

Custodian REIT

It's all about income

Custodian REIT (CREI) is an income-orientated REIT focused on UK commercial property outside London. Its portfolio of 133 properties is diversified by both geography and sector, is valued at c £420m, has 98% occupancy and an LTV of just 18%. Management's focus is on long-term secure income, to deliver the earnings to cover a sustainable growth in dividends. Growth in NAVPS also contributes to CREI's total return, despite the high payout ratio and regular share issues to part-fund the acquisitions. We believe the 7% premium to FY17e NAV is justified by the conservative gearing and one of the highest dividend yields in the sector.

Year end	Gross rental income (£m)	EPRA EPS* (p)	DPS (p)	EPRA NAVPS (p)	Yield (%)	P/NAV (x)
03/16	18.6	6.80	6.25	102	5.7	1.12
03/17e	26.6	6.58	6.35	103	5.8	1.07
03/18e	30.1	6.83	6.45	106	5.9	1.04
03/19e	30.7	6.99	6.54	109	5.9	1.01

Note: *EPRA EPS are normalised, excluding gains on revaluation.

An income-focused portfolio...

CREI has built a balanced portfolio of low-volatility regional UK commercial real estate, diversified by sector, location, tenant and lease term. It is focused on lot sizes of £2-10m, where CREI believes it has a competitive advantage. It has low exposure to office, a relatively high exposure to industrial and alternative sectors and its portfolio is institutional quality in all but lot size. The net initial yield on the portfolio at H117 was 6.95%. Recent acquisitions have averaged above 7%, which should make them earnings enhancing and able to meet the 6.35p dividend target.

...to deliver sustainable growth in dividends

We forecast EPRA earnings growth will improve to over 6% next year, as the recent acquisitions fully feed through to rental income during FY18. We have factored in all the acquisitions thus far in FY17, which total £105m, and have added additional passing rent of nearly £8m (41% of FY16). The target dividend for this year is 6.35p per share, which should again be fully covered, producing a current yield of 5.8%.

Committed to low gearing

Gearing is deliberately low with a target loan to value ratio (LTV) of 25%. The nine-year average debt term easily exceeds the average unexpired lease length and, with an average debt cost of 3.28% at H117, plus an LTV of just 18%, the balance sheet looks conservative. This is partly achieved via a steady flow of share issues at a premium to NAV from its committed shareholder base.

Valuation: A justified premium to NAV

CREI trades at a premium of 7% to our forecast FY17 NAV, which is not out of line with the more income-orientated listed peers. This premium looks justified by its dividend yield and is supported by our dividend discount model. Given the business model of focusing on all market sectors, sub £10m lot sizes and a wide tenant base, the risk profile is reduced, which also supports the premium in our view.

Real estate

22 March 2017

Price 110p
Market cap £372m

Net debt (£m) at H117	79.2
Shares in issue	338.26m
Free float	92%
Code	CREI
Primary exchange	LSE
Secondary exchange	N/A

Share price performance



%	1m	3m	12m
Abs	(0.9%)	2.1%	0.5%
Rel (local)	0.5%	(2.9%)	(15.0%)
52-week high/low	113.5p	99.0p	

Business description

CREI 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.

Next events

NAV announcement	25 April 2017
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Investment summary

An income-orientated REIT

CREI has a balanced investment portfolio of UK commercial real estate, diversified by sector, location, tenant and lease term, with lower volatility versus London focused peers. It has low exposure to office and a relatively high exposure to industrial and alternative sectors like leisure, which offer income diversification. The objective is to grow the dividend on a sustainable basis, at a rate which is fully covered by projected net rental income, with conservative gearing. CREI is managed by Custodian Capital, a subsidiary of Mattioli Woods (MW), which holds 8% of CREI on behalf of its clients, through its discretionary portfolio management service. The initial £95m portfolio of 48 properties was previously held by MW's pension clients in syndicated structures.

Regional property with small lot sizes

The portfolio of 133 assets focuses on smaller properties valued between £2m and £10m. CREI believes this provides it with a competitive advantage, as larger funds tend not to look at properties below £10m and private investors are driving yield compression in sub-£2m properties. It targets single let properties with high-quality tenants on long leases and an average unexpired lease term of over five years. No tenant should represent more than 10% of rentals, unless a government body. The current largest tenant represents just 2% of the rent roll. The focus is on areas with high residual values, strong local economies and favourable supply-demand characteristics. CREI does not focus on development or refurbishment to drive NAV growth.

Regional property is less volatile than prime London

The regions were slower to recover than London after 2009 and secondary property recovered more slowly than prime. However, regional property attracted a record investment level of £22bn in 2015 and £17bn in H116, due to the higher yields on offer. The yield spread between the regions and London remains historically wide at c 2%. At the peak of the market in 2008 it was just c 0.5% (see Exhibit 14). Although this seems likely to narrow, it is not a driver of CREI's strategy. New supply has been limited and occupier demand has been strong, due to the relative attractions of the regions, the strength of the economic recovery, growth in employment and business relocation away from London. This has supported rental growth in regional office and industrial sites.

Valuation: Modest NAV premium justified

CREI trades at a small premium to the sector averages for regional and London-focused REITs on P/NAV, which is in line with its main peers in our sample. However, CREI's premium can be justified by its dividend yield of nearly 6%, one of the sector's highest. It also has the widest yield spread over its cost of debt, so should have among the most secure dividend streams. The premium to NAV has also been very stable, due to the steady income yield. Our dividend discount model produces a fair value range of 109-131p, using a discount rate of 7% and DPS growth of 1.6%.

Sensitivities: More sensitive to yield movements than rents

Some of the inherent cyclical risk of the property sector has been reduced via the large diversified portfolio, multiple tenants, with low exposure to the South East and minimal exposure to London. The regional property markets have shown less volatility than London recently. Voids are limited currently, but we forecast an increase to 4% in FY18-19, in line with management assumptions. Specific sensitivities show a 1% rise in rents would increase EPRA earnings by 1% in FY18 and 2% in FY19. A 1% fall in valuation yields would increase EPRA NAV by 19% in FY18-19.

Company description

An income-orientated REIT

CREI has a nationwide portfolio of 133 assets, with a current value of c £420m and 250 tenants, across all commercial sectors, targeting income and long-term capital growth, with a fully covered dividend and conservative gearing.

