

Custodian REIT

Reinstating forecasts with improved DPS outlook

Amidst challenging market conditions, Custodian REIT (CREI) declared a Q121 DPS 0.95p, 27% ahead of the minimum level indicated for each of the first two quarters of FY21, and fully covered by net cash receipts. With robust rent collection and the lockdown easing, we have reinstated our estimates and look for the quarterly DPS run rate to increase in H221.

Year end	Net rental income (£m)	EPRA earnings* (£m)	EPRA EPS* (p)	EPRA NAV/ share (p)	DPS (p)	P/NAV (x)	Yield (%)
03/19	37.6	28.5	7.3	107.1	6.55	0.80	7.6
03/20	38.1	28.7	7.0	101.6	6.65	0.85	7.7
03/21e	35.5	24.3	5.8	94.5	4.20	0.91	4.9
03/22e	35.4	25.7	6.1	95.2	5.60	0.90	6.5

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

Q121 DPS well ahead of minimum indications

The DPS of 0.95p declared for Q121 was well ahead of the minimum 0.75p that the company had previously indicated for each of the first two quarters of FY21. It was fully covered by net cash receipts, reflecting better than expected rental collection, and was 140% covered by EPRA earnings, including accrued rents that are yet to be collected. Unrealised valuation losses weighed on NAV per share, down by 5.9p to 95.7p, and including DPS paid the Q121 NAV total return was -4.2%. Rent collection is robust and the easing of the lockdown should support a further improvement in H221. Although a good deal of economic and market uncertainty remains, we have tentatively reinstated estimates, allowing for a reduction in occupancy and rent roll through the balance of the year. Our NAV forecast allows for further market-led valuation weakness. We assume a more normal collection pattern in FY22 and some recovery in occupancy, driving a further increase in the DPS run rate.

We forecast higher quarterly DPS in H221

As at 30 July, 82% of Q121 rents had been collected with a further 11% subject to agreed deferrals. At the same date, 80% of rents expected for Q221 had been collected, net of the 5% deferred by contractual agreement, to be recovered over the next 12–18 months. With the lockdown easing we expect further improvement, supporting an increase in the quarterly DPS run rate to 1.15p in Q321 and Q421. Our forecast aggregate DPS for the year of 4.20p is 1.3x covered by forecast EPRA earnings and for this to be covered by rent receipts 82% of IFRS rental income needs to be collected. Meanwhile, Custodian is supported by a strong and liquid balance sheet with low levels of gearing.

Valuation: Attractive yield with upside

The prospective FY21e yield of 4.9% (or 4.4% based on the current quarterly DPS run rate) compares favourably with risk-free alternatives (little more than 0.2% for 10-year UK government debt). The c 10% discount to Q121 EPRA NAV of 95.7p per share compares with an average of an c 8% premium since IPO in 2014.

Q121 NAV update

Real estate

25 August 2020

Price **86p**
Market cap **£361m**

Net debt (£m) at 30 June 2020	125.4
Net LTV (%) at 30 June 2020	23.5
Shares in issue	420.1m
Free float	92%
Code	CREI
Primary exchange	LSE
Secondary exchange	N/A

Share price performance



%	1m	3m	12m
Abs	(1.4)	1.7	(26.6)
Rel (local)	(1.6)	(1.4)	(15.9)
52-week high/low	118p	76p	

Business description

Custodian REIT is a London Main Market-listed REIT focused on commercial property in the UK outside London. It is income focused, with a commitment to pay a high but sustainable and covered dividend, with the potential for capital growth.

Next events

Q121 DPS payment	28 August 2020
H121 period end	30 September 2020

Analyst

Martyn King +44 (0)20 3077 5745

financials@edisongroup.com

[Edison profile page](#)

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Improved DPS outlook

In the three months that ended 30 June 2020 (Q121) NAV per share reduced by 5.9p to 95.7p, driven by unrealised valuation losses on the investment portfolio, and including the 1.6625p DPS paid in respect of Q420, the NAV total return was -4.2%.

