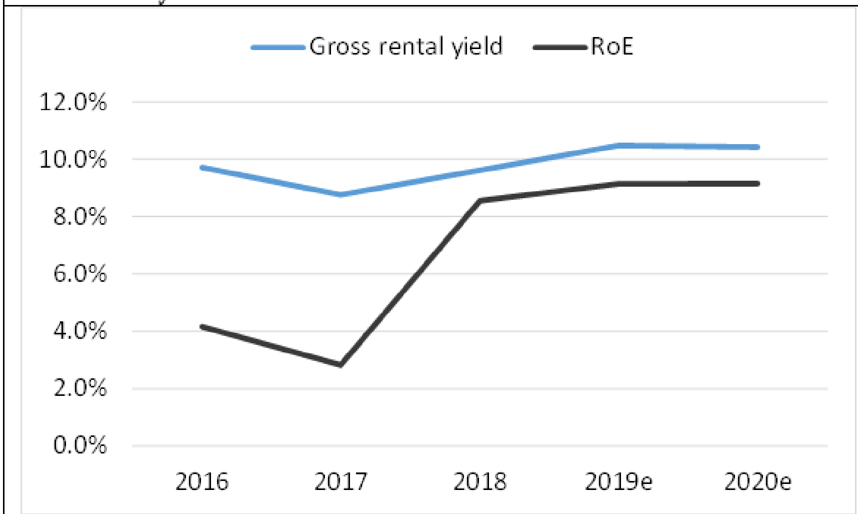
Targeted returns model



Source: Capital Network

The company has already achieved rental income returns in line with the business model. In terms of NAV returns, we believe that results for FY June 2018 demonstrate that returns are converging on target, and we expect this to continue in 2019e and 2020e. The following chart shows gross rental yield compared with return on equity (return on NAV).

Gross Rental yields vs RoE



Source: Capital Network

For this purpose, we have defined gross rental yield as:

- Gross rental income divided by average value of property portfolio (simple average of year's beginning and ending values)

We define Return on Equity as:

- "Adjusted EPRA net income" divided by average NAV (simple average of year's beginning and ending values)

The adjusted EPRA net income is an important measure of profitability in our view, as it offers the best measure of cash net rental income available for distribution to shareholders, i.e. it is the adjusted EPRA net income which underpins dividend payments. The profit measure can be described as follows:

Adjusted EPRA net income

EPRA is the European Public Real-Estate Association. This trade body has defined a set of standardised accounting metrics applicable to property companies, and these are the industry standard for LSE-listed property companies.

EPRA net income differs from IAS net income in that it strips out certain non-cash items, notably fair value adjustments on property values. In this sense EPRA net income attempts to capture the true level of cash income from rent.

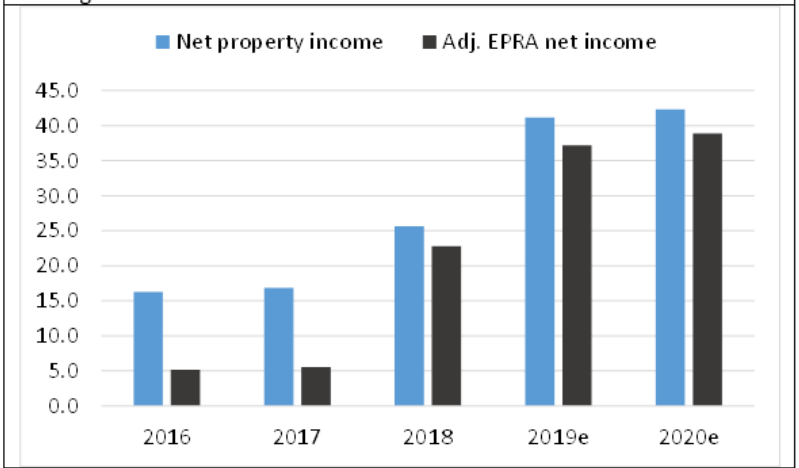
Grit's adjusted EPRA income strips out some further non-cash items such as accounting tax accruals.

Based on adjusted EPRA net income, we are forecasting RoE of 9% in 2020e. This is after admin costs and taxes, but before NAV capital gains. Once capital gains are included, we believe the company meets it target returns model.

