

# Picton Property Income

H121 results

Resilient performance with positive returns

Real estate

In the challenging environment created by COVID-19, H121 results were resilient and we have increased our full-year FY21 forecast. Sector positioning, asset management and robust rent collection all contributed to performance. Portfolio returns were well ahead of the MSCI UK Quarterly Property Index and NAV total return was positive, underpinning the first steps in restoring the level of DPS towards pre-COVID-19 levels.

Year end	Net property income (£m)	EPRA earnings* (£m)	EPRA EPS* (p)	DPS (p)**	EPRA NAV/ share (p)	P/NAV (x)	Yield (%)
03/19	38.3	22.9	4.3	3.50	93	0.81	4.6
03/20	33.6	19.9	3.7	3.25	93	0.81	4.3
03/21e	32.7	19.6	3.6	2.73	93	0.81	3.6
03/22e	33.9	20.4	3.7	3.50	93	0.81	4.6

Note: \*EPRA earnings excludes revaluation gains/losses and other exceptional items.

\*\*Declared basis. 3.5p paid during FY19 and FY20.

## Robust earnings and NAV and strong DPS cover

The H121 property portfolio total return of 1.5% was well ahead of the MSCI Quarterly Property Index (-1.6%). EPRA NAV total return was a positive 0.7% with EPRA NAV unchanged (at 93p) and continuing quarterly DPS paid. With better than expected rent collection (well over 90%) and an increase in occupancy to 90% (FY20: 89%), temporarily reduced DPS payments have begun to increase with the Q221 DPS declared up 12% to an annualised 2.8p. EPRA earnings of £10.1m were similar to H120 but included c £1.3m of additional non-rental income with EPRA EPS at 1.8p. DPS cover was 148% (or 129% excluding the other income). We have lifted our FY21 forecasts and this provides a solid foundation for the recovery we forecast in FY22 and FY23, driven by capture of the reversionary potential in the portfolio through new lettings and lease renewals at market rents.

## Strong reversionary potential

Picton has outperformed the MSCI benchmark index over one, three, five and 10 years and performance continues to benefit from active asset management and a strong overweighting of the better performing industrial and regional office sectors, with a significant underweighting of retail and leisure now just 12% of the total. Looking forward there is a significant opportunity to grow income from the current portfolio and support capital values. The end-H121 estimated market rental value at full occupancy was £8.5m or 23% above the passing rent of £36.8m. Void reduction represents £4.4m of the upside potential, substantially represented by a small number of key completed refurbishments, only a part of which is built into our forecasts. Gearing is low (LTV c 22%) and £50m of low-cost borrowing headroom is available to support accretive acquisitions.

## Valuation: A good yield with strong DPS upside

The prospective FY21e yield of 3.6% compares favourably with risk-free alternatives (below 0.3% for 10-year UK government debt), and we expect material DPS growth. The 16% discount to H121 EPRA NAV compares with a five-year average of 3% and anticipates capital value weakness.

11 December 2020

**Price** 75.3p  
**Market cap** £411m

Net debt (£m) at 30 September 2020	147.9
Net LTV at 30 Sept. 2020	22.4%
Shares in issue	547.6m
Free float	100%
Code	PCTN
Primary exchange	LSE
Secondary exchange	N/A

### Share price performance



%	1m	3m	12m
Abs	3.7	9.0	(18.8)
Rel (local)	(1.0)	(1.5)	(12.3)
52-week high/low	103p	52p	

### Business description

Picton Property Income is an internally managed UK REIT that invests in a diversified portfolio of commercial property across the UK. Its total return driven with an income focus and aims to generate attractive returns through the proactive management of the portfolio.

### Next events

FY21 year-end	31 March 2021
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## Investment summary

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### Total return with an income focus

Picton's diversified portfolio of commercial property across the UK is actively managed for total returns but with a strong focus on income (historically c 70% of UK commercial property market returns) and dividends. Through its occupier-focused, opportunity-led approach, the company aims to be one of the consistently best-performing diversified UK REITs. And at the property level it has built a strong and consistent track record, in recent years benefiting from an overweight position on office and industrial sectors (c 88% by value). On an ungeared basis it has outperformed the MSCI UK Quarterly Property Index over one, three, five and 10 years to 30 September 2020 (H121). NAV total return in the five years to end-FY20 was a compound annual average 10.0% and, although COVID-19 has created more challenging market conditions, we expect returns to remain positive and benefit from significant reversionary potential and asset-management opportunities within the portfolio.

### Continued positive returns despite COVID-19 challenge

The H121 property portfolio outperformance of the MSCI Quarterly Property Index was across all sectors, but particularly benefited from a positive performance from industrial assets, strongly overweighted in the portfolio. Estimated rental value (ERV) increased slightly (0.2%) to £45.3m and annualised contracted rent roll of £36.8m ended the period above the end-FY20 level of £36.2m, with occupancy increasing to 90% (end-FY20: 89%) as a result of strong tenant retention and leasing progress in industrial. Leasing has continued into H221 and management is optimistic about further progress. With the 12% increase in Q221 DPS (0.625p) to an annualised 2.8p, distributions have begun to rebuild (3.5p of DPS was paid in each of FY19 and FY20) and H121 dividend cover was strong. We have lifted our FY21 forecasts, and this provides a solid foundation for the recovery we forecast in FY22 and FY23, including a return to annualised DPS of 3.5p. Forecast growth is driven by the capture of the reversionary potential in the portfolio through new lettings and lease renewals at market rents.

### Attractive total return with sustainable income

The end-H121 estimated market rental value at full occupancy was £8.5m or 23% above the passing rent of £36.8m. Void reduction represents £4.4m of the upside potential, substantially represented by a small number of key completed office refurbishments. Our forecasts build in c £2.5m growth in annualised contracted rent roll by end-FY23, comprising reversion to market rents in industrial (effectively fully occupied already) and leasing of available, refurbished office space, partly offset by further weakness in retail and leisure. Gearing is low (LTV c 22%) and existing drawn debt is long term and fixed rate. A £50m low-cost, flexible revolving credit facility is undrawn and available to support accretive acquisitions as opportunities may arise.

### Sensitivities: Macro and sector

We review the main sensitivities on page 13. We consider these to be related mainly to the broader macroeconomic background and the cyclical nature of the commercial property market, with the pandemic and Brexit continuing to increase near-term uncertainties. Commercial property has historically exhibited substantial swings in valuation through cycles. Income returns are significantly more stable, but still fluctuate according to tenant demand and rent terms.

## Robust interim results

For those familiar with the company, in this section we provide a brief overview of the recently reported interim results for the six months ended 30 September 2020 (H121); details of our increased forecasts can be found in the Financials section on page 10; and an update on valuation can be found on page 12.

