

# Picton Property Income

Acquisition

Accretive reinvestment

Real estate

Picton's strategic objective is to grow both its asset base and income stream. It actively manages its portfolio and during FY17 and the early months of the current year completed the sale of £62m of non-core assets at prices above book value, reducing central London office exposure and reducing debt. The £23.15m acquisition of a Grade A office building in Bristol with significant potential from the letting of recently refurbished vacant space and rent reversion, meets the company's strategic objectives and further rebalances the portfolio geographically. We have increased our EPRA EPS estimates by c 1% for FY18 and c 4% for FY19.

| Year end | Revenue (£m) | EPRA EPS* (p) | DPS (p) | EPRA NAV/share (p) | P/EPRA NAV (x) | Yield (%) |
|----------|--------------|---------------|---------|--------------------|----------------|-----------|
| 03/16    | 40.8         | 3.68          | 3.30    | 77.2               | 1.10           | 3.9       |
| 03/17    | 47.9         | 3.81          | 3.30    | 81.8               | 1.04           | 3.9       |
| 03/18e   | 42.5         | 3.94          | 3.40    | 84.2               | 1.01           | 4.0       |
| 03/19e   | 44.0         | 4.18          | 3.50    | 84.9               | 1.00           | 4.1       |

Note: \*EPS are normalised, excluding exceptional items.

## Diversified asset and income growth

Picton has acquired a Grade A office building located in Bristol's city centre for £23.15m. Known as Tower Wharf, the building provides 70,664 sqft of office accommodation, 64% occupied by four tenants with an average lease length of 5.2 years (2.8 years to first break). The remaining vacant space is fully refurbished and available to let into an improving occupational market. With continuing high take-up and limited new supply the market for Grade A office space in Bristol city centre has continued to tighten and Picton sees significant reversionary potential in addition to letting vacant space.

## Immediately accretive with significant upside

The consideration has been met partly out of cash resources and partly by drawing £12.5m on one of the two revolving credit facilities which will slightly lower the average cost of debt and increase LTV to just below 30%. The purchase price represents a net initial yield of 3.6% which managements expects to grow to 7.5% with new leasing and rent reversion. Although average occupancy will fall slightly from 96% to 94%, the transaction is immediately accretive of earnings, adding c £0.3m on annual basis and increasing dividend cover by c 2%. Although ahead of our FY19 assumptions, once fully let, management expects the additional earnings to reach £1.4m and increase dividend cover by 8%.

## Valuation: Improving dividend prospects

Picton's 2% premium to NAV remains below the peer group average of c 6% and while the 4% prospective dividend yield is below the group average of 5%, improving dividend prospects suggest potential for the premium to rise closer to the average. With no changes to the assumptions in our dividend discount model (see our [initiation note](#)), which we use as a sense check, the fair value range produced by our model remains 79p to 103p.

15 August 2017

**Price** 85p  
**Market cap** £459m

|                               |        |
|-------------------------------|--------|
| Net debt (£m) at 30 June 2017 | 171.5  |
| Shares in issue               | 540.1m |
| Free float                    | 100%   |
| Code                          | PCTN   |
| Primary exchange              | LSE    |
| Secondary exchange            | N/A    |

### Share price performance



|                  |     |       |       |
|------------------|-----|-------|-------|
| %                | 1m  | 3m    | 12m   |
| Abs              | 2.7 | 0.0   | 24.5  |
| Rel (local)      | 2.7 | 0.9   | 16.1  |
| 52-week high/low |     | 86.0p | 66.8p |

### Business description

Picton Property Income is an internally managed investment company that invests in commercial property across the UK. The investment objective is to provide investors with an attractive level of income and the potential for capital growth.

### Next events

|                    |               |
|--------------------|---------------|
| September 2017 NAV | October 2017  |
| H117 results       | November 2017 |

### Analysts

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## Accretive reinvestment

### Tight supply in the Bristol city centre office market

Colliers International estimates that through a combination of strong take-up and little new supply availability of office space in Bristol city centre is at its lowest level since before the global financial crisis. They estimate that Grade A availability declined by 12% in Q217 compared with Q1, and that 95% of all Grade A space is let. Q2 city centre take-up is estimated by Colliers at 142,000 sqft, 12% up on Q117, and while the H117 total of 268,000 sqft is below the level of H116, 2016 take-up was exceptionally strong (at 783,000 sqft) and 29% above the five-year average. The H117 total is just 6% below the five-year average and more broadly based with a significant increase in the number of transactions and a decline in the average transaction size. There is no new Grade A space due to complete until 2018, expected to add just over 200,000 sqft, while 170,000 sqft of refurbished space is expected to become available in 2017. Colliers expects continuing demand from the professional services, technology and service office sectors which given the tightness of supply, seems a positive indicator for rents.

