

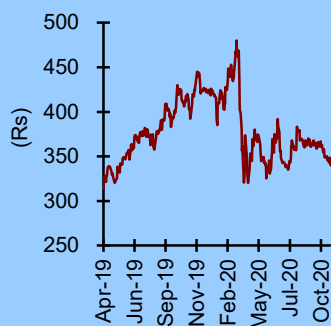
Q2FY21 result update
and target price change

Real Estate

Target price Rs408

Target price revision
Rs408 from Rs430

Price chart



INDIA

Embassy Office Parks REIT

BUY

Maintained
Rs343

Resilient show in tough times

The Embassy Office Parks REIT (Embassy REIT) delivered a resilient performance in Q2FY21 with office rental collections of over 99% (similar to Q1FY21) and also achieved contracted rental increases of 11% on 1.9msf of leasable area in Q2FY21 and 12% rental increases on 3.7msf of area in H1FY21. While our FY21-23E revenue/NOI/EBITDA estimates remain intact, we cut our FY21-23E NDCF estimates by 8-9%, factoring in extended weakness in hotel operations and working capital/balance sheet debt adjustments. We reiterate our BUY rating based on March 2021 DCF based NAV with a revised target price of Rs408/unit (earlier Rs430). At CMP of Rs343, the Embassy REIT offers a distribution yield of 6.5% in FY21E, 7.0% in FY22E and 7.4% in FY23E, on our revised estimates. Key risk to our call is rise in vacancies owing to greater adoption of Work-from-Home.

- **Strong office rental collections, rental escalations remain on track:** The REIT's office rental collections have been robust with collections of over 99 % in H1FY21 and the REIT portfolio has achieved contracted rental increases of 11% on 1.9msf of leasable area across 18 leases in Q2FY21 and 12% rental increases on 3.7msf of area across 40 leases in H1FY21. In Q2FY21, the REIT also raised listed debentures of Rs7.5bn at a 7.25% quarterly coupon to be used towards refinancing existing debt, construction development and for general corporate purposes. The REIT also has cash and investments of Rs12.2bn as of 30th September, 2020 to cushion against COVID-19. Post Q2FY21, the REIT has raised additional debt of Rs7.5bn at 6.7% coupon of which Rs4.7bn has been utilised to acquire the property maintenance operations of 20.3msf of leasable area in Manyata, Bengaluru and Tech Zone, Pune.
- **Embassy REIT portfolio cushions the COVID-19 impact:** The REIT's current tenant portfolio has ~50% of tenants in the technology domain with even smaller verticals such as financial services and research/consulting consisting of Global in-house captives. Currently, the REIT's top ten occupiers contribute ~42% of the gross overall rental income as of September 2020. We expect the REIT to deliver 11% NOI CAGR over FY20-23E driven by incremental leasing and recovery in hotels. While the mark-to-market opportunity for higher rentals in the REIT portfolio are now at risk, with just 7% of overall portfolio expiring in FY21E and 5% in FY22E, we do not see any risk to our assumptions of a 5% CAGR growth in rentals across the portfolio with FY23E having ~9% of portfolio expiry when the demand situation may normalise.
- **Limited completions in FY21-22E:** With the next set of completions of 0.9msf being in Techzone, Pune, 0.7msf in Embassy Oxygen and 1.0msf in Manyata (M3) only in FY23E with the rest of the completions of 4.5msf scheduled post FY23E, the REIT has enough leeway to control supply depending on the market dynamics over the medium-term.

Market Cap	Rs265bn/US\$3.6bn
Reuters/Bloomberg	EMBASSY IN
Shares Outstanding (mn)	771.7
52-week Range (Rs)	480/321
Free Float (%)	NA
FII (%)	NA
Daily Volume (US\$'000)	5,096
Absolute Return 3m (%)	(2.7)
Absolute Return 12m (%)	(13.0)
Sensex Return 3m (%)	6.1
Sensex Return 12m (%)	0.2

