EDISON

Custodian REIT

FY20 results

Diversified income base

Real estate

In the year to 31 March 2020 (FY20), Custodian REIT (CREI) delivered on its recurring income targets, supporting fully covered DPS of 6.65p (+1.5%) and a positive total return despite increased year-end pressure on valuations from COVID-19. The company entered this challenging environment with a diversified portfolio, good levels of occupancy and a strong and liquid balance sheet. Current quarterly DPS annualises at 3.0p, a yield of 3.4%, with upside potential later in the year from improving collections following relaxation of the lockdown.

Year end	Net rental income (£m)	EPRA earnings* (£m)	EPRA EPS* (p)	EPRA NAVPS (p)	DPS (p)	P/NAV (x)	Yield (%)
03/18	33.2	25.2	6.9	107.3	6.45	0.81	7.4
03/19	37.6	28.5	7.3	107.1	6.55	0.81	7.5
03/20	38.1	28.7	7.0	101.6	6.65	0.86	7.6

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

FY20 income target delivered

FY20 recurring (EPRA) earnings of £28.7m were in line with our expectations and very marginally ahead of FY19 (£28.5m) supported by an increased asset base (despite pressure on volumes) and slightly increased rent roll while costs were tightly controlled. The diversified portfolio mitigated the impacts of retail valuation pressure until the end of year, when COVID-19 had a more negative overall affect. EPRA NAV per share reduced to 101.6p (FY19: 107.1p) but including DPS paid, the full-year total return remained positive. In common with peers, the company has seen a material slowdown in rents collected due to the pandemic but as previously guided it intends to pay quarterly dividends at a reduced rate of at least 0.75p in each of Q121 and Q221. Thereafter it hopes that as deferred rents are collected, the DPS can return towards the target level.

We see scope for DPS to normalise

At the time of reporting, CREI had collected 70% of quarterly rent due for Q120 and had agreed to defer 12%, while 18% remained outstanding. In common with industry trends, we would expect a more challenging Q220 collection performance, reflecting the greater impact of the lockdown, especially for the retail sector. However, we estimate that cash cover of the reduced dividend (an annualised 3.0p per share) requires 68% of start-year rents to be collected for the year as a whole, highlighting the scope for later year uplifts if, as we expect, collections improve as the lockdown eases and as the temporary protection for tenants, which reduces the incentive to pay rent even when this is possible, is lifted. A strong balance sheet with low levels of gearing is a defence against near-term uncertainties and provides scope for opportunistic acquisitions when the outlook become clearer.

Valuation: Relatively attractive yield with upside

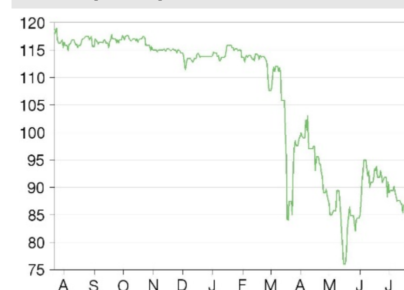
The prospective yield of 3.4%, based on the reduced DPS, compares favourably with risk-free alternatives (below 0.2% for 10-year UK government debt) with scope to increase as collections normalise. The c 14% discount to EPRA NAV compares with an average c 8% premium since IPO in 2014.

21 July 2020

Price	**87p**
Market cap	**£365m**

Net debt (£m) at 31 March 2020	125.5
Net LTV at 31 March 2020	22.4%
Shares in issue	420.1m
Free float	92%
Code	CREI
Primary exchange	LSE
Secondary exchange	N/A

Share price performance



%	1m	3m	12m
Abs	(3.7)	(6.2)	(25.7)
Rel (local)	(3.0)	(13.2)	(12.0)
52-week high/low		119p	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