In the challenging environment created by the COVID-19 pandemic, the H121 results were strong and we have significantly increased our full year FY21 forecast. Sector positioning, asset management and a good level of rent collection all contributed to a relatively strong portfolio performance, well ahead of the MSCI UK Quarterly Property Index, and positive NAV total returns, and underpinning the first steps in restoring the level of DPS towards pre-COVID-19 levels.

## Good levels of rent collection through the pandemic

At the time of reporting the interim results (12 November 2020), Picton had received 90% of the March quarter's rents, expected to increase to 96% under agreed deferred payment plans, and 90% of the June quarter's rent, expected to increase to 93% with deferred payments. For the September quarter, 93% had either been collected or was expected to be received under monthly payment plans.

**Exhibit 1: Rent collection performance (as at 12 November 2020)**

Rent quarter	Sep-20	Jun-20	Mar-20
Collected	86%	90%	90%
Moved to monthly	7%	0%	0%
Deferred	0%	3%	6%
Concessions agreed	1%	1%	1%
Outstanding	6%	6%	3%
<b>Total</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>

Source: Picton Property Income

With Picton's annualised contracted rent roll of more than £36m, we estimate that outstanding rents (for which no repayment agreements were in place) amounted to c £0.8m in respect of the March and June quarters and c £0.6m in respect of the September quarter. In addition to unpaid rents there will be outstanding service charge contributions. At end-H121, aggregate provisions (taken as an income deduction) against these amounts and other receivables taken during Q420 (c £0.5m) and H121 (c £1.7m) amounted to c £2.2m, which Picton describes as prudent. Our forecasts allow for an additional net £0.75m in H221, representing additional gross provisions adjusted for recoveries. Outstanding balances are concentrated within the retail and leisure sector and are likely to include a mix of distressed tenants that are currently unable to pay and tenants that have chosen not to pay, taking advantage of the temporary suspension by government of the ability of landlords to pursue recovery. The company has indicated that it will take a patient approach with landlords where this is appropriate and consistent with optimising longer-term recoveries and occupancy.

## Resilient EPRA earnings and net asset value

Exhibit 2 provides a summary of the H121 financial results. Despite the challenges posed by COVID-19, the underlying performance was robust, with EPRA earnings and NAV at a similar level to H120.

**Exhibit 2: Summary of H121 financials**

£m unless stated otherwise	H121	H120	H220	H121/H120	H121/H220
Rental income	17.6	19.4	18.4	-8.9%	-4.2%
Other income	1.3	0.9	0.3	49.9%	333.0%
Property operating costs	(0.9)	(1.3)	(1.0)	-31.9%	-3.9%
Void costs	(1.5)	(1.7)	(1.3)	-11.4%	11.7%
<b>Net property income</b>	<b>16.5</b>	<b>17.2</b>	<b>16.4</b>	<b>-3.9%</b>	<b>0.6%</b>
Total operating expenses	(2.3)	(2.9)	(2.7)	-18.7%	-12.7%
<b>Underlying operating profit</b>	<b>14.2</b>	<b>14.3</b>	<b>13.7</b>	<b>-1.0%</b>	<b>3.3%</b>
Net finance expense	(4.1)	(4.2)	(4.1)	-2.7%	1.6%
Tax	0.0	0.1	0.1		
<b>EPRA earnings</b>	<b>10.1</b>	<b>10.2</b>	<b>9.7</b>	<b>-0.9%</b>	<b>3.3%</b>
Debt prepayment fees	0.0	0.0	0.0		
Profit on disposal of investment property	0.0	0.0	3.5		
Investment property valuation movements	(6.4)	4.3	(5.2)		
<b>IFRS net profit</b>	<b>3.7</b>	<b>14.5</b>	<b>8.0</b>		
<b>EPRA EPS (p)</b>	<b>1.8</b>	<b>1.9</b>	<b>1.8</b>	<b>-1.4%</b>	<b>3.3%</b>
IFRS EPS (p)	0.7	2.7	1.5		
<b>DPS declared (p)</b>	<b>1.33</b>	<b>1.75</b>	<b>1.50</b>		
DPS paid (p)	1.25	1.75	1.75		
Dividend cover (x)	1.48	1.07	1.02		
Net assets, IFRS & EPRA (£m)	505.9	510.7	509.3		
<b>NAV per share, IFRS &amp; EPRA (p)</b>	<b>93</b>	<b>93</b>	<b>93</b>		
NAV total return	0.7%	2.4%	2.0%		
Investment property assets (IFRS)	661.6	693.4	664.6		
Net LTV	22.4%	24.5%	21.7%		

Source: Picton Property Income data, Edison Investment Research

In particular we highlight:

- The end-H121 annualised contracted rent roll of £36.8m was above the level at end-FY20 (£36.2m) but lower than at end-H120 (£37.8m). The movement compared with H120 mainly reflects disposals made in H220. EPRA basis occupancy increased to 90% compared with 89% at end-FY20 and 88% at end-H120.
- As a measure of the full rental potential of the portfolio, the externally assessed full occupancy ERV based on market-level rents increased slightly (0.2%) to £45.3m, driven by growth in industrial assets (2.6%) with a fairly resilient performance from offices (-0.6%), and weakness in retail and leisure (-3.7%).
- Rental income declined compared with H120 and H220, primarily driven by the receivables provisioning but also held back by more difficult leasing conditions as a result of the pandemic. Compared with H120, this was significantly offset by lower property operating costs, lower void costs and higher other income. The majority of the £1.3m of other income reported in H121 relates to dilapidation receipts arising from active asset management.
- Including lower operational costs, underlying operating profit of £14.2m was at a similar level to H120 and up on H220. The reduction in operating costs was largely due to lower variable staff costs, in line with the reduced returns and lower share price in the period.
- With net finance costs little changed, EPRA earnings of £10.1m were little changed on H120 (£10.2m) and up on H220 (£9.7m). EPRA EPS of 1.8p covered dividends paid in the period 148% or 129% excluding the other 'non-rental' income.
- The two quarterly dividends of 0.625p per share paid in the period were in respect of Q420 and Q121. Reflecting the good rental collection performance and leasing progress, the quarterly DPS declared for Q221 (and paid at the end of November) was increased 12% to 0.7p or an annualised 2.8p per share.
- IFRS earnings of £3.7m also included net negative property revaluation movements of £6.4m with growth in industrial assets (2.9%) offset by weaker values for offices (-2.6%) and retail and

leisure assets (-6.4%). The portfolio was independently valued at £661.6m (end-FY20: £664.6m) with the movement also including capex of £2.6m.