Exhibit 1: Quarterly trend in NAV total return*

	Jun-19	Sep-19	Dec-19	Mar-20	Jun-20
(p)	Q120	Q220	Q320	Q420	Q121
Opening NAV per share	107.1	106.0	104.3	104.4	101.6
Closing NAV per share	106.0	104.3	104.4	101.6	95.7
DPS paid	1.6	1.7	1.7	1.7	1.7
NAV total return (%)	0.5%	0.0%	1.7%	-1.1%	-4.2%

Source: Custodian REIT data. Note: *Dividends added back but not reinvested.

From listing in March 2014 to March 2020 (end-FY20), CREI generated an aggregate EPRA NAV total return of 40.1% (without assuming reinvestment of dividends) or a compound annual average return of 5.8% pa. Of the total return, the vast majority (91%) has been generated by dividend payments and the balance by growth in EPRA NAV per share. With market conditions recently more uncertain, the contribution of income to returns is increasingly important.

Exhibit 2: EPRA NAV total return history (DPS added back but not reinvested)

Year ending 31 March (p)	2015*	2016	2017	2018	2019	2020	2015–20 cumulative
Opening EPRA NAV per share	98.2	101.3	101.5	103.8	107.3	107.1	98.2
Closing EPRA NAV per share	101.3	101.5	103.8	107.3	107.1	101.6	101.6
Dividends paid per share	3.750	6.350	6.350	6.425	6.525	6.625	36.0
EPRA NAV total return (%)	7.0%	6.4%	8.5%	9.6%	5.9%	1.0%	40.1%
Compound annual total return (%)							5.8%
o/w income returns (%)							91%

Source: Custodian REIT data, Edison Investment Research. Note: *Opening NAV adjusted for IPO costs.

Income remained robust during Q121 (£9.8m compared with £10.0m in Q420 and an average quarterly rate of £10.2m through FY20), but expenses, including precautionary provisioning against rents owed (we estimate c £0.9m) increased. Q120 income net of expenses of c £6.1m did not fully cover payment of the Q420 DPS during the period, however the c £4.0m cost of the Q121 DPS was c 1.4x covered by EPRA earnings in the period and was fully covered by net cash receipts (allowing for rents accrued but yet received). The 0.95p DPS declared was 27% ahead of the minimum 0.75p that the company had previously indicated, for each of the first two quarters of FY21, reflecting better than expected rental collection (see below), and was fully covered by net cash receipts. With the lockdown easing we expect quarterly dividends throughout FY21 to be at least at the same level. For details of Custodian's tenant base, see our [last note](#).

Exhibit 3: Quarterly NAV development

	Jun-19	Sep-19	Dec-19	Mar-20	Jun-20
(£m)	Q120	Q220	Q320	Q420	Q121
Opening NAV	426.6	432.7	428.5	430.2	426.7
Issue of equity	11.6	2.9	1.5	9.0	0.0
Movement in property values	(6.0)	(7.3)	(0.9)	(12.5)	(23.7)
Income in period	10.8	9.8	10.3	10.0	9.8
Expenses in period	(3.8)	(2.8)	(2.4)	(3.1)	(3.7)
Dividends paid	(6.5)	(6.8)	(6.8)	(6.9)	(7.0)
Closing NAV	432.7	428.5	430.2	426.7	402.1
NAV per share (p)	106.0	104.3	104.4	101.6	95.7

Source: Custodian REIT data

During the quarter all sectors across Custodian's diversified portfolio experienced unrealised valuation decreases; reflecting market-wide trends industrial assets (including logistics) remained

more robust while high street retail assets were the weakest. Amidst low transactional activity in the market (investment volumes during the period to 30 June were only 20% of the previous quarter's levels) the Royal Institute of Chartered Surveyors (RICS) continues to recommend the imposition of a 'material uncertainty' caveat against the valuations of all but industrial and logistics properties. Valuations meanwhile are seeking to reflect the change in market conditions resulting from the pandemic, and particularly the risks to deferred and overdue rents. Custodian's investment manager comments that while this may be inevitable in the short term it does not necessarily represent an irrecoverable shift, expecting demand from occupiers to remain firm as infection management improves. As well as the easing of the lockdown, sentiment around rent collection should also benefit from a reinstatement by the government (after September) of the ability of landlords to formally pursue non-paying tenants.