CREI is managed by Custodian Capital, a property management and investment business, regulated by the FCA. Custodian Capital is a subsidiary of Mattioli Woods, the specialist wealth management and employee benefits consultants, with £7.5bn of assets under management or advice. The company originated from MW and its clients provided the initial £95m portfolio of 48 properties, which was previously held in syndicated structures. The portfolio was diversified across the main commercial sectors: office, retail, industrial and distribution, as well as a range of alternatives. These now include leisure, car showrooms, trade counters and day nurseries.

History: Derived from the pension schemes of clients

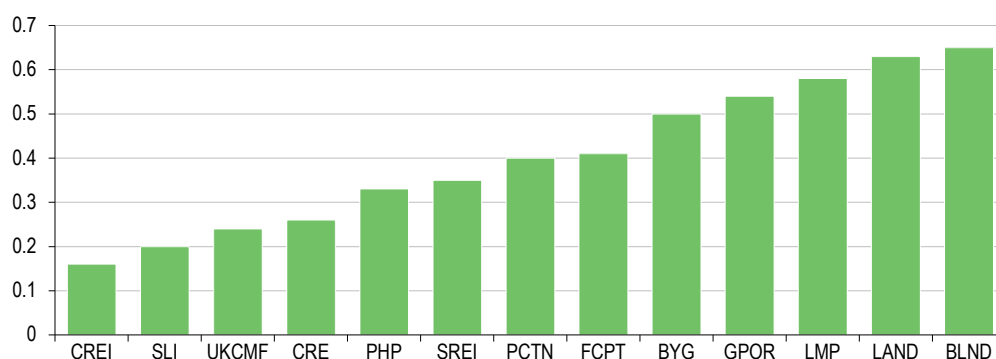
The portfolio had been built up over 12 years before the IPO in March 2014, for SIPP and SSAS clients, who invested via their pension schemes in direct property through syndicated structures, to generate an annual yield of c 6%. By 2014 converting to a REIT made sense with the combined pressures of liquidity, growth, administrative efficiency and the demand from MW clients who wanted to continue investing.

All of the 1,200 investors in the syndicated structures sold their property to Custodian REIT and became shareholders at the IPO. The strategy of generating income, with low volatility and conservative gearing was always the priority for CREI, making it an attractive investment for pension schemes.

This strategy has provided a ready source of demand for the shares and of subscribers for new share issues to fund the steady growth in the portfolio, producing capital raises of £213m since IPO. The most recent placing programme ended last November, but CREI is still able to use tap issues to raise funds from wealth managers and other retail and pension clients.

CREI's low correlation with the FTSE All-Share Index, as shown in the chart below, suggests that management has been successful in its mission of building a portfolio with low volatility.

Exhibit 1: Correlation of property sector with FTSE All-Share Index over two years



Source: Custodian REIT data

Strategy: Property investment policy focused on income

CREI's target is to find value in UK commercial property by focusing on properties between £2m and £10m. The objective at IPO was to provide a long-term secure income, with a targeted dividend

yield of 6.25% on the IPO price from year two, up from 5.25% in year one. Management is not, therefore, as focused on generating short-term NAV growth. Exhibit 15 shows how important income is forecast to be towards generating total returns over the next few years, which supports management's strategy.

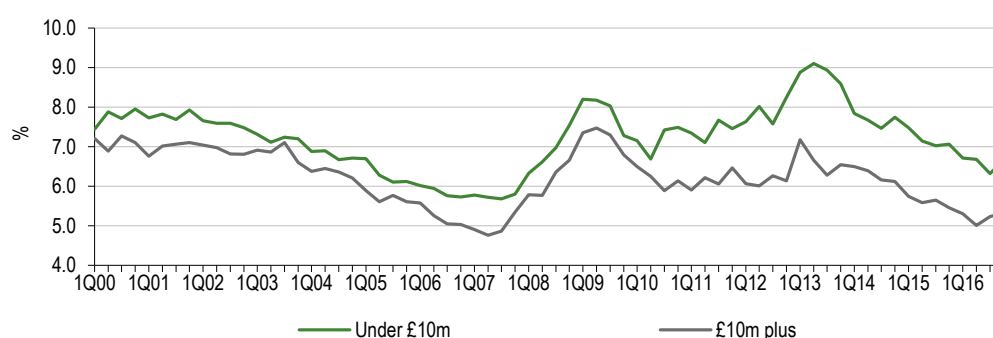
The strategy has various aspects to it:

- A focus on regional properties, with a target lot size of £2-10m.
- A preference for single let properties to high-quality tenants on long leases.
- No tenant to represent more than 10% of the rent roll, unless a government body.
- An average unexpired lease term of over five years.
- A maximum weighting to any one property sector, or any geographic region, of 50%.
- Focus on areas with high residual values, strong local economies and favourable demand-supply characteristics.
- No speculative development, except for refurbishing of existing assets or forward funding of pre-let schemes.
- A conservative gearing ratio, limited to a maximum LTV of 35%, with an expected long-term average of 25%.
- A high payout ratio and a fully covered dividend.

Management believes that targeting sub £10m lot sizes provides a competitive advantage, because the larger funds tend not to look at properties below £10m and private investors are driving yield compression in sub-£2m properties. Therefore, there are trading opportunities in the £2-10m price range.

Although income is the main priority, NAV is expected to continue growing as the portfolio experiences rental growth, despite the increased shares in issue from fund-raising and the high dividend payout ratio.

Exhibit 2: Small lots yield spread over larger assets



Source: LSH, CREI

Management of the fund is fully delegated to Custodian Capital. This includes at least an annual inspection of all properties and rent collection. CREI does use a number of property advisers for lease renewals and new lettings and outsources service charge management.

The manager takes a long-term approach to investment and does not trade CREI's properties regularly (£9m in sales this year). The focus is on properties with low obsolescence and low capital expenditure requirements. It also prefers properties with high residual values, rather than just focusing on the terms of the lease contracts. It has a strategic exposure to the alternative sectors listed above (14% of the portfolio) and forward funding of pre-let properties (3% of the portfolio).