- There is currently no difference between IFRS NAV and NAV on an EPRA basis. EPRA NAV per share was unchanged at 93p. Including dividends paid in the period, EPRA NAV total return was 0.7%.

Gearing remained low at 22.4% with £50m of flexible borrowing facilities undrawn and available for investment opportunities that may arise.

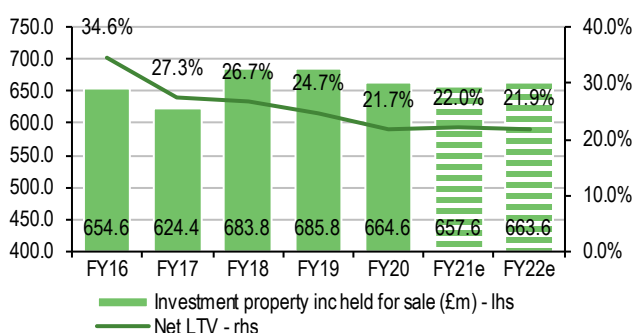
## Focus on income to deliver returns

### Background

Picton Property Income is an internally managed UK REIT that invests in a diversified portfolio of commercial property assets from the main commercial property sector across the UK. It is total return driven with an income focus and aims to generate attractive returns through pro-active management of the portfolio, investing in assets where it believes there are opportunities to enhance income and/or value. Its dividend policy is to distribute most of the recurring income earnings to shareholders via quarterly dividends, maintaining full cover and generating surplus cash for reinvestment back into the portfolio. The company's aim is to be one of the consistently best-performing diversified UK REITS.

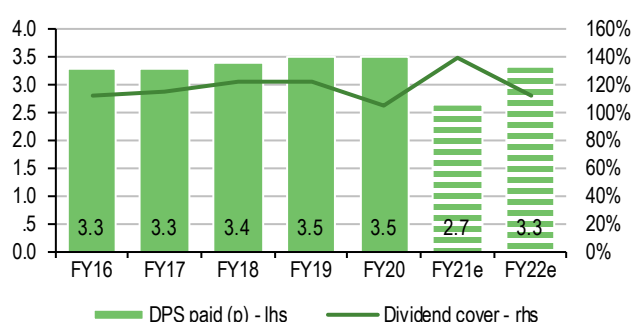
Picton was originally launched in October 2005 as the ING UK Real Estate Income Trust in an offshore structure and listed on the London Stock Exchange. In 2011, the company name was changed to Picton Property Income and in January 2012 the investment management function of the company was internalised. On becoming a UK REIT in October 2018, it also changed its technical listing status from an investment company to a commercial company, bringing it more into line with other internally managed property company peers, although with no material impact on the way that the portfolio is managed.

**Exhibit 3: Asset growth and gearing\***



Source: Picton Property Income. Note: \*Gearing measured as net loan to value (LTV).

**Exhibit 4: Trend in DPS and dividend cover\***



Source: Picton Property Income. Note: \*Dividend cover measured as aggregate EPRA earnings divided by aggregate dividends paid.

### Leadership and governance

The board comprises six members: four non-executive and two executives. The non-executive directors bring considerable experience from across the real estate, real estate financing and financial services sectors. Nicholas Thompson is currently the non-executive chairman but will retire in February 2021. The other non-executives are Mark Batten (chair of the audit and risk committee and the senior independent director), Maria Bentley (chair of the remuneration and nominations committees) and Richard Jones (chair of the property and valuation committee). Richard Jones

joined the board in September 2020, replacing Roger Lewis who retired. Lena Wilson CBE will join the board in January 2021 and will replace Nicholas Thompson as chairman. Lena Wilson brings a wide range of business and board experience to the group; she is on a number of boards in a non-executive capacity, including NatWest Group, Intertek Group and Argentex Group, and is chair of Chiene + Tait LLP; she was chief executive of Scottish Enterprise from 2009 until 2017 and prior to that, was a senior investment adviser at The World Bank.

The executive board members are CEO Michael Morris and FD Andrew Dewhurst. Michael Morris has more than 25 years' experience in the UK commercial property sector and has worked with the group since it was launched in 2005. Andrew Dewhurst joined Picton in 2011 and has over 30 years' experience in the real estate and financial services sector. Brief biographies of the key members of the leadership team may be found on page 15 and detailed board biographies may be found on the [company website](#).

Including the CEO and CFO, the broader Picton management team comprises nine individuals, of whom five are property professionals.

## Portfolio summary

At 30 September 2020 (H121), the fair value of the investment portfolio was £661.6m (the balance sheet value of £646.6m includes an adjustment for lease incentives and finance leases and excludes £4.0m of properties held for sale), diversified across 47 assets and let to a broad spread of around 350 occupiers, providing stability to the income base.

### Exhibit 5: Portfolio summary

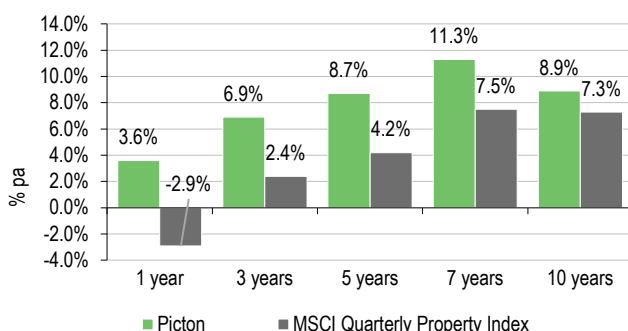
	30 September 2020	31 March 2020	31 March 2019
	H121	FY20	FY19
Portfolio valuation	£662m	£665m	£685m
Number of properties	47	47	49
Average lot size	£14.1m	£14.1m	£14.0m
Net initial yield	5.0%	4.9%	5.0%
Net reversionary yield	6.5%	6.4%	6.3%
Annualised rental income	£36.8m	£36.2m	£37.7m
Annualised reversionary income	£45.3m	£45.2m	£46.8m
Occupancy as % estimated rental value (ERV)	90%	89%	90%
Weighted average unexpired lease term	5.2 years	5.5 years	5.1 years

Source: Picton Property Income

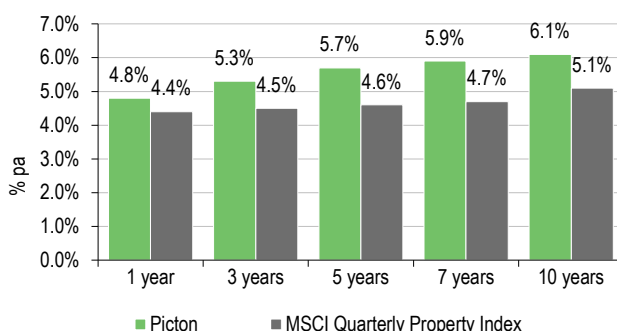
The held for sale asset is a retail property in Peterborough where contracts had been exchanged at end-H121. The c £4.0m sale price for the partly vacant asset (and soon to be fully vacant) was a 30% premium to the end-FY20 valuation.