The valuation movement during the period continued to be tempered by asset management initiatives and this has continued into the current (Q221) quarter with a positive underlying impact on valuation.

Exhibit 4: Like-for-like revaluation movements by sector

	Mar-20	Jun-20	Mar-20	Jun-20
	Q420	Q121	Q420	Q121
Sector	£m		Like for like %	
Industrial	3.1	(5.5)	1.2	(2.2)
Retail warehouse	(5.9)	(5.9)	(5.1)	(5.1)
Other	(4.7)	(6.3)	(5.1)	(6.8)
High street retail	(4.7)	(4.3)	(8.2)	(7.5)
Office	(0.3)	(2.2)	(0.6)	(4.1)
Total	(12.5)	(24.2)	(2.2)	(4.2)

Source: Custodian REIT

Rent collection better than expected

Custodian's investment manager invoices and collects rents directly and, in some cases, this has provided an opportunity to negotiate a positive asset management outcome where tenants have struggled to meet near-term rental payments due to the lockdown. This may typically include an extension to the lease term in return for rent concessions, providing short-term cash flow relief for occupiers and longer-term income security for the company.

The process of collecting rent arrears has continued and as of the date of the Q121 NAV announcement (30 July) 92% of rent relating to Q121, net of agreed rent deferrals (11% of rents), had been collected. Applied to the total invoiced rents this implies 82% collection, 11% deferral and 7% outstanding/due.

With collections continuing, at 30 July, 80% of rents expected for Q221 had been collected, net of amounts deferred by contractual agreement to be recovered over the next 12–18 months. The rents expected to be collected in Q221 include rents due relating to the quarter, net of agreed deferrals of 5% of Q221 rents, and collections of some part of rents deferred in Q121. This implies 82% collection of the rents expected in Q221, 5% deferral and 19% still outstanding/due.

Custodian remains in discussion with tenants in respect of the Q121 and Q221 outstanding rents due and we expect the Q221 collection to increase although a proportion of arrears are potentially at risk of non-recovery from company voluntary arrangements (CVAs) or pre-pack administrations accounting for c 3.6% of rent roll.

Estimates reinstated

As [previously reported](#), the pandemic came too late to significantly impact FY20 recurring income, with the increased DPS target for the year met and fully covered by EPRA earnings, although year-

end valuations and NAV were negatively affected. Our forecasts for FY21 were withdrawn at the start of the pandemic due to the heightened uncertainty about the extent and duration of its impact on accounting income, cash rent collection and capital values. Although a good deal of uncertainty remains, we believe it is now reasonable to make tentative forecasts, supported by published cash rental collection data, the Q120 performance and recent trends in market valuations. However, we note that our confidence in these forecasts is lower than normal and that the actual results could be materially higher or lower in several respects.

Income assumptions

The factors that will determine future rental income include:

- Retention of existing tenants and success with letting vacant space. At the start of FY21, c 9% of income was subject to a lease break option or expiry during the following 12 months and occupancy was 95.6% (end-Q121: 93.8%).
- Non-contractual tenant failures, particularly in the more challenged retail and leisure sectors. As noted above, the company has identified c 3.6% on rent roll as being at risk from CVAs and pre-pack administrations.
- Potential weakness in estimated rental values (ERVs), particularly in the retail and leisure sector, with the impact on current rents potentially accelerated by market weakness with lower rents agreed to maintain occupancy.

For FY21 we have assumed that:

- Custodian makes further provisions against accrued rent receivables, taking the total to £1.6m (including our estimate £0.9m in Q121).
- That occupancy falls further during H221, primarily as a result of the identified income at risk, with the balance of other leasing activity otherwise neutral through the balance of the year.

FY21 IFRS rental income is thus assumed to be £37.8m, before the £1.6m of assumed provisioning against rent receivables (included in expenses) compared with £40.0m in FY20.

In some instances, the assumed aggregate £1.6m provisions taken against rents receivable may represent concessions with occupancy and rent income continuing, but in most cases we would expect a reduction in contracted income and a decrease in occupancy until such time as re-letting occurs. This implies an end-FY21 annualised rent roll of £36.9m compared with £40.5m at the start of the year.