FY21 half year-end	30 September 2020

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Edison profile page

Custodian REIT is a research client of Edison Investment Research Limited

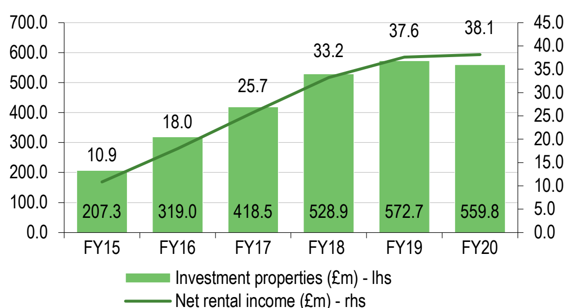
Diversified income focus

CREI is strongly focused on generating sustainable income returns, with the potential for additional capital growth over time and until the COVID-19 pandemic, it had steadily increased fully covered DPS each year since IPO. Portfolio diversification, by sector, location, tenant and lease term, is a key element of strategy, while the focus on good-quality properties but with smaller lot sizes (less than £10m at the point of investment) not only differentiates the company from a number of peers that also focus on regional commercial, but also enables CREI to benefit from a favourable pricing/yield arbitrage. Smaller lot size properties may appeal to a broader array of occupiers yet be too small for larger institutional buyers and too large for many private investors. As a result, pricing tends to be less competitive and yields higher, to an extent that is more than sufficient to offset the additional administrative complexity of a broader portfolio.

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. The COVID-19 pandemic had a relatively modest impact on FY20 income earnings, with total return for the year remaining positive (+1% NAV total return without assuming reinvestment of dividends) as a result, despite a negative impact on year-end property valuations. Reflecting this positive performance, the investment management agreement with Custodian Capital has been renewed for an additional three years, with a reduction in the marginal rate of management fees that will apply to an increase in net asset value above £750m.

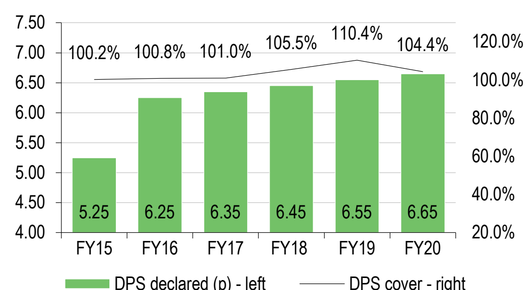
Economic and market conditions have become highly uncertain as a result of the pandemic but although the commercial property sector is cyclical, income returns have historically been much more stable than capital values, delivering c 70% of long-term total returns. At the time of reporting FY20 results (23 June 2020) CREI had collected 70% of rent due relating to invoicing for the quarter ended 30 June 2020 (Q121), with 12% deferred by agreement for later collection, while 18% remained the subject of discussion with tenants. In common with industry trends, we would expect a more challenging Q220 collection performance reflecting the extended impact of the lockdown. We estimate that cash cover of the reduced dividend (an annualised 3.0p per share) requires 68% of start-year rents to be collected leaving scope for quarterly DPS to be lifted later in the year if, as we expect, collections improve as the lockdown eases. Meanwhile, a strong balance sheet with low levels of gearing is a defence against near-term uncertainties and provides scope for opportunistic acquisitions when the outlook become clearer. Before reviewing the FY20 results we first provide an update on the impacts of COVID-19.

Exhibit 1: Growth in investment property value and net rental income



Source: Custodian REIT data

Exhibit 2: Growth in DPS, fully covered by recurring earnings



Source: Custodian REIT data

Portfolio diversification supports income stability

Portfolio diversification provides a mitigation to risk in uncertain times such as these and CREI's portfolio is well spread across the main commercial property sectors as well as by location, tenant and lease term.

Exhibit 3: Portfolio summary

	FY20	FY19
	31-Mar-20	31-Mar-19
Property value	£559.8m	£572.7m
Separate tenancies*	280	269
EPRA occupancy rate	95.80%	95.90%
Number of properties*	161	155
Weighted average unexpired lease term (WAULT)	5.3 years	5.6 years
Net initial yield (NIY)	6.80%	6.60%
Rent roll	£40.5m	£40.3m

Source: Custodian REIT. Note: *160 properties and 279 tenancies at 1 July 2020 as per Q221 Factsheet.