## Strong portfolio performance underpins returns

At the portfolio level Picton has built a strong track record of outperformance versus the MSCI IPD Quarterly Property Index, generating above index income returns and total property returns on an ungeared basis over the one, three, five, seven and 10 years (to 30 September 2020). Exhibit 7 also demonstrates the relative stability of property income returns over the longer term.

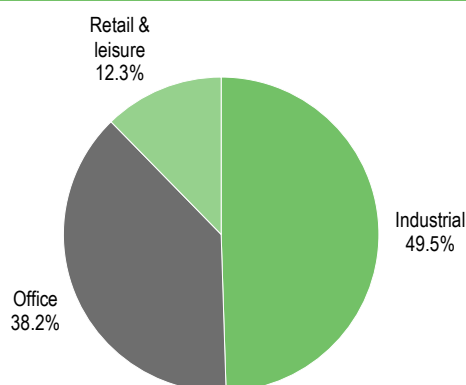
**Exhibit 6: Total property return versus index\***


Source: Picton Property Income, MSCI. Data to 30 September 2020. Note: \*Annualised percentage returns.

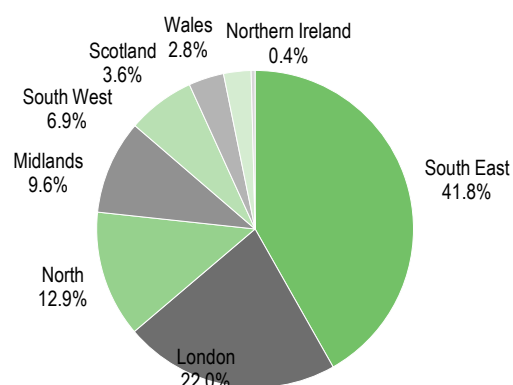
**Exhibit 7: Property income return versus index\***


Source: Picton Property Income, MSCI. Data to 30 September 2020. Note: \*Annualised percentage returns.

We attribute this strong performance to both successful asset management and an active unconstrained approach to portfolio construction that adapts the sector and asset weighting to changing market conditions. Picton describes itself as 'occupier focused and opportunity led'. Occupier focused refers to working closely with tenants to understand their needs, enhance occupancy, improve retention and maximise income. Picton continues to invest in its assets, improving the quality of the space and ensuring it meets occupier demand. In a broader sense, it also applies to the overall occupier market, which Picton closely monitors to help drive portfolio strategy and asset selection. This drives an 'opportunity led' approach to acquisitions and disposals, as well as asset-management decisions, seeking to buy, manage and sell effectively. The portfolio is actively positioned compared with the MSCI IPD Quarterly Benchmark ('the index'). Throughout the past year, performance has continued to benefit from the portfolio being strongly overweight in industrial (49.5% at end-H120, compared with 29.2% for the index) and office properties (38.2%, compared with 27.5% for the index), and taking an underweight position in retail and leisure property, now down to just 12.3% (less than half the index weight). Geographically, the portfolio has a regional focus.

**Exhibit 8: Portfolio value by sector**


Source: Picton Property Income as at 30 September 2020

**Exhibit 9: Portfolio value by region**


Source: Picton Property Income as at 30 September 2020

Combining these property level returns with an effective use of gearing and efficient operation, over the five full years to end-FY20 Picton has generated an aggregate EPRA NAV total return, or accounting return, of 61.1%, equivalent to a compound annual return (no dividend reinvestment assumed) of 10.1%. Due to the effects of the pandemic, the H121 total return was below the historical trend but remained positive at 0.7% or an annualised c 1.4%. The loan to value ratio (LTV) has averaged a conservative level of c 27% over the five years to end-FY20 and was a modest c 22% coming into the pandemic.



**Exhibit 10: Five-year EPRA NAV total return\***

Year ending 31 March	FY16	FY17	FY18	FY19	FY20	Cumulative end-FY15- end-FY20
Opening EPRA NAV per share (p)	69	77	82	90	93	69
Closing EPRA NAV per share (p)	77	82	90	93	93	93
DPS paid (p)	3.3	3.3	3.4	3.5	3.5	17.0
EPRA NAV total return	17.6%	10.2%	14.7%	6.4%	4.4%	61.1%
Compound annual total return						10.0%

Source: Picton Property Income data, Edison Investment Research. Note: \*Dividends paid added back but not reinvested.

## Industrial and office assets continue to drive portfolio returns

Going into the pandemic there was a clear polarisation of sector performance across the UK commercial property market and this has become more accentuated. Both the industrial and regional office sectors had been benefiting from a positive demand-supply balance, while the retail sector was struggling with rising costs and the structural impact of online competition.

In the six months ending 30 September 2020, the MSCI Monthly UK Property Index showed a total return for All Property of -1.6%, with an income return of 2.7% and capital growth of -4.2%. Rental growth was -1.7% for the six months to September 2020, compared to -0.5% for the six months to March 2020. Of the three main property sectors, industrial was the only sector to produce a positive total return for the period; the total return was 1.7%, comprising 2.4% income return and -0.7% capital growth. In the office sector, the six-month total return was -0.8%, comprising 2.4% income return and -3.2% capital growth. The All Retail total return was -5.8%, comprising 3.6% income return and -9.1% capital growth.

Across each of the main sectors, valuation performance has improved month by month since April with positive monthly valuation performance in the industrial sector since July, stabilising office valuations and retail valuations declining at a slower pace.

Picton's strong overweighting in the industrial and office sectors and strong underweighting in retail was positive for performance but it also outperformed within each sector during H121. The expected bounce back in economic activity in 2021 should be further supported by the recent progress on COVID-19 vaccination. In this context the positive fundamentals of steady occupier demand and limited new supply that have supported Picton's industrial assets seem likely to remain in place. Its UK-wide distribution assets are fully let and its multi-let industrial estates have minimal vacancy.

Although the pandemic has raised many questions about the future role of the office, Picton believes there is continuing demand for quality space and that the 'death of the office' has been vastly overstated, highlighting the important role that the office plays in company culture and productivity, being a place for both concentrated work and collaboration, connection, innovation and social interaction. It is difficult to predict an end to the pressures on the retail sector, although Picton's exposure is relatively low and is focused on retail warehouses (7%) that should continue to fair better than high street retail (less than 4%), given their convenience, ease of parking and ability to support online purchases through click and collect.