Our FY22 forecast assumes an improvement in contracted passing rent to £38.4m by end-FY22 driven by a recovery in occupancy.

Capital assumptions

Taking account of recent market trends and the unusually wide range of market forecasts, Exhibit 5 shows our best guess at capital value movements across the market for FY21 and applied to the Custodian portfolio as at end-FY21. Our assumptions imply a relative stabilisation in valuation movements throughout the balance of FY21 following sharp declines in Q420 and Q121 (Exhibit 4 above) but given the level of uncertainty are best treated as an illustration. For FY22 we see the possibility for some improvement in valuations if market conditions return to a more normal situation; however, given the uncertainty that remains we have for now assumed flat capital values in FY22.

Exhibit 5: Portfolio valuation assumptions for FY21

	End-FY20 (£m)	Assumed FY21 valuation movement (%)	Assumed FY21 valuation movement (£m)
Industrial	257.3	-4.0%	(10.3)
Retail warehouse	109.7	-8.0%	(8.8)
Other	87.4	-8.0%	(7.0)
High street retail	52.8	-12.0%	(6.3)
Office	52.6	-6.0%	(3.2)
Total	559.8	-6.4%	(35.6)

Source: Edison Investment Research

Based on these assumptions our forecast end-FY21 EPRA NAV per share is 94p (FY20: 102p and Q121: 95p). Alternatively, 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-Q121 EPRA NAV (95p) to fall to match the current share price (86p) would require a c 8% reduction in the end-Q121 portfolio value.

Dividend assumptions

Based on our income assumptions we expect Custodian to increase the level of quarterly DPS payments in the second half of the year and our 4.2p aggregate FY21 DPS forecast assumes quarterly declarations of 1.15p per share in Q321 and Q421 after 0.95p per share in both Q221 and Q221. At 4.2p the aggregate DPS is 1.3x covered by our forecast EPRA earnings; for DPS to be covered by net cash receipts requires 82% of IFRS rental income to be collected.

Our income assumptions for FY22 imply further scope for DPS to increase and we assume a return to aggregate DPS of 5.6p for the year. At this level DPS is 1.10x covered by EPRA EPS and with collection of a part of the FY21 deferred rents continuing into FY22, the cash cover of DPS should be higher.

Forecast summary

Our forecasts are shown in detail in Exhibit 8 and a summary is shown in Exhibit 6. For FY21 we show a comparison with our pre-pandemic forecasts, withdrawn in March 2020. We provide FY22 forecasts for the first time.

Exhibit 6: Estimate summary

	Net rental income (£m)			EPRA EPS (p)			DPS (p)			EPRA NAV/share (p)			Net LTV		
	Old	New	Chge (%)	Old	New	Chge (%)	Old	New	Chge (%)	Old	New	Chge (%)	Old	New	Chge (pp)
2021e	39.0	35.5	-8.2	7.0	5.8	-16.2	6.72	4.20	-37.5	103	94	-8.5	22.6%	23.0%	1.8
2022e	N/A	35.4	N/A	N/A	6.1	N/A	N/A	5.60	N/A	N/A	95	N/A	N/A	22.9%	N/A

Source: Edison Investment Research. Note: The FY21 'old forecast' was in place before the COVID-19 pandemic and was subsequently withdrawn.

Valuation

Our forecast 4.2p FY21 DPS represents a 4.9% prospective FY21 yield (or 4.4% based on the current quarterly rate of DPS of 0.95p or 3.8p annualised). If DPS further increases to 5.6p in FY22 as our forecasts indicate, the prospective FY22 yield is 6.5%. Meanwhile, the c 10% discount to the Q121 NAV compares with an average c 8% premium since IPO in March 2014.

In Exhibit 6 we show a summary performance and valuation comparison of Custodian 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 have reduced DPS payouts for the time being and it will take some time before the full-year prospective DPS outlook becomes clearer and

a true comparison can be made. We also note that the historical data does not reflect our expectation that Custodian's quarterly DPS will increase later in the year. We believe the slight outperformance of CREI shares versus the peer group over the past 12 months and its higher P/NAV in part reflects its focus on smaller lot size properties with a yield premium that supports income returns and dividend paying capacity without additional risk/costs, as well as low gearing, and the company's track record of income generation.