### Estimate changes and valuation

Having recently increased our NAV estimates ([Progress continues](#)) to take account of the 25 July NAV statement, we now add the accretive impact expected from the Tower Wharf acquisition. We have assumed that the current 64% occupancy of Tower Wharf will increase to 75% by the end of FY18 and 90% by the end of FY19. We have further assumed only a modest 2% increase in average rent per sqft from FY18 to FY19 which is materially below the reversionary potential identified by management (to more than £26 per sqft compared with the current average passing rent of £19.65) and is a potential source of additional upside to our forecasts. Our current assumptions take the end FY19 run rate of gross rents to c £1.2m or c £1.0m net of void costs, still some way short of the £1.6m (net of void costs) that management anticipates from occupancy improvement and rent reversion. Our estimated dividend cover (excluding valuation increases and realised gains on disposal) increases from 115% to 116%, broadly consistent with the 2% improvement that management estimates on a full year basis. For FY19 our estimated dividend cover increases from 115% to 119%, although for now we have made no changes to our dividend forecasts. As noted above, management sees potential for dividend cover to be enhanced by 8% over time.

#### Exhibit 1: Estimate changes

|       | Revenue (£m) |      |          | Adj. EPRA EPS (p) |      |          | EPRA NAV/share (p) |      |          | DPS (p) |      |          |
|-------|--------------|------|----------|-------------------|------|----------|--------------------|------|----------|---------|------|----------|
|       | Old          | New  | % change | Old               | New  | % change | Old                | New  | % change | Old     | New  | % change |
| FY18e | 41.8         | 42.5 | 1.6%     | 3.90              | 3.94 | 1.1%     | 84.2               | 84.2 | 0.0%     | 3.40    | 3.40 | 0.0%     |
| FY19e | 42.8         | 44.0 | 2.8%     | 4.03              | 4.18 | 3.7%     | 84.7               | 84.9 | 0.3%     | 3.50    | 3.50 | 0.0%     |

Source: Edison Investment Research

We have previously noted Picton's smaller (c 2%) premium to NAV compared with peers (c 6%) and although its prospective yield of c 4% is below the peer average of c 5.0% improving dividend growth prospects are a positive indicator for potential revaluation. Our dividend discount model gives a valuation potential within the range of 79p to 103p assuming a 7% cost of equity and 3.0% dividend growth rate and applying a 50bp sensitivity to each.