## Significant potential within the existing portfolio

The end-H121 ERV of £45.3m was £8.5m or 23% ahead of the annualised contracted rent roll of £36.8m. With an EPRA occupancy rate of 90%, c £4.4m of this upside potential relates to void reduction and the balance represents the upside from lease incentive run-off (c £3.3m) and the potential to increase existing rents to market levels at lease expiry (c £0.8m).

By sector the greatest potential is within the industrial and office sectors. With occupancy close to full in the industrial sector the upside is from reversion to market rents, while market rents continue



to increase. In the office sector there is considerable upside from void reduction. In retail and leisure there is scope to increase occupancy, although currently contracted rents are on average above ERV while ERV remains under pressure from market conditions.

#### Exhibit 11: ERV by sector

£m unless stated otherwise	ERV	Contracted rents	Occupancy	Void reduction	Total reversion
Industrial	19.1	16.8	99%	0.1	2.3
Office	19.0	13.1	81%	3.7	5.9
Retail & leisure	7.2	6.9	91%	0.6	0.3
<b>Total portfolio</b>	<b>45.3</b>	<b>36.8</b>	<b>90%</b>	<b>4.4</b>	<b>8.5</b>

Source: Picton Property Income data and Edison Investment Research forecasts

Although the pandemic has slowed letting activity across the market, during H121 Picton completed nine lettings securing income of £1.2m pa, 2.8% ahead of the March ERV. A positive indication for the effectiveness of the Picton Promise was the upsizing of three existing occupiers. There were also 16 lease renewals or regears, retaining income of £2.3m pa, an increase on the previous passing rent of 12.1%, and 14.3% above ERV. Additionally, break options were removed or pushed back in three leases, securing £0.5m pa for a further period. Five rent reviews were concluded, securing a £0.3m per annum uplift in income, 16.3% above ERV. Retention during the period was good, with only £0.1m pa of rental income lost through occupiers vacating and EPRA occupancy increased to 90% from 89% at end-FY20. Around half the increase in occupancy relates to the short-term letting of a distribution unit in Rugby to UPS, which left the industrial portfolio with just two small vacant multi-let units, one of which is under offer.

Five office assets, mostly refurbished, represented c 70% of the void opportunity at end-H121. This includes the Stanford Building in Covent Garden, London, where the refurbishment is now substantially complete, with an ERV of £1.6m at end-H121, of which £0.4m has since been let. The formerly retail asset was reclassified as an office following the planning application to convert the first floor from retail to office space.

#### Exhibit 12: Key void reduction opportunities

### Vacancy breakdown

23

Total void ERV of £4.4 million with top five accounting for over 70%\*

**£1.6m**

Stanford Building, London, WC2

Building refurbishment practically complete. Landmark retail unit and Grade A offices with concierge and amenities. One office floor let post period end.



**£0.6m**

Angel Gate, London, EC1

Refurbished office village with car parking and Cat A+ space available.



**£0.3m**

50 Pembroke Court, Chatham

Refurbished ground floor office, 25% let to the Government post period end at £0.1 million pa. Remaining space under offer.



**£0.3m**

Tower Wharf, Bristol

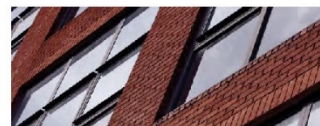
Grade A office, available in two suites, one of which is being refurbished. The other suite is under offer.



**£0.3m**

Longcross Court, Cardiff

Refurbishment worked up and to be instructed post lockdown.



Source: Picton Property Income. Note: £0.4m pa of lettings post period end.

## Asset-management initiatives to create additional value

Early in FY20 Picton provided details of more than 20 identified asset management initiatives within the portfolio, representing an aggregate investment of c £15m, which it expected would be spread over several years. These initiatives are aimed at improving the quality of the existing portfolio assets with the intention of delivering higher occupancy, rental income and capital values and include:

- upgrading and repositioning of internal space,
- converting assets to higher value uses, and
- enhancing the external fabric to help retain existing or attract new occupiers.

During FY20 it invested £8.9m across a range of projects and during H121 a further £2.5m, with several projects completed and available for letting as noted above. There are several projects, underway, each individually smaller than the Stanford Building (substantially completed) and the Swiftbox distribution unit in Rugby (where the refurbishment is complete and the building let). We expect Picton to take a flexible approach to the remaining identified opportunities, taking into consideration evolving market developments.

## Financials

With rent collection performance and occupancy stronger than we had allowed for, and property expenses lower, our income forecasts for the current FY21 year are quite considerably increased. Similar factors drive an increase in the FY22 forecast, although we had already assumed recovery from FY21. Our FY23 income forecast assumes further progress driven by capturing a part of the reversionary potential contained within the existing portfolio. The pandemic impact on capital values in H121 has been less than we had assumed and this feeds through into our NAV increase.

**Exhibit 13: Summary of forecast revisions**

	Net property income (£m)			EPRA earnings (£m)			EPRA EPS (p)			EPRA NAV/share (p)			DPS (p)		
	Old	New	% change	Old	New	% change	Old	New	% change	Old	New	% change	Old	New	% change
FY21e	30.5	32.7	7.3	17.6	19.6	11.7	3.2	3.6	11.6	88	93	5.6	2.75	2.73	(0.9)
FY22e	33.4	33.9	1.5	19.9	20.4	2.6	3.6	3.7	N/A	88	93	5.8	3.50	3.50	0.0
FY23e	N/A	35.2	N/A	N/A	21.4	N/A	N/A	3.9	N/A	N/A	95	N/A	N/A	3.58	N/A

Source: Edison Investment Research

Our forecasts are based on an unchanged portfolio, although with modest gearing and undrawn borrowing facilities the company is well placed to seize accretive opportunities. Picton says that it is actively looking for acquisition opportunities, particularly where the vendors are in distress, perhaps because of a heavy debt burden.

## Income assumptions

The factors that will determine future rental income include:

- Retention of existing clients at lease breaks and lease maturities and success with letting vacant space.
- Non-contractual tenant failures, particularly in the more challenged retail and leisure sectors.
- The development of ERVs. In H121, the ERV of the industrial assets continued to increase, fell slightly in the office portfolio, and more significantly so in the retail and leisure portfolio. Where tenants are in distress the impact on current rents may be accelerated if lower rents are agreed to maintain occupancy.

In our forecasts we have assumed no increase in office/industrial ERVs and a decline in retail and leisure. Our forecast income growth is driven by void reduction (in office) and reversion to market

rents in industrial, partly offset by occupancy/rent reduction in retail and leisure. We estimate that our assumptions represent an increase in EPRA occupancy from 90% at end-H121 to just over 93% at end-FY23.