Year to Mar	FY20	FY21E	FY22E	FY23E
Revenue (Rs bn)	21.4	21.8	24.9	28.5
Adjusted PAT (Rs bn)	9.4	8.3	8.9	9.2
EPD (Rs)	9.9	10.8	11.5	11.9
% Chg YoY	109.5	8.6	7.2	2.8
P/E (x)	34.6	31.9	29.7	28.9
P/B (x)	1.2	1.2	1.3	1.4
Net D/E (x)	0.2	0.3	0.4	0.5
Distribution yield (%)	7.1	6.5	7.0	7.4
RoCE (%)	3.7	4.3	5.2	5.9
RoE (%)	3.4	3.8	4.3	4.7

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Overview of Assets

Table 1: Embassy Office Parks REIT Asset Portfolio (as of September 2020)

Property	Leasable Area (msf)/Keys/MW			WALE* (yrs)	Occupancy (%)	Rent (₹ psf / mth)		
	Completed	Development	Total			In-place	Market	MTM (%)
Embassy Manyata	11.8	3.1	14.8	7.3	97.0%	61	91	49%
Embassy Golflinks	2.7	-	2.7	8.3	98.6%	115	148	27%
Embassy One	0.3	-	0.3	8.4	5.5%	156	147	-6%
Bengaluru Sub-total	14.7	3.1	17.8	7.6	95.7%	72	102	42%
Express Towers	0.5	-	0.5	3.4	90.2%	266	270	1%
Embassy 247	1.2	-	1.2	4.0	85.6%	99	110	11%
FIFC	0.4	-	0.4	3.5	77.5%	297	285	-4%
Mumbai Sub-total	2.0	-	2.0	3.6	85.2%	173	178	3%
Embassy Techzone	2.2	3.3	5.5	5.2	90.6%	49	48	-3%
Embassy Quadron	1.9	-	1.9	2.8	77.0%	44	48	8%
Embassy Qubix	1.5	-	1.5	4.9	97.6%	40	48	21%
Pune Sub-total	5.5	3.3	8.8	4.4	87.8%	45	48	7%
Embassy Oxygen	2.5	0.7	3.2	10.7	77.7%	48	54	13%
Embassy Galaxy	1.4	-	1.4	2.7	98.9%	35	45	28%
Noida Sub-total	3.9	0.7	4.6	8.0	85.2%	43	50	18%
Subtotal (Office)	26.2	7.1	33.3	6.5	91.7%	70	89	28%
Four Seasons at Embassy One(2)	230 Keys	-	230 Keys	-	NM	-	-	-
Hilton at Embassy Golflinks	247 Keys	-	247 Keys	-	NM	-	-	-
Manyata (5 & 3 star)	-	619 Keys	619 Keys	-	-	-	-	-
Embassy Energy	100MW	-	100MW	-	-	-	-	-
Subtotal (Infrastructure Assets)	477 Keys / 100MW	619 Keys	1,096 Keys / 100MW					
Total	26.2 msf / 477 Keys / 100MW	7.1 msf / 619 Keys	33.3 msf / 1,096 Keys / 100MW					

Source: Company, I-sec research, WALE = Weighted Average Lease Expiry

Table 2: Q2FY21 Walkdown of Financial Metrics*(Rs mn, year ending Mar 31)*

Consolidated	Q2FY21	Q2FY20	YoY (%)	H1FY21	H1FY20	YoY (%)
Revenue from Operations	5,401	5,206	3.7	10,563	10,557	0.0
Property Taxes and Insurance	(196)	(181)		(389)	(360)	
Direct Operating Expenses	(392)	(641)		(792)	(1,284)	
Net Operating Income	4,813	4,384	9.8	9,382	8,913	5.3
Other Income	389	300		768	442	
Property Management Fees	(119)	(115)		(236)	(234)	
Indirect Operating Expenses	(111)	(179)		(199)	(353)	
EBITDA (excluding other income)	4,583	4,090	12.1	8,947	8,326	7.4
EBITDA (including other income)	4,972	4,390	13.3	9,715	8,768	8.0
Working Capital Adjustments	(276)	245		(159)	1,102	
Cash Taxes	(124)	(356)		(366)	(682)	
Other Adjustments	(80)	(381)		(455)	(590)	
Cash Flow from Operating Activities	4,492	3,897	15.3	8,735	8,598	5.9
External Debt (Interest & Principal)	(436)	(237)	NM	(880)	(904)	
Other Income from Investments	-	241	NM	322	358	
NDCF at SPV Level	4,056	3,901	4.0	8,177	8,052	5.5
Distribution from SPVs to REIT	4,088	4,249	(3.8)	8,268	7,998	
Distribution from Embassy Golflinks	258	480		738	960	
REIT Management Fees	(55)	(61)		(114)	(103)	
Other Inflows at REIT level (Net of Expenses)	(62)	(7)		(168)	(14)	
NDCF at REIT level	4,229	4,661	(9.3)	8,724	8,841	(1.1)
Distribution	4,244	4,630	(8.3)	8,743	8,797	(0.6)