At end-FY20 the portfolio was externally valued at £559.8m, subject to the industry-standard material uncertainty clause (FY19: £572.7m) with a rent roll of £40.5m pa reflected in a net initial yield of 6.8%. The weighted average unexpired lease term at end-FY20 was 5.3 years with just 9% of income 'at risk' over one year from lease expiry or the exercise of a lease break option and 32% over two years. While a significant proportion of tenants do not exit at break or expiry, this could be negatively affected by the pandemic and economic weakness. Also, in addition to the enforced reduction of rents through, for example, a company voluntary arrangement (CVA), it may in certain circumstances be necessary to reduce rents to secure long-term occupancy. We would highlight the retail sector as having above average vulnerability. Since the end of FY20, Travelodge, The Restaurant Group, Poundstretcher, and JTF Wholesale have entered into or proposed CVAs, affecting several assets in the portfolio, and if all pass CREI says this could reduce rent roll by c 2.5%.

There are c 280 individual tenancies across the c 160 properties, the largest being Menzies Distribution at just under 4% of the overall rent roll, spread over eight individual assets. Menzies is one of the UK's leading print media logistics companies, servicing 1,700 routes per day from over 50 sites across the UK and Ireland. The top 10 tenants account for just under 23% of total rent roll.

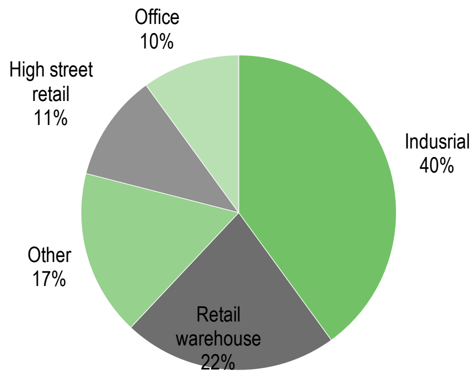
Exhibit 4: Top 10 tenants (% of rent roll)

Menzies Distribution	3.96%	Wickes Building Supplies	1.94%
B&Q	3.34%	Benham (Specialist Cars)	1.83%
B&M Retail	3.04%	Regus (Maidstone West Mailing)	1.57%
VW Group (UK)	2.08%	First Title	1.55%
Superdrug Stores	2.02%	JTF Wholesale	1.44%
Top 10 tenants		**22.77%**	

Source: Custodian REIT, Q221 Factsheet

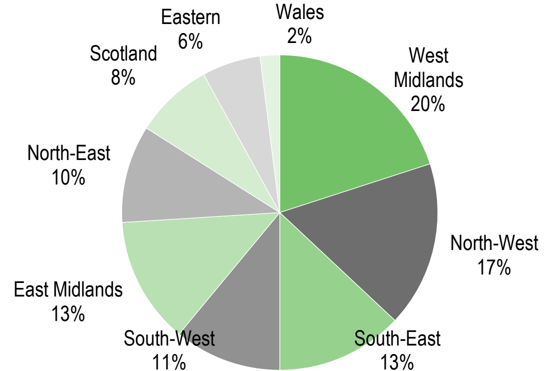
Exhibits 5 and 6 show the sector and geographic spread of the portfolio at 1 July 2020 (as per the Q221 Factsheet), not materially different from end-FY20. The portfolio has minimal exposure to London, but exposure to every other region. It is split between the main property sectors, in line with the company's objective of maintaining a suitably balanced portfolio, with relatively low exposure to office and high street retail combined with relatively high exposure to industrial and alternative sectors ('other', including car showrooms, petrol filling stations, children's day nurseries, gymnasiums, hotels and healthcare units).

Exhibit 5: Sector split by income



Source: Custodian REIT, Q221 Factsheet

Exhibit 6: Regional split by income



Source: Custodian REIT, Q221 Factsheet

Sector strategy

The fund manager sees industrial property as a particularly good fit with CREI's investment strategy, where it is possible to acquire modern, 'fit for purpose' buildings, where the vacant possession value is closer to the investment value than may be the case in other sectors ('high residual values') and where there is less risk of obsolescence requiring capital expenditure to maintain vales. For these reasons, CREI's portfolio has always been weighted towards regional industrial and logistics assets (broadly equal parts of CREI's industrial portfolio) and this has continued to benefit performance as both subsectors have been experiencing a favourable occupier supply-demand balance, particularly for smaller lot size properties, which is driving rental growth and positive investor sentiment.