Exhibit 7: 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	53	112	0.59	10.1	7.6	-1%	19%	-41%	-43%
BMO Real Estate Investments	65	156	0.67	6.7	3.8	20%	22%	-25%	-28%
BMO Commercial Property Trust	68	540	0.56	4.4	4.4	21%	4%	-38%	-45%
Picton	71	386	0.76	4.6	3.5	5%	16%	-19%	-35%
Regional REIT	77	331	0.68	10.8	9.9	13%	2%	-26%	-37%
Schroder REIT	31	158	0.53	5.9	5.1	-12%	-7%	-44%	-47%
Standard Life Investment Property	54	220	0.67	7.9	5.3	-5%	-17%	-38%	-46%
UK Commercial Property REIT	66	863	0.79	4.2	2.8	1%	21%	-19%	-28%
Average			0.64	7.2	5.7	5%	8%	-31%	-39%
Custodian	86	362	0.90	6.9	4.4	-1%	2%	-27%	-27%
	Index level				Prospective yield (%)				
UK property index	1,501				8.5	3%	10%	-8%	-24%
FTSE All-Share Index	3,402				3.4	0%	3%	-13%	-20%

Source: Company data, Refinitiv prices at 15 August 2020. Note: *Based on last reported EPRA NAV; **based on DPS declared in past 12 months; ***based on last declared DPS annualised.