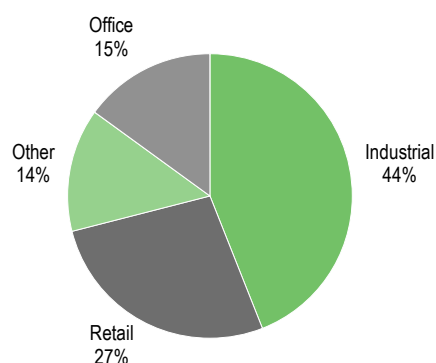
Gearing is deliberately low, such that management's sensitivity analysis suggests it would not exceed a 40% LTV in a property sector downturn like that of 2008. Debt is used to reduce the cash drag of raising equity to fund acquisitions, but the company prefers to sit on undrawn debt, rather than cash. The outstanding debt is secured on a pool of assets, up to a 50% gearing level and CREI uses equity fund-raises to pay down additional debt post acquisition.

The portfolio is well diversified

CREI's nationwide portfolio of 133 properties covers the main commercial sectors: industrial, office and retail, but also a number of the alternative sectors as mentioned above, mainly including restaurants, leisure, car showrooms and trade counters. The portfolio is deliberately underweight in offices (15% at H117), which management regards as having more obsolescence risk and so requiring more capital expenditure. It is also overweight in the industrial sector (44%) and the alternatives (14%) relative to its peers.

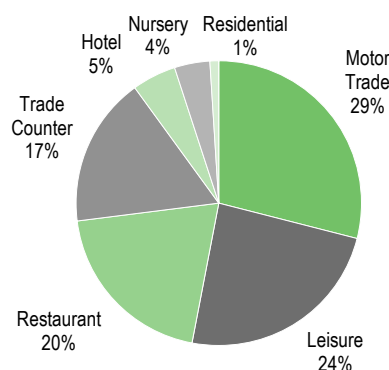
The portfolio was valued at £384m on a net initial yield of 6.95% as at H117, with an occupancy rate of 98%. The reversionary yield was 7.09%.

Exhibit 3: Portfolio split by income (H117)



Source: Custodian REIT data

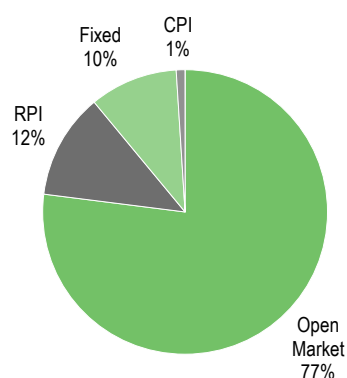
Exhibit 4: Other split by income (H117)



Source: Custodian REIT data

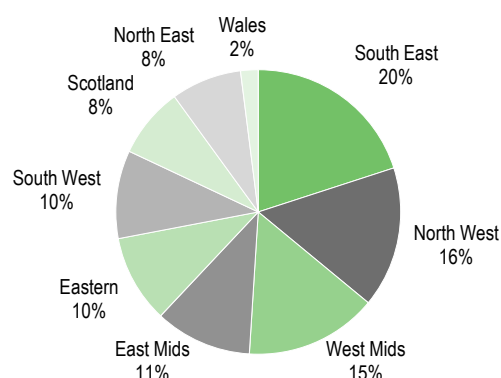
The portfolio is also well diversified geographically, with minimal exposure to London, but exposure to every other region. 23% of the leases have fixed or inflation-linked uplifts. The remainder are subject to open market reviews.

Exhibit 5: Rent review analysis (H117)



Source: Custodian REIT data

Exhibit 6: Regional Split by income (H117)



Source: Custodian REIT data

The table below shows seven typical properties. They are also the seven most recent acquisitions, all of which have been completed during H217. CREI has invested £38m in H217 on these properties, with an average value of just under £6m. All but Shrewsbury are within the £2-10m target range, but that reflects the multiple property nature of the Shrewsbury transaction. They were acquired at an average net initial yield of c 7%, in line with the target.

Exhibit 7: H217 acquisitions (£m)

Location	Tenant	Type	Value	Annual rental	Lease expiry
Burton	Kings Rd Tyres	Industrial	7.06	0.51	2031
Daventry	Cummins	Industrial	3.08	0.22	2019
Bedford	Heywood Williams	Industrial	3.25	0.23	2022
Liverpool	Tai Pan/NHS	Other	6.40	0.41	2023-2038
Stoke	Nuffield Health	Other	4.86	0.35	2025
Shrewsbury	Multiple	Retail	10.30	0.67	Six years avg
Chester	Signet, Feldale	Retail	2.75	0.14	2021, 2026
Total			37.70	2.53	

Source: Custodian REIT data

Generally, CREI acquires single assets, but one example of a recent portfolio acquisition was the Light Industrial Fund, which was acquired last September. This was a national portfolio of 10 properties ranging from the south coast to Newcastle. The passing rent of £2.2m implied a net initial yield of 7.86% at an acquisition price of £26.8m. The portfolio was acquired via a corporate transaction, saving £0.3m of acquisition costs compared with a direct property transaction.

Exhibit 8: Light Industrial Fund acquisition

Gross lettable area (sq ft)	430,000
Modern industrial estates	2
Single industrial units	8
Current rent (£m)	2.21
Acquisition price (£m)	26.8
Net initial yield (%)	7.86%
Reversionary yield (%)	8.03%

Source: Custodian REIT data

Only four disposals so far this year

CREI has only made four disposals so far this year. One of these was a Kia car dealership in Solihull, sold last September for £1.9m. This produced a gain on disposal versus the last valuation of £0.35m, or 22%. Management believed the property was over-rented and would, therefore, see a fall in its value over time. The acquirer was an owner-occupier so not driven by the same return considerations as CREI. The others were a Premier Inn in Dudley and a student site in Lenton. They were sold at an average yield of 5.8%. The fourth was a pub in Southsea sold recently for £1.7m.