**Exhibit 2: Financial summary**

| Year end 31 March                              | £'000s | 2014      | 2015      | 2016      | 2017      | 2018e     | 2019e     |
|--|--------|-----------|-----------|-----------|-----------|-----------|-----------|
|  |        | IFRS      | IFRS      | IFRS      | IFRS      | IFRS      | IFRS      |
| <b>PROFIT &amp; LOSS</b>                       |        |           |           |           |           |           |           |
| Revenue  |        | 31,967    | 35,151    | 40,770    | 47,911    | 42,487    | 43,981    |
| Service charge income                          |        | 4,782     | 4,511     | 5,153     | 6,487     | 6,374     | 6,522     |
| Total revenue                                  |        | 36,749    | 39,662    | 45,923    | 54,398    | 48,861    | 50,503    |
| Gross property expenses                        |        | (8,992)   | (9,320)   | (10,001)  | (12,011)  | (12,059)  | (12,284)  |
| Net rental income                              |        | 27,757    | 30,342    | 35,922    | 42,387    | 36,803    | 38,219    |
| Administrative expenses                        |        | (1,139)   | (1,194)   | (1,510)   | (1,613)   | (1,634)   | (1,672)   |
| Operating Profit before revaluations           |        | 26,618    | 29,148    | 34,412    | 40,774    | 35,169    | 36,548    |
| Revaluation of investment properties           |        | 18,422    | 53,163    | 44,171    | 15,087    | 9,600     | 0         |
| Profit on disposals                            |        | 5,660     | 412       | 799       | 1,847     | 588       | 0         |
| Management expenses                            |        | (2,127)   | (2,591)   | (2,901)   | (3,636)   | (3,664)   | (3,740)   |
| Operating Profit                               |        | 48,573    | 80,132    | 76,481    | 54,072    | 41,693    | 32,807    |
| Net Interest                                   |        | (10,868)  | (10,930)  | (11,417)  | (10,823)  | (9,706)   | (9,734)   |
| Profit Before Tax                              |        | 37,705    | 69,202    | 65,064    | 43,249    | 31,987    | 23,074    |
| Taxation                                       |        | (357)     | (347)     | (216)     | (499)     | (731)     | (514)     |
| Profit After Tax                               |        | 37,348    | 68,855    | 64,848    | 42,750    | 31,256    | 22,560    |
| Profit After Tax (EPRA)                        |        | 13,266    | 15,280    | 19,878    | 20,566    | 21,300    | 22,560    |
| Average Number of Shares Outstanding (m)       |        | 359.9     | 445.3     | 540.1     | 540.1     | 540.1     | 540.1     |
| EPS (p)  |        | 10.38     | 15.46     | 12.01     | 7.92      | 5.79      | 4.18      |
| Adj EPRA EPS (p)                               |        | 3.69      | 3.43      | 3.68      | 3.81      | 3.94      | 4.18      |
| Dividends paid per share (p)                   |        | 3.0       | 3.0       | 3.3       | 3.3       | 3.4       | 3.5       |
| Dividend cover (x)                             |        | 1.23      | 1.14      | 1.12      | 1.15      | 1.16      | 1.19      |
| <b>BALANCE SHEET</b>                           |        |           |           |           |           |           |           |
| Fixed Assets                                   |        | 421,393   | 536,898   | 649,406   | 618,391   | 642,941   | 646,441   |
| Investment properties                          |        | 417,207   | 532,926   | 646,018   | 615,170   | 639,720   | 643,220   |
| Other non-current assets                       |        | 4,186     | 3,972     | 3,388     | 3,221     | 3,221     | 3,221     |
| Current Assets                                 |        | 42,879    | 84,111    | 37,408    | 49,960    | 50,648    | 51,778    |
| Debtors  |        | 10,527    | 14,019    | 14,649    | 16,077    | 14,397    | 15,141    |
| Cash   |        | 32,352    | 70,092    | 22,759    | 33,883    | 36,250    | 36,636    |
| Current Liabilities                            |        | (17,369)  | (17,480)  | (47,521)  | (21,171)  | (21,014)  | (21,852)  |
| Creditors/Deferred income                      |        | (14,434)  | (16,468)  | (18,430)  | (20,067)  | (19,910)  | (20,748)  |
| Short term borrowings                          |        | (2,935)   | (1,012)   | (29,091)  | (1,104)   | (1,104)   | (1,104)   |
| Long Term Liabilities                          |        | (232,807) | (233,559) | (222,161) | (205,255) | (217,755) | (217,755) |
| Long term borrowings                           |        | (231,081) | (231,834) | (220,444) | (203,540) | (216,040) | (216,040) |
| Other long term liabilities                    |        | (1,726)   | (1,725)   | (1,717)   | (1,715)   | (1,715)   | (1,715)   |
| Net Assets                                     |        | 214,096   | 369,970   | 417,132   | 441,925   | 454,819   | 458,612   |
| Net Assets excluding goodwill and deferred tax |        | 214,096   | 369,970   | 417,132   | 441,925   | 454,819   | 458,612   |
| NAV/share (p)                                  |        | 56.4      | 68.5      | 77.2      | 81.8      | 84.2      | 84.9      |
| EPRA NAV/share (p)                             |        | 56.4      | 68.5      | 77.2      | 81.8      | 84.2      | 84.9      |
| <b>CASH FLOW</b>                               |        |           |           |           |           |           |           |
| Operating Cash Flow                            |        | 23,145    | 24,705    | 33,283    | 36,283    | 33,616    | 32,900    |
| Net Interest                                   |        | (8,768)   | (8,695)   | (8,836)   | (9,211)   | (9,706)   | (9,734)   |
| Tax  |        | (394)     | (369)     | (426)     | (232)     | (731)     | (514)     |
| Net cash from investing activities             |        | (10,838)  | (61,729)  | (68,123)  | 48,691    | (14,950)  | (3,500)   |
| Ordinary dividends paid                        |        | (10,711)  | (13,102)  | (17,822)  | (17,957)  | (18,361)  | (18,766)  |
| Debt drawn/(repaid)                            |        | (1,031)   | (3,191)   | 14,591    | (46,450)  | 12,500    | 0         |
| Proceeds from shares issued                    |        | 18,043    | 100,121   | 0         | 0         | 0         | 0         |
| Other cash flow from financing activities      |        |           |           |           |           |           |           |
| Net Cash Flow                                  |        | 9,446     | 37,740    | (47,333)  | 11,124    | 2,367     | 386       |
| Opening cash                                   |        | 22,906    | 32,352    | 70,092    | 22,759    | 33,883    | 36,250    |
| Closing cash                                   |        | 32,352    | 70,092    | 22,759    | 33,883    | 36,250    | 36,636    |
| Closing debt                                   |        | (234,016) | (232,846) | (249,535) | (204,644) | (217,144) | (217,144) |
| Closing net (debt)/cash                        |        | (201,664) | (162,754) | (226,776) | (170,761) | (180,894) | (180,508) |

Source: Picton, Edison Investment Research

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