The portfolio has a relatively low exposure to office property. Although the regional office market has continued to see rental growth driven by continuing occupier demand and relatively tight supply, the fund manager regards the cost of ownership (through obsolescence and the requirement for capital expenditure, as well as lease incentives) to be higher than for other sectors, requiring a highly selective approach.

The investment in alternative sectors provides additional portfolio diversification, which in normal circumstances may be less correlated with economic performance than the mainstream sectors. However, the exceptional circumstances of the pandemic and lockdown have seen many tenants closed for business altogether.

Within the broad retail area, CREI's strategy has been to give greater focus to out-of-town retail warehouses as opposed to traditional high street retail. The pandemic seems likely to accelerate the structural challenge facing the latter while in contrast, beyond the immediate challenges, CREI's fund manager sees opportunities for the retail warehouse subsector to benefit from restricted supply, generally free parking, and the convenience that is complementary to increasing online sales for both click-and-collect and customer returns.

Portfolio development

The c £13m reduction in the value of the portfolio during the year mostly comprises £24.6m (excluding acquisition costs) invested in eight property acquisitions, the disposal of two properties at valuation for an aggregate consideration of £15.7m (before costs, rental top-ups and rent guarantees), £2.8m of capex, and a full-year valuation decrease of £25.8m. Asset management initiatives such as rent reviews, new lettings, lease extensions and the retention of tenants beyond their contractual break clauses resulted in a £6.1m valuation increase. However, this more than offset by a £31.9m valuation decrease, broadly reflecting market trends. The weakness in retail

asset valuations was driven by a decrease in estimated rental values for high street retail properties, negative market sentiment for retail properties in general and the impact of COVID-19. These factors offset a positive valuation performance from CREI's strong weighting towards regional industrial and logistics assets.

Acquisition activity during the year was relatively light compared with prior years due to reflecting market conditions (Brexit and election uncertainty) and the difficulty in identifying opportunities that would meet the company's investment criteria. The key transaction in FY20 was the October 2019 £24.6m (before costs) corporate acquisition of the Menzies portfolio, comprising eight geographically spread distribution units leased back to Menzies Distribution on new 10-year leases, with only one unit having a second-year break option. The initial passing rent is £1.61m pa, reflecting a net initial yield of 6.4%, but the eases provide for a 13.1% fixed rental uplift at year five. As a result of the pandemic and to protect cash flows, CREI withdrew from two regional office acquisitions on which terms had been agreed.

COVID-19 impacts

Rental collection

CREI's rents are collected directly by the investment manager. This provides it with the opportunity of communicating directly with occupiers to optimise rent collection, provide support where this is appropriate to assist them through the current uncertainties and minimise the impact on the company's cash flows and capital values. In some cases this has led to positive asset management outcomes including the extension of leases for rent concessions, providing short-term cash flow relief to the occupiers and longer term income security for CREI. At the time of reporting FY20 results (23 June 2020) no rent due had been waived or cancelled. Rents are normally billed quarterly or monthly in advance and with the results CREI reported that:

- 70% of rent due relating to invoicing for the quarter ended 30 June had been collected as expected;
- 12% had been deferred by agreement (and was therefore no longer due in the quarter) to be paid either monthly in arrears or to be recovered through an agreed payment plan within existing lease terms over a 12–18-month period; and
- 18% remained the subject of discussion with tenants.

CREI has not provided a breakdown by sector but industry wide, the retail and leisure sector was the weakest area both for collections and outstanding rents where no agreement on contractually due unpaid rent had been reached. We expect the collection for the quarter ending September 2020 to be weaker than for the quarter ending June due to the continuing effects of the lockdown and the extension by the government until September of the right of landlords to serve notice to quit weakened the incentive for tenants to pay rent even when they are able to do so. However, we expect the easing of the lockdown to lead to a gradual improvement in quarterly collection rates. Rents that have been deferred by agreement are expected to be collected in instalments (we estimate starting in H221 and mostly completed by end-FY22). Over a similar period, we also expect it to become clear which of the tenants with outstanding rents, for which no deferral agreement has yet been reached, will ultimately return to a normal path of rent payment. In addition to possible further rent-free agreements, in some cases, particularly in the challenged retail and leisure sector, it may be necessary to agree lower rents although we would expect CREI to seek improvements to other lease terms, including extensions or the removal of break options to mitigate the valuation impact.