For **FY21** we have assumed:

- An increase in contracted passing rent to £37.4m at end-FY21 compared with £36.2m at end-FY20 and £36.8m at end-H121. This compares with our previous assumption of a flat contracted rent roll during the year with the uplift reflecting the leasing progress in H121 and further progress/pipeline already disclosed for H221.
- Further provisions against rent receivables, taking the FY21 total to £2.4m (previously £1.5m) including the £1.7m reported in H121 (£0.8m in Q1 and £0.9m in Q2) and an additional £0.75m in H221, which is best viewed as the net balance of new gross provisions less recovery of outstanding rents. Including the £0.5m provision taken in Q420 this would take the total pandemic related provision to £2.9m.
- Including IFRS lease incentive adjustments FY21 rental income is thus assumed to be £36.0m (previously £35.6m). Including higher other income (£1.1m) and lower direct property costs (£0.7m), reflecting H121 performance, our net property income forecast increases to £32.7 (previously £30.5m).

For **FY22 and FY23** we have assumed:

- An increase in passing rent to £38.0m at end-FY22 and £39.3m at end-FY23 driven by occupancy gains in the office sector, reversion to market rents in industrial, and partly offset by weakness in retail and leisure.
- No net impact from provisioning/recoveries.
- Rental income of £38.4m, including IFRS adjustments, in FY22 and £39.4m in FY23.

## Dividend assumptions

Our previously published forecasts had expected an increase in quarterly DPS during H221 and the increase in Q221 DPS came sooner and takes the full year DPS to broadly the same level. We continue to assume a further increase in DPS in FY22, taking the annual aggregate back to the pre-pandemic level, followed by further growth in FY23. Relative to our EPRA earnings forecasts, dividend cover is 140% for FY21, 113% for FY22 and 110% for FY23. The REIT distribution requirement is that at least 90% of property income is paid out within 12 months of the accounting period. The calculation of property income may differ somewhat from the calculation of EPRA earnings, including the impact of capital allowances, but our forecasts imply a c 80% distribution of the aggregate FY21/22 EPRA earnings.

## Capital growth assumptions

Taking account of recent market trends and the unusually wide range of market forecasts, we have assumed some further weakness in the aggregate portfolio valuation in H221 (0.5%), no change in FY22 and a modest uplift (1.5%) in FY23. The outcome may differ quite materially from this. We expect the leasing progress that we forecast to support valuation but have only partially reflected this. We believe our assumptions are consistent with an increase in the net initial yield from 5.0% at end H121 to 5.2% at end-FY23 and a slight reduction in the reversionary yield from 6.5% to 6.2%.

Each 1% increase/decrease in the total portfolio value is equivalent to an increase/decrease in EPRA NAV per share of c 1.3p. For the end-H121 EPRA NAV per share (93p) to fall to match the current share price (75p) would require a c 14% reduction in the portfolio value.

## Strong balance sheet with low gearing

At end-H121 borrowings amounted to £166.8m, comprising long-term (first maturity 2027), fixed-rate loan notes with Aviva and Canada Life. Having repaid all drawings under its flexible revolving credit facilities (RCF) with the proceeds from disposals during the last financial year, in June 2020, the existing facility was replaced with a new £50m RCF, extending duration and reducing cost. For now, it too remains undrawn.

H121 cash was £18.9m and with net debt of £147.9m the net LTV was 22.4%.

The average fixed cost of the drawn debt was c 4.2% with a weighted average term to maturity of 9.4 years at end end-H121. The undrawn RCF has a low margin over Libor of 1.5%.

Given the current low level of market interest rates, the disclosed fair value of the secured loan facilities at 30 September 2020 of £197.9m was above the carrying value and while it would be possible to refinance the existing debt at a lower annual interest cost, it would also be necessary to compensate the existing lenders. We would expect the result of refinancing to be broadly value neutral with the benefit of any reduction in annual interest cost offset by the early termination costs in net present value terms. For this reason, we do not assume any refinancing.

The borrowing covenants provide a good level of headroom and Picton estimates that, on average, rental income or asset values would need to fall by more than 40% for there to be any impact. In any case Picton is in constant dialogue with its lenders, who remain fully supportive of the company.

### Exhibit 14: Summary of debt portfolio at end-H121

	Canada Life	Aviva	RCF
Amount drawn	£80.0m	£86.8m	nil
Undrawn	Fully drawn	Fully drawn	£50.0m
Maturity	Jul-27	Jul-32	01/05/2023*
Interest rate	4.08%	4.38%	Libor + 1.5%
Commitment fee	N/A	N/A	0.60%
LTV covenant	65%	65%	55%
Interest cover covenant	1.75x		2.5x
Debt service cover ratio covenant		1.4x	

Source: Picton Property Income. Note: \*Two one-year extension options subject to lender approval.

## Valuation

Our forecast 2.73p FY21 DPS represents a 3.6% prospective FY21 yield (also 3.6% based on the current quarterly rate of DPS of 0.7p or 2.8p annualised). Our FY22 DPS forecast of 3.5p in FY22 represents a yield of 4.7%. Meanwhile, the 19% discount to the H121 NAV compares with an average 3% discount over the past five years.

Our forecasts imply a positive but modest (2.8%) NAV total return for the current year (FY21), increasing through FY22 (4.1%) and FY23 (6.3%). Although these prospective returns are below the 10% compound annual average return in the five years to end-FY20 we believe they are attractive in the context of a continuing low-rate environment. The yield on the 10-year UK gilt remains below 0.3%.

In Exhibit 15 we show a summary performance and valuation comparison of Picton and what we consider to be its closest diversified income-oriented peers. In terms of valuation, we show the trailing yield based on aggregate declared DPS over the past 12 months, as well as the forward-looking yield based on the most recently declared DPS annualised. Neither is entirely satisfactory as the sector remains in a state of flux; most companies reduced DPS payouts during the pandemic and some postponed payments altogether for a time, and it will be a while before the full-year prospective DPS outlook becomes clearer and a true comparison can be made. Picton shares have

outperformed the peer group over the past year, which we attribute to its strong track record of property level performance, the future income and valuation growth potential embedded in its portfolio, and its strong balance sheet with relatively modest gearing.