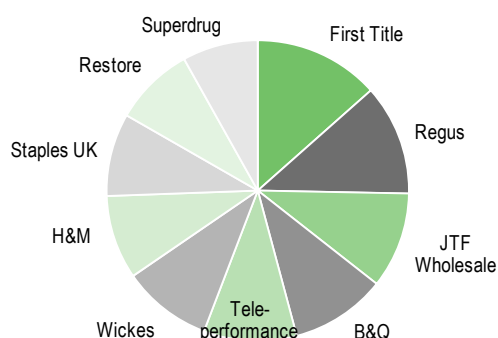
Exhibit 9: FY17 disposals (£m)

	Consideration	Market rent	Net Initial Yield	Sector	Date
Solihull	1.88	0.15	7.2%	Other	10-Nov-16
Dudley	4.45	0.24	5.0%	Other	29-Jul-16
Lenton	1.20	0.09	7.1%	Other	16-May-16
Southsea	1.67	N/A*	N/A*	Other	16-Feb-17
Total	9.20	0.48	5.8%		

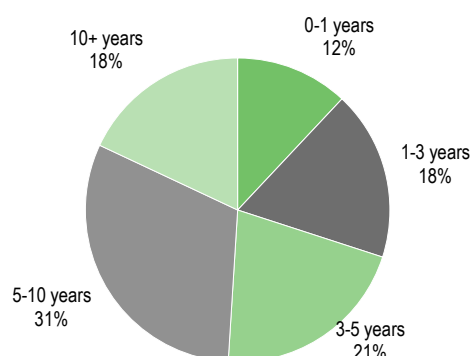
Source: Custodian REIT data, *Full details not currently disclosed

Tenants and leases

The portfolio has over 250 separate tenancies. The current tenant list includes Tesco, Wickes, Honda, Superdrug, Royal Mail, Regus and B&Q. Exhibit 10 below shows the top 10 tenants, which together make up just 18% of the total rent roll, with the largest representing just 2%. Indeed, the top 20 tenants account for less than 32% of total rental income.

Exhibit 10: Top 10 tenants (H117)


Source: Custodian REIT data

Exhibit 11: Income profile (H117)


Source: Custodian REIT data

The income profile of CREI is intended to be long term and, as shown in Exhibit 11, nearly 50% of the leases are over five years. As at September last year the weighted average unexpired lease term (WAULT) to first break was 6.2 years. There is 12% of income due within the next 12 months and a similar proportion is due annually over the next few years.

Management and board

The investment management team members are executive directors of Custodian Capital, while the board has three independent non-executives and one from MW.

Richard Shepherd-Cross: MD of Custodian Capital and the fund manager of Custodian REIT. Since joining MW in 2009 he has been responsible for the syndicated property initiative, which was the precursor to CREI.

Nathan Imlach: FD of Custodian Capital with responsibility for all financial matters, as well as the financial strategy and operations of MW, where he is CFO.

David Hunter: independent chairman. Mr Hunter is a strategic adviser focused on UK and international real estate. He qualified as a chartered surveyor in 1978 and has over 25 years' experience as a fund manager, including as MD of Aberdeen Asset Management's property fund business. He is a former president of the British Property Federation and was actively involved in the introduction of REITs to the UK.

Ian Mattioli: non-executive director. Mr Mattioli has over 30 years' experience in the financial services industry and founded Mattioli Woods with Bob Woods, which now has over £7.5bn of assets under management, administration and advice. He is responsible for the vision and operational management of Mattioli Woods and instigated the development of the investment proposition, including the structured products initiative.

Barry Gilbertson: independent non-executive director. Mr Gilbertson is an international consultant focusing on real estate, strategy and risk, who has over 40 years' experience advising on property. He was an adviser to the Bank of England from 2003 to 2014 and was global president of the Royal Institution of Chartered Surveyors in 2004/05. He has been a non-executive consultant to Knight Frank LLP, and has held advisory appointments with the United Nations and the UK government. Barry is an independent non-executive director of Granite REIT, quoted on the NYSE and TSX.

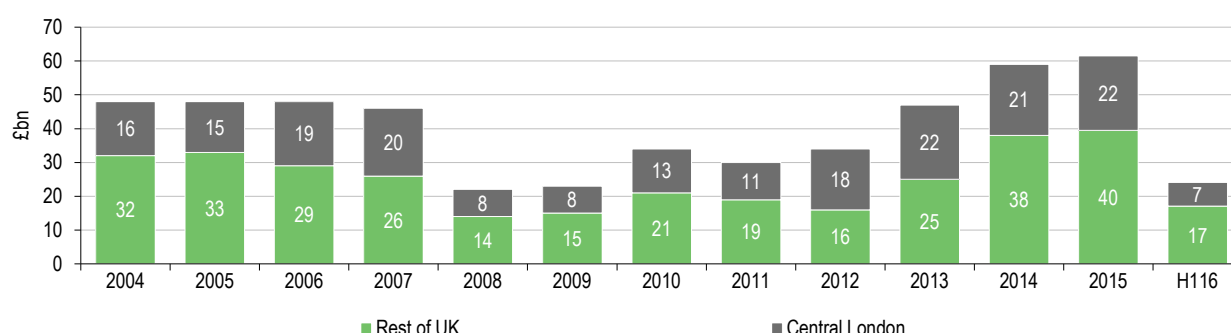
Matthew Thorne: independent non-executive director. Mr Thorne is an independent non-executive director of Bankers Investment Trust, chairing the audit committee, and since May 2007 has been an advisor to Consensus Business Group (led by Vincent Tchenguiz). He is also a finance member of the advisory board and audit committee chair of Greenwich Hospital. His previous executive roles have included group FD of McCarthy & Stone (1993 to 2007), FD of Ricardo (1991-92) and investment director of Beazer (1983-91).

Regional commercial real estate

Investment volumes have fallen since the 2015 peak

UK commercial property recovered well after the 2008-09 crisis and recession, despite a dip in 2011, but the regions were slower to recover than London and secondary property recovered slower than prime. Indeed, total investment volumes in 2014-15 exceeded the peak years of 2004-07, with Cushman & Wakefield reporting investment of £61.5bn in 2015. Foreign investment has accounted for 45% of the total on average since 2009. Regional property attracted a record level of £22bn in 2015, as shown in Exhibit 13 below, due to the higher yields on offer. Although the EU referendum increased uncertainty in the market, even before the vote (Exhibit 13), CREI believes there is still ample opportunity in the asset class. Management believes this to be especially the case in sub £10m lot size properties, in industrial and other asset segments.