The pandemic was largely responsible for £12.5m valuation write-down during the quarter ending 31 March 2020 (Q420) with sector performances broadly matching industry trends. Industrial asset

valuations increased by £3.1m (1.2%) but were offset by weakness in high street retail (£4.7m or 8.2% lower), retail warehouse (£5.9m or 5.1% lower) and 'other' (£4.7m or 5.1% lower). Office asset valuations were resilient (£0.3m or 0.6% lower).

Market update

MSCI UK Property Index monthly return data show that across the UK commercial property sector as a whole, positive total returns were recorded until March 2020, with a positive performance from the industrial and office sectors offsetting weakness in retail and leisure, which continues to undergo structural change due to evolving shopping habits, resulting in excess supply and falling rents. From March through May, due to the pandemic and lockdown all main sectors experienced weakening capital values and negative total returns, while the weakness of retail and leisure accelerated. Data for June from CBRE suggest industrial and office values may be stabilising (-0.1% and -0.2% respectively) while the decline in retail values continued (-1.4%).

The industrial sector should continue to find support from a general tightness of supply relative to demand and has continued to see rental growth through May. Office rental value growth was broadly stable in May but capital values weakened and there is much debate as to whether the pandemic and remote working will have a negative long-term impact on the demand for office space. Home working has probably received an enduring boost but the case for full-time office working is less clear. When in the office, it is likely each worker will require an increased amount of space. Well-appointed offices, with good transport links, good IT infrastructure and environmental credentials are likely to retain a premium.

The investment market saw reduced volumes, especially after March 2020 when transactions effectively dried up, causing the Royal Institute of Chartered Surveyors to introduce a material uncertainty clause in respect of external valuations across most sub-sectors. The clause was not intended to signify that valuations were unreliable but rather that there was limited transactional evidence against which they could be benchmarked. As investment volumes begin to increase once again, the material uncertainty clause has been lifted from an increasing number of subsectors, including most recently industrial and logistics properties.

Strong, liquid balance sheet with low gearing

CREI operates with moderate gearing and had a liquid balance sheet, no short-term refinancing risk and significant headroom on borrowing covenants at 31 March 2020. Pre-emptive interest cover waivers are in place with all lenders until the end of the September quarter (end-Q220) to allow for further anticipated near-term reductions in rent collection.

Year-end total debt was £150.0m and after adjustment for a strong £24.5m of unrestricted cash balances net debt was £125.5m. Despite the reduction in property values, the loan to value (LTV) ratio reduced further to 22.4% during FY20 (FY19: 24.1%).

Custodian operates with four loan facilities amounting to £165m in aggregate, comprising:

- A £20m term loan with Scottish Widows at a fixed rate of 3.9335%, repayable in August 2023.
- A £45m term loan with Scottish Widows at a fixed rate of 2.987%, repayable in June 2028.
- A £50m term loan with Aviva Investors Real Estate Financing comprising:
  - a £35m tranche at a fixed rate of 3.02%, repayable in April 2032; and
  - a £15m tranche at a fixed rate of 3.26%, repayable in November 2032.
- A £50m variable rate revolving credit facility with Lloyds Bank that carries an interest margin of between 1.5% and 1.8% (depending on LTV) and matures in September 2022 with an option to extend by a further two years, subject to the bank's agreement. The £50m facility includes an

'accordion option' with the end-FY20 facility limit set at £35m, increasing to £50m subject to Lloyd's agreement.

The weighted average cost of the agreed debt facilities at end-FY20 was 3.0% with a weighted average maturity of 7.8 years. In total, 70% of the facilities and 77% of the drawn facilities were at a fixed interest rate.

Each of the facilities has its own discrete security pool comprising individual properties over which the relevant lender has security and covenants. The facilities contain market-standard cross guarantees such that a default on an individual facility results in all facilities falling into default. The covenants include:

- A maximum LTV for the security pools of between 45% and 50% with an overarching covenant on the company level property portfolio of a maximum 35% LTV.
- Minimum historical interest cover requiring net rental receipts (rather than accounting income) from each discrete security pool, over the preceding three months, to be at least 250% of the quarterly interest liability.