**Exhibit 15: Peer group valuation and performance comparison**

	Price (p)	Market cap. (£m)	P/NAV (x)*	Trailing yield (%)**	Annualised yield (%)***	Share price performance			
						1 month	3 months	12 months	From 12m high
Ediston Property	67	141	0.77	7.3	6.0	7%	26%	-23%	-28%
BMO Real Estate Investments	62	150	0.66	7.0	4.0	3%	7%	-24%	-31%
BMO Commercial Property Trust	80	635	0.68	1.9	3.8	9%	25%	-30%	-34%
Custodian	88	370	0.92	6.1	4.8	-1%	0%	-22%	-24%
Regional REIT	80	344	0.78	9.3	8.0	4%	10%	-26%	-35%
Schroder REIT	38	192	0.66	4.5	6.0	9%	21%	-30%	-34%
Standard Life Investment Property	58	235	0.73	6.6	4.9	-4%	8%	-35%	-42%
<b>Average</b>			<b>0.74</b>	<b>6.1</b>	<b>5.4</b>	<b>4%</b>	<b>14%</b>	<b>-27%</b>	<b>-33%</b>
<b>Picton</b>	<b>76</b>	<b>418</b>	<b>0.82</b>	<b>3.7</b>	<b>3.7</b>	<b>5%</b>	<b>9%</b>	<b>-16%</b>	<b>-29%</b>
UK property index						-2%	8%	-15%	-20%
	1,570								
FTSE All-Share Index						3%	10%	-7%	-13%
	3,709								

Source: Company data, Refinitiv prices at 10 December 2020. Note: \*Based on last reported EPRA NAV. \*\*Based on DPS declared in past 12 months. \*\*\*Based on last declared DPS annualised.

## Sensitivities

The commercial property market is cyclical, historically exhibiting substantial swings in valuation through cycles. Income returns are significantly more stable, but still fluctuate according to tenant demand and rent terms. From a sector viewpoint we also highlight the increased risks and uncertainties that attach to development activity, including planning consents, timing, construction risks and the long lead times to completion and eventual occupation. Picton is not a developer, but is exposed to similar but lesser uncertainties, as it actively invests in improvements to existing assets with the aim of enhancing long-term income growth and returns. In particular we note:

- The COVID-19 pandemic and Brexit continue to create uncertainty regarding the UK **economic outlook**. The HM Treasury comparison of independent forecasts for the UK economy published in October 2020 indicated a consensus UK GDP decline of 10.2% for 2020 followed by an increase of 5.9% in 2021, but with a wide range of expectations. Consensus expectations for the rate of unemployment have broadly doubled since before COVID-19 to around 7%, while inflation and interest rate expectations have been tempered.
- **Sector risk**: some of the inherent cyclical risk to vacancy in commercial property can be mitigated by portfolio diversification. As noted above, Picton invests across the main UK commercial property sectors, with a portfolio that is well diversified by property and by individual occupiers. As at H121 the largest tenant accounts for less than 5% of the total portfolio income and the largest property for less than 15% of portfolio value. While the long-term outlook for certain key commercial property sectors has become more uncertain as a result of the pandemic, portfolio occupancy is currently below the long-term trend due to the timing of lease surrenders and asset management activity undertaken in the past two years, and contains significant reversionary potential for income upside.
- **Funding risks** are relatively low for Picton in a sector context. The company continues to operate with low gearing (LTV of 22.4% at end H121) and has £50m undrawn flexible borrowing facilities to provide scope for attractive acquisitions should opportunities arise. All outstanding debt is fixed rate and long duration (average term at end-H121 of 9.4 years). On a long-term basis interest rates remain historically low and while the cost of Picton's debt is fixed,



any significant increase in long-term rates in particular may be expected to negatively affect market-wide property valuations.

- **Management risk:** as Picton is internally managed there is some management risk. With a relatively small team, the loss of any senior member has the potential to be disruptive and if any the directors were to leave, they would need to be replaced.