Profit growth

The next chart provides some more detail on the convergence of NAV returns towards the target. The chart shows adjusted EPRA net profit compared with net property income (rent for wholly owned and joint venture properties, net of property operating costs).

Profit growth versus rental income



Source: Capital Network

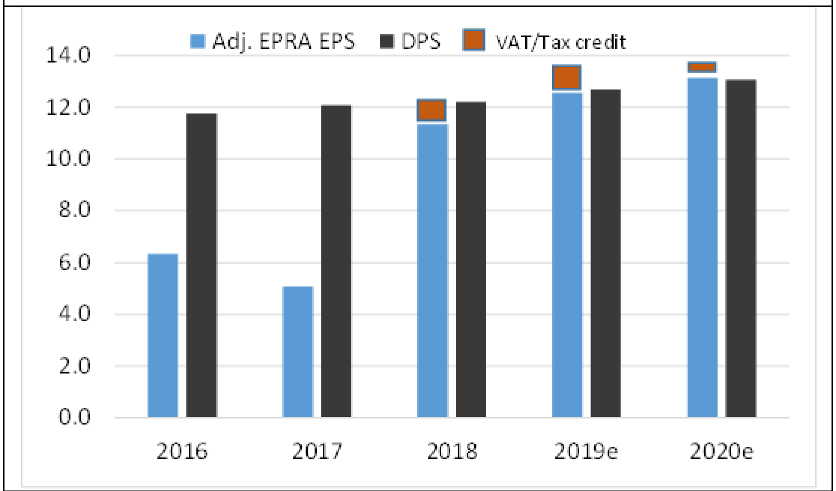
In our forecasts, the net property income is driven by the rental yield of 8.2%, in line with history and targets. The increases in absolute net property income come about from full-year inclusion of the expanded portfolio.

The chart shows the gap between net property income and EPRA operating profit remaining broadly constant, as administration cost remains broadly constant over the forecast period (details p14). This means that the incremental property income is delivering a strong drop-through to net profit, and this is the main driver of the increases in RoE in our forecast.

Dividend cover

Given that dividend yield is one of the main elements of the Grit investment proposition, we are interested in measuring how well the dividend is covered by cash earnings. For this purpose, we focus on adjusted EPRA earnings per share, as this is the best proxy for distributable cash. There are some other elements to consider, the largest being cash benefits from value added tax (VAT) and tax credit arrangements. These are detailed in Note 15 of Grit's June 2018 earnings release. The following chart shows dividend cover by adjusted EPRA earnings per share (EPS), plus the VAT/tax benefit.

Dividend cover



Source: Capital Network

We believe that the 2019e and 2020e projections therefore fully realise the shareholder return model, with NAV returns of around 8% property income and 3-5% capital gains, and with fully covered dividends.

CONCLUSIONS

We conclude that Grit presents a compelling offering to shareholders:

- Superior dividend income relative to LSE-listed and global comparable companies
- Driven by a high quality and diverse property portfolio with high rental yields
- Robust risk mitigation

The shares have only been listed in London since July 2018. We believe that as the market becomes more familiar with the Grit investment proposition, the shares could re-rate from the current valuation of 1.04x price/NAV.

GLOSSARY

EPRA – European Public Real-Estate Association

EPRA EPS – A definition of earnings per share determined by EPRA, which excludes property revaluations and other non-operating items

Net initial yield – annualised rental income divided by gross market property value

Weighted Average Capitalisation Rate – Ratio of Net Operating Income to Property Asset Value