With unencumbered property assets (ie assets not within the discrete security pools) of c £184.8m (around one-third of the portfolio) LTV covenants are not a concern in current market conditions. Based on the end-FY20 net debt it would require a c 36% decline in the end-FY20 property valuation (including currently unencumbered assets) to increase the LTV to 35%, although in practice the complexities of maintaining adequate security balances in each discrete security pool would suggest a smaller effective buffer.

To address the difficulty of collecting rents in a timely way resulting from the pandemic and lockdown, pre-emptive waivers were put in place with lenders for at least the June 2020 and September 2020 quarter ends, providing flexibility to collect rents in the most advantageous way for medium/long term income security while supporting tenants and minimising vacancies.

Group interest cover (including currently unencumbered assets) was more than 600% in the three months ended 31 March 2020. With interest costs of c £4.7m pa (net finance expense also includes non-cash loan arrangement fee amortisation and a small amount of other fees), a 250% cover ratio represents net rental receipts of c £12m pa or c £3m on a quarterly basis compared with annualised rent roll at 31 March of £36.2m.

FY20 results

FY20 recurring (EPRA) earnings were in line with our expectations, supporting increased aggregate quarterly dividends of 6.65p (+1.9%), as targeted, and fully covered (1.04x) by EPRA earnings.

Net rental income showed a slight increase in line with the larger portfolio (despite a reduction in valuation) and slightly increased annualised rent roll, with administrative expenses tightly controlled. Interest expense increased with a higher average level of debt, partly offset by a reduced average cost of debt. EPRA earnings increased 0.8% to £28.7m (FY19: £28.5m) with EPRA EPS of 7.0p, slightly reduced by an increase in the average number of shares in issue. Responding to continuing strong investor demand prior to the pandemic, CREI raised new equity under the block-listing facility by issuing 21.9m new shares at an average premium of 11% the prevailing NA adjusted for dividends.

The sharply reduced IFRS earnings reflect the impact of property valuation movements, which also affected EPRA NAV per share, reduced to 101.6p from 107.1p. Taking into account DPS paid, the EPRA NAV total return remained positive at 1.1% despite the challenging environment for the retail sector throughout the year and impact of COVID-19 on year-end valuations.

Exhibit 7: Summary of FY20 financials

£m unless stated otherwise	FY20	FY19	H119 v H118
Net rental income	38.1	37.6	1.5%
Administrative expenses	(4.8)	(4.7)	0.7%
Operating Profit before revaluations	33.4	32.8	1.6%
Net interest	(4.7)	(4.4)	7.1%
EPRA earnings	28.7	28.5	0.8%
Revaluation of investment properties	(25.9)	(5.5)	
Costs of acquisitions	(0.6)	(3.4)	
Profit on disposal	(0.1)	4.3	
Non-recurring costs		(0.2)	
IFRS earnings	2.1	23.6	-91.0%
EPRA EPS (p)	7.0	7.3	-3.6%
IFRS EPS (p)	0.5	6.0	-91.4%
DPS (declared) (p)	6.6500	6.5500	1.5%
Dividend cover (%)	104.4	110.4	-5.5%
Investment portfolio (£000s)	559,817	572,745	-2.3%
IFRA and EPRA NAV per share (p)	101.6	107.1	-5.2%
NAV total return*	1.0%	5.9%	
Net LTV	22.4%	24.1%	

Source: Custodian REIT data, Edison Investment Research

Dividend outlook

CREI is strongly focused on paying dividends on a sustainable basis at a rate fully covered by net rental income and does not inhibit the flexibility of investment strategy. During FY20 the company declared four quarterly dividends of 1.6625p, amounting to 6.65p, 1.5% ahead of the FY19 total and in line with the target set earlier in the year. Dividends paid during the year, comprising three interim dividends and the FY19 final dividend, amounted to 6.625p. The fourth FY20 quarterly DPS of 1.6625p was paid in May 2020.