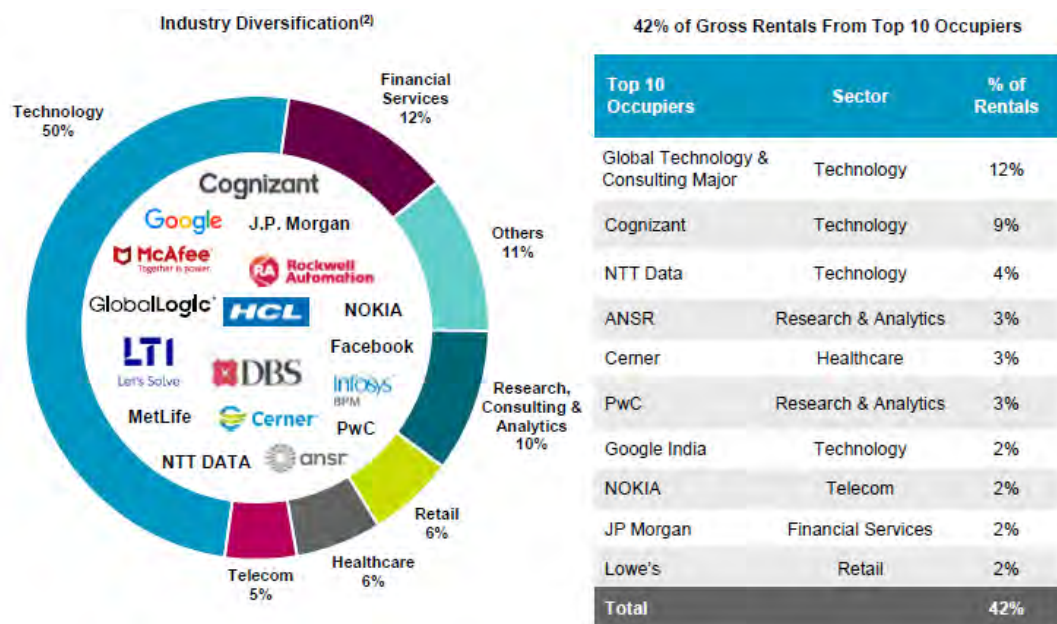
Source: Company, I-Sec research

Embassy REIT portfolio cushions the COVID-19 impact

While we acknowledge the risk to medium-term demand for office spaces in India, we believe that the office portfolio of the Embassy REIT is relatively resilient in these tough times for the following reasons:

- **Tenant mix of global IT MNCs and Global In-House Captives:** Embassy REIT's current tenant portfolio has around 50% of tenants in the technology domain with even smaller verticals such as financial services and research/consulting consisting of Global in-house captives. Currently, the REIT's top ten occupiers contribute ~42% of the gross overall rental income as of September 2020.
- **Only 6% of overall portfolio has exposure to stressed sectors:** Among the directly impacted sectors by COVID-19, the Embassy REIT has 6% of its overall portfolio consist of occupiers who are directly impacted by COVID-19 including co-working spaces, hospitality, aviation and retail which could see some stress in collections/occupancy.
- **Rental collections of over 99% in H1FY21:** The Embassy REIT has maintained strong rental collections (including facility management and common area maintenance) till date for April-September 2020 with 99.5% of rental collections in Q2FY21 and 99.7% in Q1FY21.