**Exhibit 16: Financial summary**

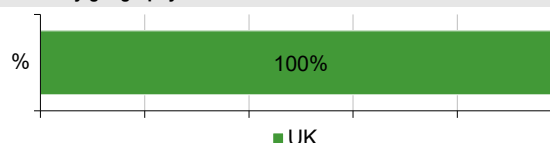
Year end 31 March	£m	2016	2017	2018	2019	2020	2021e	2022e	2023e
		IFRS	IFRS	IFRS	IFRS	IFRS	IFRS	IFRS	IFRS
<b>PROFIT &amp; LOSS</b>									
Rents receivable, adjusted for lease incentives		39.7	40.6	41.4	40.9	37.8	36.0	38.4	39.4
Other income		1.1	7.4	1.4	1.1	1.2	1.4	0.4	0.4
Service charge income		5.2	6.5	5.9	5.7	6.7	5.7	6.1	6.3
Revenue from properties		45.9	54.4	48.8	47.7	45.7	43.1	45.0	46.1
Property operating costs		(3.3)	(3.5)	(2.6)	(2.3)	(2.3)	(1.9)	(2.3)	(2.2)
Property void costs		(1.5)	(2.0)	(1.8)	(1.4)	(3.0)	(2.8)	(2.6)	(2.4)
Recoverable service charge costs		(5.2)	(6.5)	(5.9)	(5.7)	(6.7)	(5.7)	(6.1)	(6.3)
Property expenses		(10.0)	(12.0)	(10.3)	(9.4)	(12.0)	(10.4)	(11.1)	(10.9)
Net property income		35.9	42.4	38.4	38.3	33.6	32.7	33.9	35.2
Administrative expenses		(4.4)	(5.2)	(5.6)	(5.8)	(5.6)	(5.1)	(5.7)	(6.0)
Operating Profit before revaluations		31.5	37.1	32.9	32.5	28.1	27.7	28.3	29.2
Revaluation of investment properties		44.2	15.1	38.9	10.9	(0.9)	(9.4)	0.0	10.0
Profit on disposals		0.8	1.8	2.6	0.4	3.5	0.0	0.0	0.0
Operating Profit		76.5	54.1	74.4	43.7	30.7	18.3	28.3	39.2
Net finance expense		(11.4)	(10.8)	(9.7)	(9.1)	(8.3)	(8.0)	(7.8)	(7.8)
Debt repayment fee		0.0	0.0	0.0	(3.2)				
Profit Before Tax		65.1	43.2	64.7	31.4	22.4	10.2	20.4	31.4
Taxation		(0.2)	(0.5)	(0.5)	(0.5)	0.1	0.0	0.0	0.0
Profit After Tax (IFRS)		64.8	42.8	64.2	31.0	22.5	10.2	20.4	31.4
Adjust for:									
Investment property valuation movement		(44.2)	(15.1)	(38.9)	(10.9)	0.9	9.4	0.0	(10.0)
Profit on disposal of investment properties		(0.8)	(1.8)	(2.6)	(0.4)	(3.5)	0.0	0.0	0.0
Exceptional income / expenses		0.0	(5.3)	0.0	3.2	0.0	0.0	0.0	0.0
Profit After Tax (EPRA)		19.9	20.6	22.6	22.9	19.9	19.6	20.4	21.4
Fully diluted average Number of Shares Outstanding (m)		540.1	540.1	539.7	541.0	546.2	547.1	547.1	547.1
EPS (p)		12.01	7.92	11.89	5.75	4.14	1.87	3.74	5.75
EPRA EPS (p)		3.68	3.81	4.19	4.25	3.66	3.60	3.74	3.92
Dividend declared per share (p)		3.30	3.33	3.43	3.50	3.25	2.73	3.50	3.58
Dividends paid per share (p)		3.300	3.300	3.400	3.500	3.500	2.650	3.325	3.560
Dividend cover (x) EPRA EPS/DPS declared		112%	115%	122%	121%	113%	132%	107%	109%
Dividend cover (x) - paid dividends		112%	115%	122%	121%	105%	140%	113%	110%
EPRA cost ratio including direct vacancy costs)		22.8%	26.1%	23.7%	22.9%	28.3%	26.7%	27.1%	26.4%
<b>BALANCE SHEET</b>									
Fixed Assets		649.4	615.2	670.7	676.1	654.5	646.7	652.7	668.7
Investment properties		646.0	615.2	670.7	676.1	654.5	646.7	652.7	668.7
Other non-current assets		3.4	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Current Assets		37.4	49.4	50.6	39.5	41.2	43.1	40.3	37.1
Debtors		14.6	15.5	19.1	14.3	17.6	21.0	19.0	18.0
Cash		22.8	33.9	31.5	25.2	23.6	22.1	21.3	19.1
Current Liabilities		(47.5)	(20.6)	(22.3)	(23.3)	(20.4)	(19.2)	(19.2)	(19.2)
Creditors/Deferred income		(18.4)	(20.1)	(21.6)	(22.5)	(19.5)	(18.4)	(18.4)	(18.4)
Short term borrowings		(29.1)	(0.6)	(0.7)	(0.8)	(0.9)	(0.8)	(0.8)	(0.8)
Long Term Liabilities		(222.2)	(202.1)	(211.7)	(192.8)	(166.0)	(165.2)	(165.5)	(165.9)
Long term borrowings		(220.4)	(200.3)	(210.0)	(191.1)	(164.2)	(163.5)	(163.8)	(164.2)
Other long term liabilities		(1.7)	(1.7)	(1.7)	(1.7)	(1.7)	(1.7)	(1.7)	(1.7)
Net Assets		417.1	441.9	487.4	499.4	509.3	505.4	508.2	520.7
NAV/share (p)		77	82	90	93	93	93	93	95
Fully diluted EPRA NAV/share (p)		77	82	90	93	93	93	93	95
<b>CASH FLOW</b>									
Operating Cash Flow		33.3	36.3	35.1	34.8	21.4	23.5	30.8	30.7
Net Interest		(8.8)	(9.2)	(9.1)	(8.6)	(7.9)	(7.6)	(7.5)	(7.5)
Tax		(0.4)	(0.2)	(0.3)	(0.8)	0.1	0.1	0.0	0.0
Net cash from investing activities		(68.1)	48.7	(17.8)	10.3	25.0	(1.6)	(6.0)	(6.0)
Ordinary dividends paid		(17.8)	(18.0)	(18.5)	(18.9)	(19.0)	(14.0)	(18.1)	(19.4)
Debt drawn/(repaid)		14.6	(46.5)	9.2	(22.6)	(27.2)	(1.2)	0.0	0.0
Net proceeds from shares issued/repurchased		0.0	0.0	(0.9)	(0.4)	6.1	(0.6)	0.0	0.0
Other cash flow from financing activities									
Net Cash Flow		(47.3)	11.1	(2.4)	(6.3)	(1.6)	(1.4)	(0.8)	(2.2)
Opening cash		70.1	22.8	33.9	31.5	25.2	23.6	22.1	21.3
Closing cash		22.8	33.9	31.5	25.2	23.6	22.1	21.3	19.1
Debt as per balance sheet		(249.5)	(200.9)	(210.7)	(192.0)	(165.1)	(164.3)	(164.7)	(165.0)
Un-amortised loan arrangement fees		0.0	(3.7)	(3.4)	(2.7)	(2.3)	(2.6)	(2.2)	(1.8)
Closing net (debt)/cash		(226.8)	(170.8)	(182.5)	(169.5)	(143.9)	(144.7)	(145.6)	(147.7)
Net LTV		34.6%	27.3%	26.7%	24.7%	21.7%	22.0%	21.9%	22.1%

Source: Picton Property Income, Edison Investment Research



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**Revenue by geography**

**Leadership team**
**Non-executive chairman: Nicholas Thompson**

Nicholas Thompson has served on the board as chairman since 2005 and as discussed on page 5 will retire from the board in February 2021 to be replaced by Lena Wilson. He was formerly director and head of fund and investment management at Prudential Property Investment Management. He is chairman of MSCI IPD's UK and Ireland Consultative Group, a director of the Lend Lease Retail Partnership and an independent director of the Association of Real Estate Funds. He is a fellow of the Royal Institution of Chartered Surveyors.

**Chief executive: Michael Morris**

Michael Morris was appointed to the board in October 2015. He has over 25 years' experience in the UK commercial property sector and has worked with the group since launch in 2005. As chief executive he is responsible for the implementation of the company's strategy. Prior to this, he worked in private practice, then becoming a senior director and fund manager at ING Real Estate Investment Management (UK). He is a member of the Investment Property Forum and has obtained the Investment Management Certificate and the IPF Diploma in Property Investment.

**Finance director: Andrew Dewhirst**

Andrew Dewhirst joined the group in March 2011 and became finance director and joined the board in 2018. Previously he was finance director of the group's investment management subsidiary and was director of client accounting at ING Real Estate Investment Management (UK), a role he had held since 2006. At ING he was responsible for the accounting and administration of all the UK real estate vehicles and separate client accounts. He has over 30 years' experience in the real estate and financial services sector and is an associate member of the Institute of Chartered Accountants in England and Wales and a member of the Investment Property Forum.

**Head of Asset Management: Jay Cable**

As head of asset management and a member of the executive committee, Jay Cable is responsible for overseeing all asset management activities in respect of the group's property portfolio. He has worked for the group since launch in 2005, having formerly been a director at ING Real Estate Investment Management (UK). He has over 18 years of real estate experience and is a member of the Royal Institute of Chartered Surveyors and of the Investment Property Forum.

**Principal shareholders (source: FY20 Annual Report)**

	(%)
Investec Wealth & Investment	14.0
Brewin Dolphin	6.6
Mattioli Woods	5.9
BlackRock	5.0
Thames River Capital	4.6
Interactive Investor Services	4.3
Smith & Williamson Investment Management	4.2
Canaccord Genuity Wealth Management	3.7
The Vanguard Group	3.4

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