In early April the company announced it would continue to pay quarterly dividends, at a level broadly linked to net rental receipts, but that in respect of Q121 and Q221 it would pay a minimum of 0.75p per quarter regardless of rent collection rates. It also indicated that if rent collections improve through the year, more generous dividends may be possible thereafter, helping to restore the dividend to a sustainable long-term level akin to previous years.

We believe the reduced level of quarterly dividends allows for the likelihood that June rent collections will be below the level reported for March 2020, followed by some modest recovery in collection rates as the lockdown eases. We estimate that 68% cash collection during the year of the annualised rent roll in place at the beginning of FY21 is sufficient to fully cover annualised DPS of 3.0p with cash earnings. This does not include rents where a payment plan has been agreed but where collection carries over into FY22.

Exhibit 8: We estimate 68% rent collection required to cover current DPS

£m unless stated otherwise	
DPS (p)	3.0
Number of shares (m)	420.1
Total dividends paid	12.6
Edison estimated administrative expenses	(5.0)
Edison estimated net finance expense	(5.0)
Edison estimated non-recoverable property costs	(2.0)
Required gross cash rental income	24.6
Opening contracted rent roll	36.2
Required 'rental income' as % opening contracted rent roll	68%

Source: Edison Investment Research

There are a number of factors that are likely to impact the full-year level of cash rents and the potential for a recovery in the quarterly level of DPS, as well as the likely divergence between cash

collected rents and the level of IFRS rental income (including much of any deferred rents during the year) in the income statement. These include:

- Ongoing collection rates. We expect these will improve from the September rent quarter onwards.
- The speed with which deferred rents and outstanding rents are settled and the use of rent-free periods to secure long-term occupancy. CREI expects collection of currently agreed rent deferrals to occur over a 12–18-month period.
- The rate of impairment on deferred and outstanding rents. We expect some of the deferred rents will eventually become impaired and a potentially larger share of the outstanding rents.
- Impairment of deferred/outstanding rents should be accompanied by increasing voids, but other changes to the void rate should be expected including, positively, the potential for reversionary capture.
- Acquisitions. We do not expect any immediate activity but as market conditions become clearer this is possible. We estimate that an increase in the end-FY20 LTV to 25% would potentially provide room for c £20m in acquisitions (before costs), adding perhaps £1.2m to annualised rent roll. However, this headroom is likely to be reduced by weaker asset valuations and, based on the end-FY20 debt position, a c 10% reduction in asset values would similarly lift LTV to c 25%.

We have not made a specific forecast at this stage but believe the reduced DPS level has been set prudently with upside potential from an improving collection environment and capture of some of the reversionary potential in the portfolio. Including all of the variables above, if the total cash rent collected in FY21 were equal to 75% of the start year annualised rent roll then dividend-paying capacity increases to 3.6p and at 90% it is 4.9p. Continuing collection of FY21 rent deferrals through FY22 would indicate a further improvement in cash flow in FY22, all other things being equal.

For the current year, the IFRS rental income reported in the income statement is likely to exceed the level of cash rents collected, as much of the rent deferred will still be recorded as income. For now, we expect the company to base dividend decisions on the cash figure. In FY22 it may be the case that cash rents exceed IFRS rental income as deferrals fall away and collection of FY21 rent continues.

If accounting income exceeds cash rental income in the current year and dividends are based on the latter, the retained earnings should support NAV.

NAV

We have similarly not made an estimate of capital value movements at this stage but note that based on the end-FY20 balance sheet, to close the current P/NAV discount allowing for the impact of gearing would require a c 10% decline in portfolio value.

Each 1% increase/decrease in the value of the end-FY20 portfolio value increases/reduces EPRA NAV by 1.3p.

Valuation

As an income-oriented REIT, CREI’s focus is on generating a secure and growing income stream that can support its long-term progressive and sustainable dividend objectives while delivering capital value growth over the long term. Since IPO the company has consistently paid one of the highest fully covered dividends amongst its peer group

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. Compared with the position at end-FY19, the weakness in capital values during FY20, especially in Q420 as a result of COVID-19, reduced compound annual average return since IPO but increased the income contribution to overall returns.