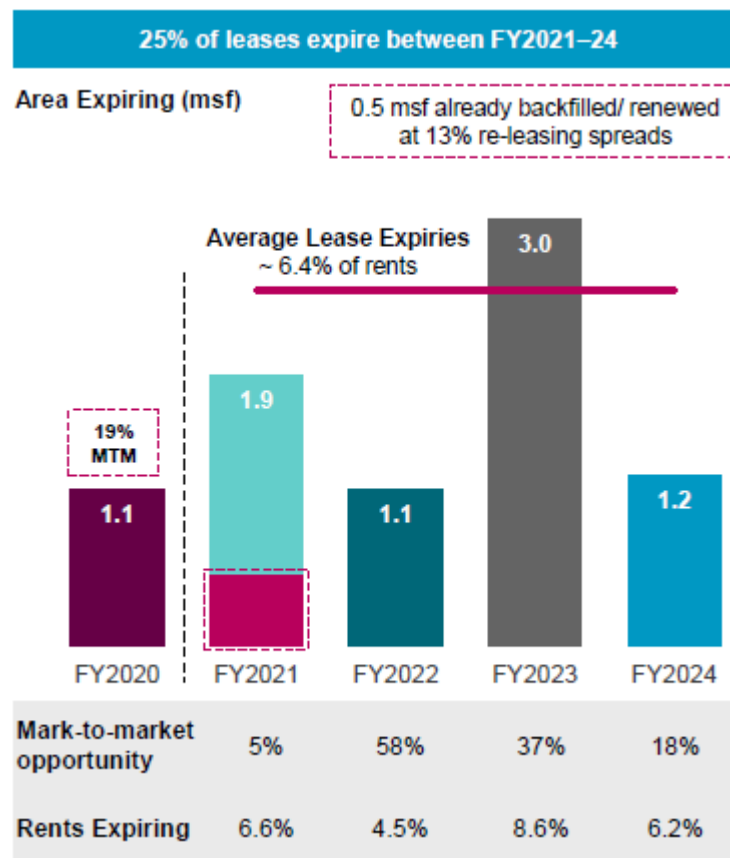
Chart 1: Embassy REIT Sectoral and Tenant Wise Breakup



Source: Company, I-Sec research

- Sticky nature of global MNC companies:** Globally MNC occupiers typically enter into long-term tenancy contracts with office developers for 8-10-year periods with a contracted rental escalation of 15% every 36 months. They also invest at least Rs3,000-4,000/psf for fit-outs for their offices in addition to the contracted rentals keeping in mind the longer tenure of their leases.
- High quality talent pool in India:** India leads in STEM (Science, Technology, Engineering, Mathematics) talent for technology assignments with over 2 million students graduating each year. Over the last decade, the emergence of GICs (Global In-House Captives) has led to more high-end development work being done in India. Further, employees' costs in India would not be more than 20-25% of comparable cost for employees in the occupier's country of origin.
- Affordable rentals:** India remains one of the more affordable office markets in the world, with average rentals for Grade A office markets in peripheral/suburban micro-markets hovering around 1 USD/psf/month or Rs70-75/psf/month. Further, with rental costs for MNC occupiers being just 2-3% of their revenues, we do not anticipate any major payment issues for the Embassy REIT.
- Mark-to-market opportunity is back-ended:** While the mark-to-market opportunity for higher rentals in the REIT portfolio are now at risk, with just 7% of overall portfolio expiring in FY21E and 5% in FY22E, we do not see any risk to our assumptions of a 5% CAGR growth in rentals across the portfolio with FY23E having ~9% of portfolio expiry when the demand situation may normalise.