Exhibit 12: UK commercial property investment volume (£bn)



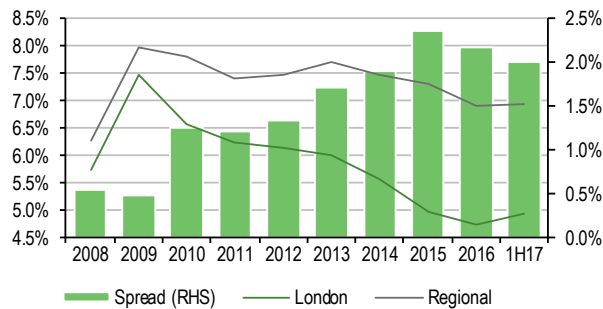
Source: Cushman & Wakefield

Relative yields favour the regions

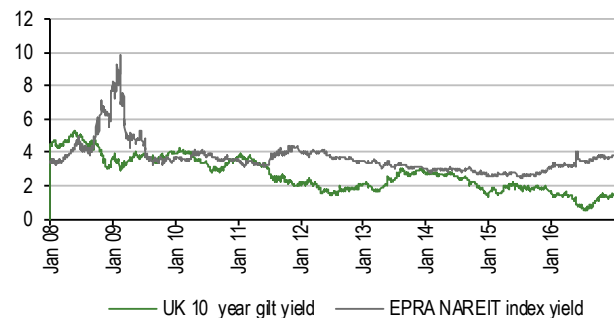
There are several ways to look at the relative attractions of regional real estate. The first is the yield gap between the regions and London. The spread remains wide on a historical basis at c 2%. At the peak of the market in 2008 it was just c 0.5%. Although this seems likely to narrow, it is not a driver of CREI's strategy. The higher income return means that total returns do not need to be driven by capital growth, although there is the potential to see valuation gains if yields do compress.

Secondly, as the chart below shows, yield movements generally follow the London market, but they are significantly less volatile. So the regions could outperform London as the cycle comes to an end and either way could see less of a correction. Also, regional assets, especially in sub £10m lot sizes, generally attract less attention from institutional investors, so there is less competition for assets and the yields have not been driven down. Finally, the regions are not as exposed to national issues like the changes in business rates or international influences like secondary investment, the fate of financial services and the direct effects of the Brexit vote.

Exhibit 15 shows the effect of this higher return on the sector's dividend yields, which are one of the main drivers for owning the majority of these stocks. This shows the yield spread over the 10-year gilt for the sector as a whole, but clearly the spread is wider again for the regional property sector.

Exhibit 13: Equivalent yields – regional vs London


Source: Edison Investment Research, Palace Capital

Exhibit 14: UK 10-year gilt and NAREIT index yields


Source: Bloomberg

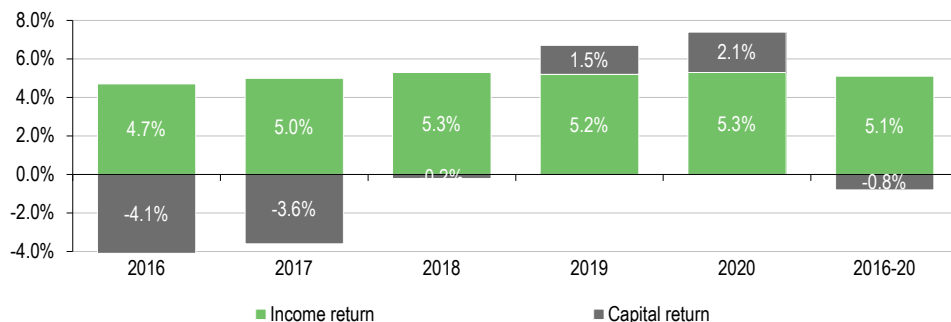
Regional occupier demand remains strong

The second factor is the relative attractions of the regions to occupiers and investors. Because of limited new supply in the regions, the strength of the economic recovery, growth in employment and business relocation away from London, tenant demand has been strong. This has helped to improve rents for regional office and industrial sites. Brexit has increased uncertainty, especially in London, and has led to delayed business decisions in general. However, there is a view that sterling weakness could turn out to be positive for industrial exporters and in turn support economic activity outside London, with a positive knock-on effect on regional industrial property.

CBRE predicts that take-up records may be broken in 2017, due to government pre-lets in the regions, which can often exceed the normal annual demand in a city. Plus, business confidence generally is looking robust, as evidenced by manufacturing PMI data in December, which surprised on the upside. This showed all regions other than Scotland exhibiting growth.

As well as occupational demand being good, supply is very tight. There has been very little new building, especially in industrial. Big box logistics have been the main area of supply growth recently and there may be a danger of oversupply in that segment. CREI estimates that new mid-sized logistics and industrial developments would require rentals 15% above current levels to be viable, which is adding pressure to rental growth.

Regional markets are thus expected to deliver higher returns in the latter stages of the cycle than London, as income drives the majority of total returns from 2017 to 2020. Also, offices and industrial property outside London should be less exposed to the knock-on effects of the Brexit vote than London or the wider retail sector.

Exhibit 15: All property total return forecasts


Source: Investment Property Forum consensus forecasts

Regional share price performance better and less volatile since Brexit

The third aspect to examine is the relative share price performance of regionally orientated stocks versus their more London-exposed peers. As the chart below shows, the wider sector had recovered all the ground lost since 2008 by the middle of 2015, since when there has been a correction, which was exacerbated by the Brexit vote in June. There was a minor recovery, but the sector is still trading well below its 2015 peak and c 20% below the level before the EU referendum.

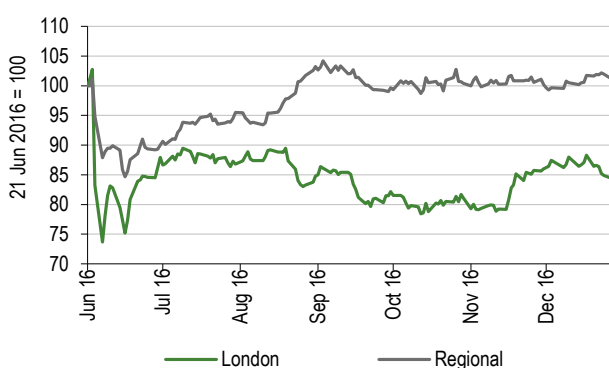
However, Exhibit 17 shows that regionally orientated stocks have outperformed the London-exposed shares significantly and were trading above their pre-referendum level in the autumn last year and again early this year. It also shows that the sell-off was not as marked in July last year, while the recovery was steadier and less volatile. Indeed, the outperformance for the regions in the period is currently over 15% and the performance has been relatively stable since the autumn.