Exhibit 9: NAV total return performance since IPO (dividends not reinvested)

Year ending 31 March	FY15	FY16	FY17	FY18	FY19	Cumulative FY15-19	FY20	Cumulative since IPO
Opening EPRA NAV per share (p)	98.2	101.3	101.5	103.8	107.3	**98.2**	107.1	**98.2**
Closing EPRA NAV per share (p)	101.3	101.5	103.8	107.3	107.1	**107.1**	101.6	**101.6**
Dividends paid per share (p)	3.750	6.350	6.350	6.425	6.525	**29.4**	6.625	**36.0**
EPRA NAV total return	**7.0%**	**6.4%**	**8.5%**	**9.6%**	**5.9%**	**39.0%**	**1.0%**	**40.1%**
Compound annual total return						**6.8%**		**5.8%**
o/w income returns						**77%**		**91%**

Source: Custodian REIT data, Edison Investment Research

The reduced run rate of DPS annualises at 3.0p per share, although we believe this has been set conservatively with scope to increase quarterly DPS later in the year if, as we expect, rental collection improves. Nevertheless, at 3.0p the prospective yield is c 3.4% while the P/NAV ratio of 0.86x compares with an average 1.08x since IPO and a consistent premium until the pandemic. Compared with the sector, the shares have continued to demonstrate relatively low levels of volatility.

Exhibit 10: Custodian REIT P/NAV history since IPO

Source: Refinitiv data. Note: Priced at 7 July 2020

In Exhibit 11 we show a summary performance and valuation comparison of CREI and what we consider to be its closest diversified income-oriented peers.

Custodian's share price declined less than the peer group average over the past 12 months, although the peer group average is below that of the broad UK property sector, which over the same period, has benefitted from the strong performance of some of the specialist long-income focused specialist REITs as well as industrial focused REITs. We expect the outlook for investment in the mainstream commercial property sector to become clearer and potentially more positive as the lockdown eases and previously closed sectors of the economy re-open. If, as we expect, rent collection stabilises and deferred rents are in large part collected, the income returns available on well let properties and the prospects for dividends to normalise should be attractive to investors in a low return environment. The yield on commercial property compared with risk-free rates (the 10-year UK government bond yield is currently less than 0.2%) is unusually wide.

In Exhibit 11 we show both 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, with some companies having indicated a reduced DPS pay-out for the time being and some postponing DPS payments altogether until later in the year. It will take some time before the full-year prospective DPS outlook becomes clearer and a true comparison can be made. We believe the outperformance of CREI shares versus the peer group over 12 months and its slightly 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 11: Peer comparison table

	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	52	109	0.48	11.1	7.7	-2%	0%	-47%	-47%
BMO Real Estate Investments	58	140	0.60	7.5	4.3	14%	16%	-30%	-35%
BMO Commercial Property Trust	58	460	0.46	7.8	0.0	-21%	-8%	-50%	-53%
Picton	69	377	0.74	4.7	3.6	0%	3%	-27%	-36%
Regional REIT	70	302	0.62	11.8	10.9	-7%	-5%	-35%	-43%
Schroder REIT	34	174	0.58	5.4	4.6	3%	-15%	-40%	-42%
Standard Life Investment Property	56	228	0.61	8.5	0.0	-17%	-22%	-39%	-44%
UK Commercial Property REIT	66	852	0.76	5.6	2.8	-1%	6%	-25%	-28%
Average			**0.59**	**8.1**	**4.4**	**-4%**	**-3%**	**-37%**	**-41%**
Custodian	**87**	**365**	**0.86**	**7.6**	**3.4**	**-5%**	**-5%**	**-27%**	**-27%**
	Index level				**Prospective yield (%)**				
UK property index	1,478				3.0	-2%	5%	-12%	-25%
FTSE All-Share Index	3,478				3.4	0%	12%	-15%	-18%

Source: Company data, Refinitiv. Note: Priced at 20 July 2020. *Based on last reported EPRA NAV. ** Based on DPS declared in past 12 months. ***Based on last declared DPS annualised,

Exhibit 12: Financial summary

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

Source: Custodian REIT data, Edison Investment Research

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