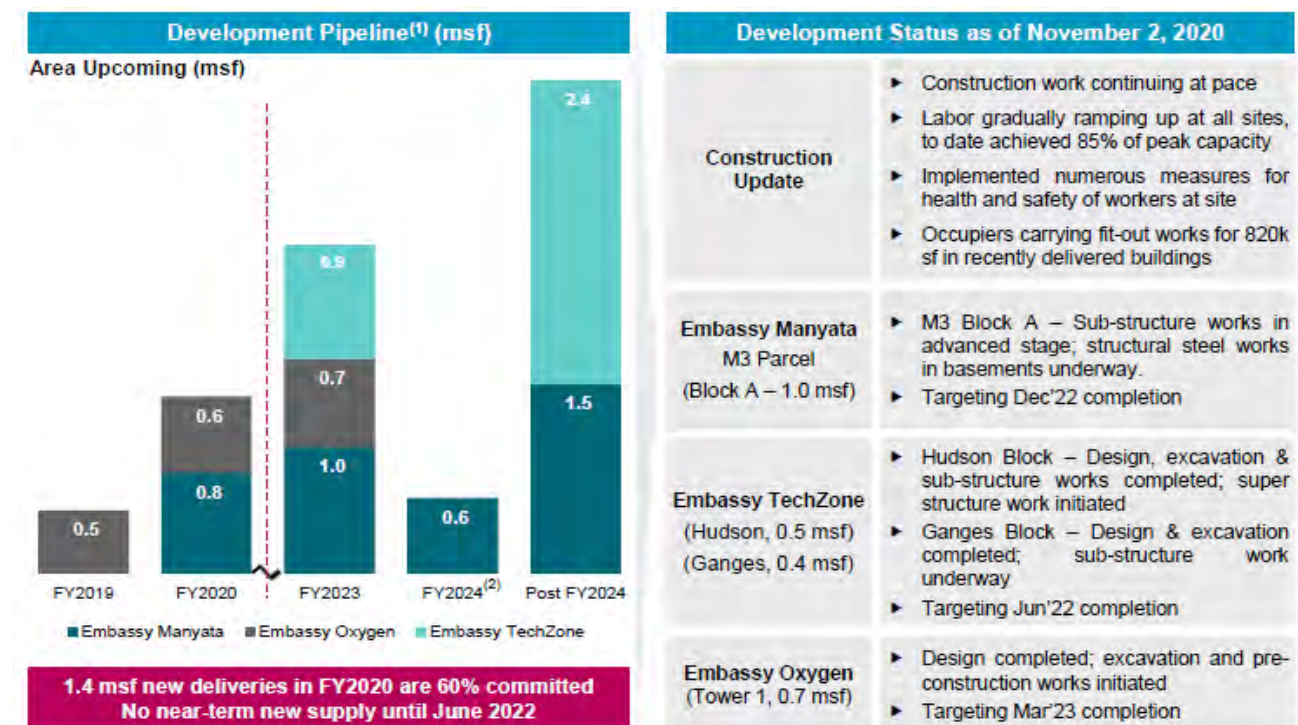
Chart 2: Mark-to-Market opportunity for REIT portfolio is back-ended



Source: Company, I-Sec research

- Limited completions in FY21-22E:** As of March 2020, the Embassy REIT had delivered 2 offices space of 1.4msf (0.8msf in Manyata, Bengaluru and 0.6msf in Oxygen, Noida) around 2-3 quarters ahead of schedule. With the next set of completions of 0.9msf being in Techzone, Pune, 0.7msf in Embassy Oxygen and 1.0msf in Manyata (M3) only in FY23E with the rest of the completions of 4.5msf scheduled post FY23E, the REIT has enough leeway to control supply depending on the market dynamics over the medium-term.

Chart 3: Near-term risk to incremental leasing is limited for the REIT portfolio



Source: Company, I-Sec research

Valuation:

REITs derive cash flows in the form of interest, debt repayment and dividend payments from owned assets which have differing cash flow profiles. Unlike assets in Infrastructure Trusts like toll/annuity roads or power transmission assets which have a fixed tenure of operations, the underlying assets in REITs which consist of offices, malls and hotels are perpetual in nature and carry an element of capital appreciation as well through escalation in rentals, addition of new assets and ramp up in occupancies.

Hence, the total return offered by a REIT should be measured as a mix of annual distributions and capital appreciation of the units of the REIT. Hence, we prefer a DCF based approach which captures the upside from uptick in rental income along with the annual distribution of at least 90% of the Net Distributable Cash Flow (NDCF) to REIT unitholders.

Our key assumptions include:

- 5% annual increase in rentals from FY22E onwards
- 4% terminal growth rate from FY30E
- Cap rate of 8% on Net Operation Income (NOI) of each asset
- WACC of 11.4% assuming 0.2x debt/equity with cost of equity of 12.5% and cost of debt of 9.0%
- 3.2msf of under construction assets to become operational in FY23-24E
- We have assumed that the zero-coupon bond maturing in June 2022 will be refinanced again on similar terms
- We have not assumed any injection of ROFO assets into the Embassy REIT
- We have assumed a collapse in the holding structure of Manyata Tech Park to a two-tier structure from the current three-tier structure from FY22E onwards.