FINANCIAL DATA

P & L

Year end June (US$ - 000)	2017 A	2018 A	2019 E	2020 E
Gross Rental income	22,872	32,128	47,575	49,050
Straight line rental accrual	1,132	1,110	1,300	1,300
Property Revenue	**24,004**	**33,238**	**48,875**	**50,350**
Property operating costs	-7,170	-7,585	-7,700	-8,000
Net property income	**16,834**	**25,653**	**41,175**	**42,350**
Other income	254	9	0	0
Admin and operating expense	-7,900	-14,653	-11,500	-11,850
Profit from operations	**9,188**	**11,009**	**29,675**	**30,500**
Fair value adjustment	-20,729	5,073	14,419	14,803
Contractual receipts from property vendors	230	8,689	0	0
Total FV adjustment	-20,499	13,762	14,419	14,803
Associates	6,893	21,028	24,737	26,020
FX, share-based expense, other	3,671	8,672	0	0
EBIT	**-977**	**45,782**	**68,831**	**71,322**
Net finance expense	-9,374	-15,285	-10,700	-10,800
PBT	**-10,351**	**30,497**	**58,131**	**60,522**
Tax	2,916	-4,752	-1,000	-1,000
Profit after tax	**-7,435**	**25,745**	**57,131**	**59,522**
Gain/(loss) on translation of functional currency	3,045	-1,495	0	0
Minorities	-801	-2,817	0	0
Total comprehensive income to shareholders	**-3,589**	**27,067**	**57,131**	**59,522**
Adj. EPRA net income*	**5,580**	**22,782**	**37,175**	**38,900**
EPS - fully diluted (US cents)	-6.8	12.8	19.3	20.1
Adj. EPRA EPS*	**5.1**	**11.3**	**12.5**	**13.1**
Dividend per share (US cents)	**12.1**	**12.2**	**12.7**	**13.1**

Source: Company data and Capital Network forecasts

Balance Sheet

Year end June (US$ - 000)	2017 A	2018 A	2019 E	2020 E
Cash and marketable securities	24,668	3,086	7,877	5,114
Receivables	23,244	29,786	36,968	38,114
Other current assets	2,000	77	77	77
Current Assets	**49,912**	**32,949**	**44,845**	**43,228**
Property	307,795	383,132	475,509	490,250
Deposits paid	24,440	11,117	11,117	11,117
Associate	89,016	165,311	188,436	194,277
PPA	1,290	1,749	1,749	1,749
Intangibles/other	592	4,639	4,639	4,639
Related party loans	8	802	802	802
Loans receivable	66,740	42,863	42,863	42,863
Deferred tax	6,496	8,999	8,999	8,999
Total Assets	**546,289**	**651,561**	**778,958**	**797,924**
Short-term debt	47,959	99,053	99,053	99,053
Accounts payable	26,177	26,136	32,438	33,443
Related party loans				
Other current liabilities	502	10,069	12,496	12,884
Long-term debt	185,051	207,106	180,106	190,106
Other non-current liabilities	16,577	20,915	20,915	20,915
Preference shares	12,840	12,840	12,840	12,840
Total Liabilities	**289,106**	**376,119**	**357,848**	**369,241**
Share capital	319,979	328,393	460,487	460,487
Reserves	-10,495	-13,031	-13,031	-13,031
Retained earnings	-51,177	-35,980	-28,721	-33,945
Other Reserves	0	0	6,316	19,113
Non-controlling interest	-1,123	-3,940	-3,940	-3,940
Shareholders' equity	**257,184**	**275,442**	**421,111**	**428,683**

Source: Company data and Capital Network forecasts

Cash flow

Year end June (US$ - 000)	2017 A	2018 A	2019 E	2020 E
Operating profit excl. Assocs	-7,870	24,754	44,094	45,303
Fair value adjustments and capital gains/losses	20,684	-13,762	-14,419	-14,803
Other non-cash	-3,589	-1,194	0	0
Operating cash before WC and interest	**9,225**	**9,798**	**29,675**	**30,500**
Movement in receivables, incl deposits	-4,255	-16,875	-7,182	-1,146
Movement in payables	7,200	179	8,729	1,393
Cash from operations	**12,170**	**-6,898**	**31,223**	**30,747**
Tax paid	-700	-111	-1,000	-1,000
Net cash from operation	**11,470**	**-7,009**	**30,223**	**29,747**
Property investment	-70,902	-33,081	-80,500	0
PPA/Intang.	-659	-685	-1,200	-2,500
Investment in subsidiaries and associates	-15,390	-10,109	-18,000	0
Dividend from associates	3,573	7,470	10,000	0
Loans advanced/repaid	-66,689	-22,934	0	0
Cash flow from investing	**-150,067**	**-59,339**	**-89,700**	**-2,500**
Share issue	110,828	-85	132,094	0
Cost of share issue	-5,330	0	-1,981	0
Pref share issue	12,840	0	0	0
Debt repayment/drawdown	44,034	51,527	-27,000	10,000
Dividends	-17,283	-14,907	-38,844	-40,009
Cash flow from financing	**145,089**	**36,535**	**64,268**	**-30,009**

Source: Company data and Capital Network forecasts