Exhibit 16: EPRA NAREIT UK Index from 3 Jan 2008



Source: Bloomberg

Exhibit 17: Regional vs London-exposed REITs



Source: Bloomberg, Regional index: PCL, RGL, RLE, CREI, SREI and MKLW. London: LAND, BLND, WKP, DLN, SHB, GPOR, LMP

Valuation

CREI trades at a premium of 7% to our forecast FY17 NAV, which is not out of line with the more income-orientated listed peers. As it has one of the highest dividend yields in the sector this premium looks justified. Given the business model is focused on all sectors of the market nationally and in small lot sizes, with a wide tenant base, CREI's risk profile is significantly reduced, which also supports the NAV premium in our view.

Absolute valuation: Dividend discount model

We have valued CREI using both absolute and relative valuation methods. As the company is an income-focused REIT we regard a dividend discount model to be a useful method of valuation, as it is derived from the income CREI is actually generating.

Our dividend discount model incorporates a cost of equity of 7.0%, which implies a significant risk premium over bond yields of c 5% and a dividend growth rate of 1.6%. The latter is the long-term dividend growth rate we are forecasting from 2018. The equity risk premium adjusts a standard market risk premium of 4% for factors including the stock's liquidity, gearing and the cyclical nature of the sector. Our sensitivity table below shows a fair value range of 109-131p, upside of up to 19% from current levels. This implies a fair value P/NAV range of 1.06-1.27x.

Exhibit 18: Dividend discount model sensitivity (p/share)

DPS growth (right) Cost of equity	0.6%	1.1%	1.6%	2.1%	2.6%
6.0%	1.19	1.31	1.46	1.65	1.90
6.5%	1.09	1.19	1.31	1.46	1.65
7.0%	1.00	1.09	1.19	1.31	1.46
7.5%	0.93	1.00	1.09	1.19	1.31
8.0%	0.86	0.93	1.00	1.09	1.19

Source: Edison Investment Research

Comparative valuations are favourable

We have compared CREI to the other listed regional REITs and property companies, plus some of the larger London-orientated REITs, to give a range of sector comparatives. It is clear that CREI trades at a small premium to NAV and to both the regional and national sector averages on a P/NAV basis. However, its premium to NAV is not out of line with its peers in the sample, and it does have the second highest dividend yield. Regional REIT has the highest, but is really an outlier, as it targets yields of 7-8%. CREI's NAV premium can therefore be justified by its current dividend yield of 5.8%. It also has the widest yield spread over its cost of debt at 3.8%, so should in theory have one of the most secure dividends.

Exhibit 19: Comparative valuations

	P/NAV (x)	Div yield (%)	Net yield (%)	Cost of debt (%)	Debt spread (%)	WAULT (years)	LTV (%)
Custodian	1.07	5.8	7.0	3.3	3.7	6.2	19.6
F&C Commercial Prop	1.07	4.4	4.7	3.6	1.1	7.0	19.0
UK Commercial Prop	1.03	4.3	4.9	2.9	2.0	8.3	11.2
Hansteen Holdings	0.93	5.1	6.7	3.2	3.5	N/A	44.9
Regional	0.97	7.4	7.1	3.7	3.4	3.6	40.0
Mucklow	1.08	4.6	6.4	4.1	2.3	6.0	20.0
Picton	1.01	3.8	5.8	4.2	1.6	5.7	37.8
Schroders	0.92	4.3	5.6	4.4	1.2	7.2	30.0
Regional avge	1.01	5.0	6.0	3.5	2.5	6.2	28.2
Land Secs	0.70	3.5	3.6	4.7	(1.1)	8.9	22.6
Gt. Portland	0.77	1.4	2.8	3.9	(1.1)	6.9	21.7
LondonMetric	1.05	5.0	4.8	3.3	1.5	12.6	36.0
Workspace	0.83	2.7	4.8	5.5	(0.7)	8.5	14.0
Derwent Ldn	0.72	1.8	3.1	3.9	(0.8)	6.8	19.1
Average	0.94	4.3	5.2	3.8	1.4	7.2	26.2

Source: Custodian REIT data, Edison Investment Research forecasts, Bloomberg

As CREI also has one of the lowest LTVs in the sector, with only four companies being lower, it is one of the least risky stocks in the selection. With an occupancy rate of over 98% at the end of H117, it also has the second lowest level of vacancy in the sector, which again reduces its risk profile and makes the dividend more secure. The final conclusion to draw from the table above is that the higher a company's exposure to London, the higher its discount to NAV. In general, the regional stocks have lower discounts or, as in the case of CREI, trade at a premium to NAV. Again, this can be partly explained by the negative debt spread of most of the London stocks shown in the table above.

Financials

This section sets out the basis for our forecasts. We have tried to be conservative in our occupancy and rental growth assumptions, although the main driver of earnings for FY17-18 is the asset acquisitions added in the past year, which are likely to continue.

Earnings

Interims showed a continued steady return

CREI reported interims in November, with a 32% increase in EPRA earnings, but a 13% fall in EPRA EPS. The total per share return was 3.4% for H117. Dividends of 3.25p were paid and 1.5875p was proposed for Q2. The company raised £43m of new equity in the first six months and invested £67m in 18 new acquisitions and developments. The portfolio was valued at £384m, using a net initial yield of 6.95% and the NAV per share was up slightly from March 2016 at 101.7p.

Earnings growth driven by portfolio expansion

CREI produced 21% growth in EPRA earnings per share in FY16 and a 21% increase in target dividends in the two years since listing. Although EPRA earnings grew 40% in FY16, the additional shares in issue from the fund-raising diluted the growth to 21%. Nevertheless, the acquisitions thus far in FY17 have been agreed at net initial yields of nearly 7.4%, which should make them earnings enhancing from FY18.