We retain BUY with a revised target price of Rs408/unit

The Embassy REIT manager has given a NOI guidance of Rs18.5-19.5bn for FY21E along with DPU (Distribution per Unit) guidance of Rs21.5-22.6/unit for FY21E. While there was no formal guidance provided at the beginning of FY21E considering the onset of Covid-19, the Embassy REIT manager has given this guidance based on continued weakness in hotels business, working capital adjustment, longer rent-free period for new leases and other cash flow adjustments.

While our revised revenue/NOI/EBITDA estimates remain intact, we cut our FY21-23E NDCF estimates by 8% for FY21E, 5% for FY22E and 9% for FY23E. We expect the REIT to deliver 11.4% NOI CAGR over FY20-23E driven by incremental leasing, new assets and recovery in hotels. We reiterate our BUY rating based on March 2021 DCF based NAV with a revised target price of Rs408/unit (earlier Rs430) factoring in extended weakness in hotel operations and working capital/balance sheet debt adjustments. At CMP of Rs343, the Embassy REIT offers a distribution yield of 6.5% in FY21E, 7.0% in FY22E and 7.4% in FY23E, on our revised estimates.

Table 3: Revised estimates of Embassy REIT

Embassy REIT Cash Flows	FY20	FY21E	FY22E	FY23E
Revenue from Operations*	21,449	21,823	24,857	28,469
Net Operating Income (NOI)*	18,170	19,146	22,544	25,127
EBITDA*	17,023	17,659	20,619	22,929
NDCF at SPV level^	16,943	18,530	19,987	21,361
NDCF at REIT level^	18,866	17,305	18,642	19,719
NDCF Distribution Payout (%)	100%	100%	100%	100%
NDCF Distribution by REIT^	18,821	17,305	18,642	19,719
Distribution per Unit	24.4	22.4	24.2	25.6
Distribution Yield (%)	7.1	6.5	7.0	7.4

Source: I-Sec research estimates, *excludes Golflinks, ^ includes Golflinks

Table 4: Old estimates of Embassy REIT

Embassy REIT Cash Flows	FY20	FY21E	FY22E	FY23E
Revenue from Operations*	21,449	21,813	24,499	28,913
Net Operating Income (NOI)*	18,170	19,316	22,064	25,000
EBITDA*	17,023	17,795	20,235	23,425
NDCF at SPV level^	16,943	18,870	20,015	22,217
NDCF at REIT level^	18,866	18,808	19,724	21,669
NDCF Distribution Payout (%)	100%	100%	100%	100%
NDCF Distribution by REIT^	18,821	18,808	19,724	21,669
Distribution per Unit	24.4	24.4	25.6	28.1
Distribution Yield (%)	7.1	7.1	7.5	8.2

Source: I-Sec research estimates, *excludes Golflinks, ^ includes Golflinks

Table 5: Revised Valuation of Embassy REIT

Enterprise Value	381,599
Less: REIT level debt	56,503
Less: Security deposits	9,985
Equity Value	315,111
Equity Value per Unit	408

Source: I-Sec research estimates

Table 6: Sensitivity of Target Price to Cap Rate and Cost of Equity

	Target Price	Cost of Equity (%)					
		10%	11%	12%	13%	14%	15%
Cap Rate (%)	6%	526	492	464	440	419	402
	7%	493	461	435	413	394	377
	8%	462	433	408	387	369	354
	9%	434	406	383	364	347	332
	10%	407	381	360	341	326	312
	11%	382	358	338	321	306	293

Source: I-Sec research estimates

Financial summary (Consolidated)

Table 7: Profit and Loss statement

(Rs mn, year ending Mar 31)

	FY20	FY21E	FY22E	FY23E
Revenue from operations	21,449	21,823	24,857	28,469
Operating Expenses	3,280	2,677	2,313	3,342
Net Operating Income (NOI)	18,169	19,146	22,544	25,127
<i>NOI Margin (%)</i>	84.7%	87.7%	90.7%	88.3%
Other expenses/REIT expenses	1,513	1,487	1,925	2,199
EBITDA	16,656	17,659	20,619	22,929
<i>% margins</i>	77.7%	80.9%	82.9%	80.5%
Depreciation & Amortisation	5,281	4,744	4,910	5,128
Interest expenses	3,804	5,193	7,375	9,325
Other Income	990	891	936	983
Exceptional items	-	-	-	-
PBT	8,562	8,613	9,270	9,459
Less: Taxes	300	1,292	1,390	1,419
PAT before Minority/Associate	8,262	7,321	7,879	8,040
Associates	1,169	995	1,032	1,119
Net Income (Adjusted)	9,431	8,316	8,912	9,159