Exhibit 8: Financial summary

Year end 31 March	£'000s	2015	2016	2017	2018	2019	2020	2021e	2022e
		IFRS	IFRS	IFRS	IFRS	IFRS	IFRS	IFRS	IFRS
PROFIT & LOSS									
Gross rental income		11,228	18,561	26,980	34,055	39,108	40,022	37,766	37,652
Re-charge income		342	451	630	758	866	881	819	906
Total revenue		11,570	19,012	27,610	34,813	39,974	40,903	38,585	38,559
Gross property expenses		(715)	(1,023)	(1,869)	(1,610)	(2,396)	(2,763)	(3,039)	(3,130)
Net rental income		10,855	17,989	25,741	33,203	37,578	38,140	35,545	35,428
Administrative expenses		(2,327)	(2,828)	(3,643)	(4,377)	(4,919)	(4,782)	(6,249)	(4,711)
Operating Profit before revaluations		8,528	15,161	22,098	28,826	32,659	33,358	29,296	30,717
Revaluation of investment properties		6,083	3,031	9,016	11,859	(5,499)	(25,850)	(23,700)	0
Costs of acquisitions		(5,844)	(5,768)	(6,103)	(6,212)	(3,391)	(599)	0	0
Profit/(loss) on disposal		269	56	1,599	1,606	4,250	(101)	496	0
Operating Profit		9,036	12,480	26,610	36,079	28,019	6,808	6,092	30,717
Net Interest		(289)	(1,273)	(2,405)	(3,659)	(4,373)	(4,685)	(4,985)	(5,030)
Profit Before Tax		8,747	11,207	24,205	32,420	23,646	2,123	1,107	25,687
Taxation		(2)	0	0	0	0	0	0	0
Profit After Tax		8,745	11,207	24,205	32,420	23,646	2,123	1,107	25,687
Net revaluation of investment property/costs of acquisition		(239)	2,737	(2,913)	(5,647)	8,890	26,449	23,700	0
Gains/(losses) on disposal		(269)	(56)	(1,599)	(1,606)	(4,250)	101	(496)	0
EPRA earnings		8,237	13,888	19,693	25,167	28,456	28,673	24,311	25,687
Average Number of Shares Outstanding (m)		146.1	204.2	298.7	362.4	391.9	409.7	420.1	420.1
IFRS EPS (p)		5.99	5.49	8.10	8.95	6.03	0.52	0.26	6.12
EPRA EPS (p)		5.64	6.80	6.59	6.94	7.26	7.00	5.79	6.12
Dividend per share (p)		5.25	6.25	6.35	6.45	6.55	6.65	4.20	5.60
Dividend cover (x)		1.00	1.01	1.01	1.06	1.10	1.04	1.28	1.09
Ongoing charges ratio (excluding property expenses)		1.41%	1.33%	1.20%	1.15%	1.12%	1.12%	1.52%	1.14%
BALANCE SHEET									
Fixed Assets		207,287	318,966	418,548	528,943	572,745	559,817	525,189	528,189
Investment properties		207,287	318,966	418,548	528,943	572,745	559,817	525,189	528,189
Other non-current assets		0	0	0	0	0	0	0	0
Current Assets		1,921	9,973	10,260	12,942	6,146	30,696	35,885	35,985
Debtors		1,072	4,518	4,453	7,883	3,674	5,297	5,297	5,297
Cash		849	5,455	5,807	5,059	2,472	25,399	30,588	30,688
Current Liabilities		(5,411)	(8,165)	(12,572)	(12,755)	(14,160)	(14,862)	(15,068)	(14,673)
Creditors/Deferred income		(5,411)	(8,165)	(12,572)	(12,755)	(14,160)	(14,862)	(15,068)	(14,673)
Short term borrowings		0	0	0	0	0	0	0	0
Long Term Liabilities		(23,811)	(65,714)	(64,359)	(113,928)	(138,108)	(148,899)	(149,179)	(149,459)
Long term borrowings		(23,811)	(65,143)	(63,788)	(113,357)	(137,532)	(148,323)	(148,603)	(148,883)
Other long term liabilities		0	(571)	(571)	(571)	(576)	(576)	(576)	(576)
Net Assets		179,986	255,060	351,877	415,202	426,623	426,752	396,827	400,041
NAV/share (p)		101	102	104	107	107	102	94	95
EPRA NAV/share (p)		101	102	104	107	107	102	94	95
CASH FLOW									
Operating Cash Flow		12,780	13,945	23,066	28,388	36,035	31,042	29,502	30,323
Net Interest		(204)	(1,285)	(2,200)	(3,521)	(4,198)	(4,399)	(4,705)	(4,750)
Tax		0	0	0	0	0	0	0	0
Net additions to investment property		(129,788)	(113,621)	(92,126)	(105,884)	(46,199)	(12,227)	(428)	(3,000)
Ordinary dividends paid		(5,546)	(12,220)	(18,493)	(23,007)	(25,484)	(27,002)	(19,795)	(22,473)
Debt drawn/(repaid)		23,811	41,700	(1,000)	49,364	24,000	10,505	0	0
Proceeds from shares issued (net of costs)		99,796	76,087	91,105	53,912	13,259	25,008	0	0
Other cash flow from financing activities		0	0	0	0	0	0	0	0
Net Cash Flow		849	4,606	352	(748)	(2,587)	22,927	4,574	100
Opening cash		0	849	5,455	5,807	5,059	2,472	25,399	29,973
Closing cash		849	5,455	5,807	5,059	2,472	25,399	29,973	30,073
Debt as per balance sheet		(23,811)	(65,143)	(63,788)	(113,357)	(137,532)	(148,323)	(148,603)	(148,883)
Unamortised loan arrangement fees		(489)	(857)	(1,212)	(1,643)	(1,468)	(1,677)	(1,397)	(1,117)
Total debt		(24,300)	(66,000)	(65,000)	(115,000)	(139,000)	(150,000)	(150,000)	(150,000)
Restricted cash		(230)	(490)	(1,307)	(1,341)	(1,369)	(911)	(911)	(911)
Closing net debt		(23,681)	(61,035)	(60,500)	(111,282)	(137,897)	(125,512)	(120,938)	(120,838)
Net LTV		11.4%	19.1%	14.4%	21.0%	24.1%	22.4%	23.0%	22.9%

Source: Custodian REIT data, Edison Investment Research

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Frankfurt +49 (0)69 78 8076 960
Schumannstrasse 34b
60325 Frankfurt
Germany

London +44 (0)20 3077 5700
280 High Holborn
London, WC1V 7EE
United Kingdom

New York +1 646 653 7026
1,185 Avenue of the Americas
3rd Floor, New York, NY 10036
United States of America

Sydney +61 (0)2 8249 8342
Level 4, Office 1205
95 Pitt Street, Sydney
NSW 2000, Australia