We are forecasting earnings growth to pick up next year as the recent acquisitions fully feed through to rental income during FY18. We have factored in all the acquisitions thus far in FY17, which total £105m, and added nearly £8m of additional passing rent. As mentioned above, there have also been £9m of disposals so far in the current year.

We have made the following assumptions in our forecasts:

- Average 2% rental growth across the portfolio, roughly in line with market inflation forecasts.
- An occupancy rate of 98% this year, falling to 96% in FY18-19.
- Re-charge income, largely insurance premiums, is entirely offset by the cost.
- The ratio of net property expenses should return to the previous year's level, after one-off costs in H117 relating to an exceptional letting and refinancing, plus voids in a couple of properties.
- The net rental margin is therefore forecast to recover to close to 97% in FY18 and FY19 after a dip to 96% this year.
- We have assumed admin costs level off, as professional and directors' fees reach a steady level.
- We have included revaluation gains based only on the rental growth assumptions above, which produces £6.4m this year and just over £8m in FY18-19.
- We have not factored in any yield compression in our asset valuations.
- We have assumed purchase costs are at the same rate for the H2 acquisitions as for the H1.
- Management fees are calculated at 0.9% of NAV up to £200m and 0.75% above £200m. There is also an admin fee for Custodian Capital of 0.125% of NAV.
- The weighted average interest cost is currently 3.28%, which produces a charge of £2.5m this year and £3m in FY18-19. The majority of interest costs are fixed, as explained below.
- As a REIT the company is not expected to pay corporation tax.
- EPRA earnings are forecast to fall slightly this year, before growing 4% in FY18 and 2.5% in FY19.
- Despite the earnings fluctuations we are forecasting dividend growth of 1.6% a year, with 6.35p targeted by management this year and our forecasts of 6.45p and 6.54p in FY18-19. As a result the dividend cover increases, as earnings grow faster than dividends.

Cash flow

Free cash flow (pre-capex) is forecast to increase significantly, from £7m to £15m this year and £23m in FY18, following the increased investment. This is the key measure for paying dividends, as acquisitions are largely funded via equity fund-raising and the debt facilities. We forecast total dividends of £19m this year and £22m next year. Therefore, dividends should be covered by free cash flow from FY18. We also expect the conversion of net rental income to operating cash flow to improve from 45% last year to 70% this year and over 80% next year.

Balance sheet

The asset base has grown from £95m at IPO to c £420m currently. This has been achieved largely by acquisitions, which have totalled £320m since IPO. As CREI generally acquires individual assets rather than portfolios in corporate structures, it incurs purchase costs (mainly stamp duty), which have so far offset any revaluation gains since acquisition. It is quick to deploy funds, due to its flexible credit facilities, aiming for 10 days from agreement to completion.

We have discussed the portfolio above, but it is worth adding that as at H117 the investment properties were valued using an average net initial yield of 6.95%, which is approximately 40bps below the yield at which CREI has been acquiring its assets during FY17. The assets are valued quarterly by Lambert Smith Hampton Group, which has experience of the categories and locations of the properties in the CREI portfolio. The equivalent yields applied ranged from 5% to over 11%.

We have only estimated revaluation gains to reflect the rental growth in the asset base in each year, which we have assumed to be 2%. We have not factored in any yield compression in our valuations. We are also not forecasting any further acquisitions, despite the company having available capital and a pipeline of potential opportunities. Indeed we are forecasting a year-end cash balance of £9.6m and a gross LTV ratio of 17.5%, so CREI has significant capacity to make further acquisitions to drive earnings and dividend growth.

Equity funding has been readily available

CREI has raised £49m so far in H217 and £92m in the financial year to date. This has generally been via small incremental issues, with the occasional larger placing, as with the £24m raise in October. They have all been completed at a premium to NAV and are not carried out to fund specific acquisitions. However, if we assume the £25m raise in October funded the £27m industrial portfolio acquired in September and that it was funded entirely with equity, then the transaction would have produced an EPS uplift of 0.66p, assuming no additional administrative expenses. To put this in context, earnings in H117 were 3.05p per share.

Exhibit 20: Equity fund-raising (H217)

Capital increases	Price (p)	Shares (m)	Total (£m)
21/10/2016	103.60	24.13	25.00
21/11/2016	105.12	1.75	1.84
28/11/2016	105.11	2.00	2.10
21/12/2016	106.11	3.00	3.18
22/12/2016	106.11	0.50	0.53
25/01/2017	106.33	7.00	7.44
22/02/2017	108.50	3.75	4.07
17/03/2017	110.00	4.00	4.40
Total	105.28	46.13	48.57

Source: Custodian REIT data, Edison Investment Research

Debt funding strategy is cautious

The main aim of CREI's debt strategy is to achieve the target loan to value (LTV) ratio of 25%. The other notable aspect of the debt structure is that the average debt term of 9.3 years easily exceeds

the average unexpired lease length, which is 6.2 years. With an average cost of debt of 3.28% as at September 2016 and a current LTV of just 18%, the balance sheet looks conservative.

Exhibit 21: Debt facilities

Provider	Type	Amount (£m)	Term	Rate	Expiry
Lloyds	RCF	35	5 years	245bp*	Nov-20
Scottish Widows	Fixed rate term loan	20	10 years	393bp	Aug-26
Scottish Widows	Fixed rate term loan	45	12 years	298bp	Jun-28
Aviva	Fixed rate term loan	35	15 years	350bp	Apr-32
Aviva	Fixed rate term loan	15	15 years	Rate TBC	Timing TBC

Source: Custodian REIT data. Note: *Margin over three-month Libor.

Sensitivities

In this section we consider some of the main risks and sensitivities affecting CREI and its sector.