Source: Company data, I-Sec research

Table 8: Balance sheet

(Rs mn, year ending Mar 31)

As at March	FY20	FY21E	FY22E	FY23E
Assets				
Total Current Assets	24,364	22,520	23,269	21,753
<i>of which cash & cash eqv.</i>	3,419	1,684	2,643	1,625
Total Current Liabilities & Provisions	13,856	15,441	16,199	17,102
Net Current Assets	10,508	7,080	7,070	4,650
Goodwill	50,289	50,289	50,289	50,289
Investments	36,365	32,365	32,365	32,365
Net Fixed Assets	2,19,777	2,16,013	2,25,950	2,26,667
Capital WIP	4,107	12,086	3,083	7,583
Total Assets	3,21,046	3,17,832	3,18,757	3,21,555
Liabilities				
Borrowings	57,461	64,461	76,461	91,461
Net Worth	2,23,178	2,12,964	2,01,888	1,89,686
Minority Interest	-	-	-	-
Deferred Taxes	40,407	40,407	40,407	40,407
Total Liabilities	3,21,046	3,17,832	3,18,757	3,21,555

Source: Company data, I-Sec research

Table 9: Cashflow statement*(Rs mn, year ending Mar 31)*

Year ending March	FY20	FY21E	FY22E	FY23E
PBT	8,562	8,613	9,270	9,459
Interest income and fair value change in financial assets	(444)	(891)	(936)	(983)
Finance costs	3,804	5,193	7,375	9,325
Depreciation and amortisation expense	5,281	4,744	4,910	5,128
Others	1,373	308	(2,059)	(3,206)
Operating cash flows before working capital changes	18,575	17,967	18,560	19,723
Changes in Working Capital	1,545	1,693	969	1,402
Cash generated from operations	20,120	19,660	19,528	21,125
Income taxes paid, net	(1,429)	(1,292)	(1,390)	(1,419)
Operating Cashflow	18,691	18,368	18,138	19,706
Capital Commitments	(11,798)	(8,958)	(5,845)	(10,345)
Free Cashflow	6,893	9,410	12,293	9,361
Investments	(7,215)	4,995	1,032	1,119
Others	(2,429)	891	936	983
Cashflow from Investing Activities	(21,442)	(3,072)	(3,877)	(8,243)
Issue of Share Capital/(Distribution)	(2,369)	(18,530)	(19,987)	(21,361)
Inc (Dec) in Borrowings	(24,515)	7,000	12,000	15,000
Finance costs	(1,562)	(5,193)	(5,315)	(6,119)
Others	(13,517)	-	-	-
Cashflow from Financing activities	(41,964)	(16,723)	(13,303)	(12,480)
Chg. in Cash & Bank balances	(44,716)	(1,427)	958	(1,017)

Source: Company data, I-Sec research

Table 10: Key ratios*(Year ending Mar 31)*

	FY20	FY21E	FY22E	FY23E
Per Share Data (Rs)				
Earnings per Unit	9.9	10.8	11.5	11.9
Distribution per unit (DPU)	24.4	22.4	24.2	25.6
Book Value per Unit (BV)	289.2	276.0	261.6	245.8
Growth (%)				
Net Sales	14.3	1.7	13.9	14.5
EBITDA	22.5	6.0	16.8	11.2
PAT	158.2	(11.8)	7.2	2.8
Valuation Ratios (x)				
P/E	34.6	31.9	29.7	28.9
P/BV	1.2	1.2	1.3	1.4
Distribution Yield	7.1	6.5	7.0	7.4
Operating Ratios				
Debt/EBITDA (x)	3.4	3.7	3.7	4.0
Net D/E	0.2	0.3	0.4	0.5
Profitability/Return Ratios (%)				
RoE	3.4	3.8	4.3	4.7
RoCE	3.7	4.3	5.2	5.9
EBITDA Margins	77.7	80.9	82.9	80.5
Net Income Margins	44.0	38.1	35.9	32.2

Source: Company data, I-Sec research

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