- **Macro risk:** Property is a cyclical sector, but some of the inherent cyclical risk can be mitigated by building up a large diversified portfolio, with multiple tenants, as we have discussed above. This reduces vacancy risk substantially. At 2% voids are limited currently, but we are forecasting an increase to 4% in FY18-19, in line with management assumptions.
- Part of this risk diversification is achieved by the national nature of the portfolio, with low exposure to the South East and none to London. The regional property markets have shown less volatility than London, as also discussed above.
- The main risk is, therefore, the wider economy. The macro outlook for the UK has improved recently, with the Bank of England recently increasing its forecast for GDP growth for 2017 to 2%, from 1.4% previously. A slight slowdown to 1.6% and 1.7% is then expected in 2018-19.
- Inflation and interest rates are a major risk for the sector. With inflation already rising this year, partly due to sterling depreciation and rising oil prices, the prospect of rising interest rates becomes more imminent. With 23% of CREI's rent roll subject to fixed or inflation-linked uplifts, it has some inherent inflation protection. However, that leaves 77% of rental income subject to open market reviews, which could lag market inflation.
- Rising interest rates would have a limited impact on CREI initially, as only its £35m revolving credit facility (35% of total facilities) is on a floating rate.
- **Main sensitivities:** A 1% rise in rents would increase EPRA earnings by 1% in FY18 and 2% in FY19, with minimal impact on FY17. A 1% fall in valuation yields would increase EPRA NAV by 19% in FY18-19, as the acquisitions make a full year rental contribution.
- **Debt capacity:** CREI has further debt capacity, as only £86m of the £100m total was drawn at the end of September. We forecast total debt peaking at £73m at the end of FY17, as we are not forecasting any further acquisitions. This means the gross LTV peaks at just 17.5% this year, so there would be capacity for debt funded acquisitions without raising further equity.
- **Share issuance:** Although CREI often raises incremental equity via tap issues, it does not mean there is a stock overhang, as generally CREI is responding to demand from shareholders, because of the structure of the investor base. There are no share options over the stock.
- **Management risk:** Given that CREI is externally managed by Custodian Capital, management risk is reduced, as if any executive were to leave they could be replaced. However, it is a relatively small team and if the managing director were to leave it could be disruptive. The current management agreement is due to be renewed in March 2017.

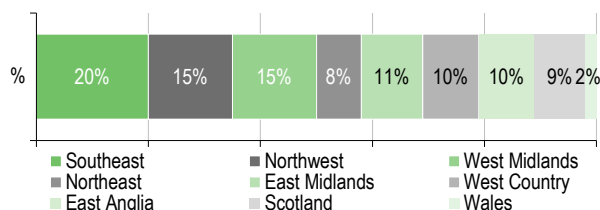
Exhibit 22: Financial summary

Year end 31 March	£'000s	2015	2016	2017e	2018e	2019e
		IFRS	IFRS	IFRS	IFRS	IFRS
PROFIT & LOSS						
Gross rental income		11,228	18,561	26,592	30,132	30,734
Re-charge income		342	451	631	722	737
Total revenue		11,570	19,012	27,223	30,854	31,471
Gross property expenses		(715)	(1,023)	(1,689)	(1,689)	(1,723)
Net rental income		10,855	17,989	25,534	29,165	29,748
Administrative expenses		(785)	(628)	(641)	(660)	(664)
Operating Profit before revaluations		10,070	17,361	24,893	28,505	29,084
Revaluation of investment properties		6,083	3,031	6,379	8,342	8,509
Costs of acquisitions/profit on disposals		(5,575)	(5,712)	(5,810)	0	0
Management fees		(1,542)	(2,200)	(3,172)	(3,353)	(3,428)
Operating Profit		9,036	12,480	22,290	33,494	34,165
Net Interest		(289)	(1,273)	(2,077)	(2,060)	(2,014)
Profit Before Tax		8,747	11,207	20,213	31,434	32,151
Taxation		(2)	0	0	0	0
Profit After Tax		8,745	11,207	20,213	31,433	32,151
Profit After Tax (EPRA)		8,237	13,888	19,644	23,091	23,642
Average Number of Shares Outstanding (m)		146.1	204.2	298.7	338.3	338.3
EPS (p)		5.99	5.49	6.77	9.29	9.50
EPRA EPS (p)		5.64	6.80	6.58	6.83	6.99
Dividend per share (p)		5.25	6.25	6.35	6.45	6.54
Dividend cover (x)		1.1	1.1	1.0	1.1	1.1
BALANCE SHEET						
Fixed Assets		207,287	318,966	417,100	425,442	433,951
Investment properties		207,287	318,966	417,100	425,442	433,951
Other non-current assets		0	0	0	0	0
Current Assets		1,921	9,973	16,144	18,317	20,050
Debtors		1,072	4,518	6,469	7,332	7,479
Cash		849	5,455	9,675	10,985	12,571
Current Liabilities		(5,411)	(8,165)	(11,619)	(12,518)	(12,746)
Creditors/Deferred income		(5,411)	(8,165)	(11,619)	(12,518)	(12,746)
Short term borrowings		0	0	0	0	0
Long Term Liabilities		(23,811)	(65,714)	(73,721)	(73,721)	(73,721)
Long term borrowings		(23,811)	(65,143)	(73,150)	(73,150)	(73,150)
Other long term liabilities		0	(571)	(571)	(571)	(571)
Net Assets		179,986	255,060	347,904	357,519	367,533
Net Assets excluding goodwill and deferred tax		179,986	255,060	347,904	357,519	367,533
NAV/share (p)		101	102	103	106	109
EPRA NAV/share (p)		101	102	103	106	109
CASH FLOW						
Operating Cash Flow		6,936	8,177	17,413	25,188	25,738
Net Interest		(204)	(1,285)	(2,077)	(2,060)	(2,014)
Tax		0	0	0	0	0
Net cash from investing activities		(123,944)	(107,853)	(91,755)	0	0
Ordinary dividends paid		(5,546)	(12,220)	(18,969)	(21,818)	(22,137)
Debt drawn/(repaid)		23,811	41,700	8,007	0	0
Proceeds from shares issued		99,796	76,087	91,600	0	0
Other cash flow from financing activities		0	0	0	0	0
Net Cash Flow		849	4,606	4,219	1,310	1,587
Opening cash		0	849	5,455	9,675	10,985
Other		0	0	0	0	0
Closing cash		849	5,455	9,674	10,985	12,572

Source: Custodian REIT data, Edison Investment Research

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Revenue by geography (H117)

Management team
Chairman: David Hunter

David Hunter is an international property consultant, specialising in supporting the creation, operation and liquidation of property funds and companies. He is chairman of a UK-based real estate debt fund manager and also has corporate advisory roles in the UK and France. He was managing director of Aberdeen Asset Management's £6.5bn UK and international property fund business from 2001-04. He was president of the British Property Federation in 2004.

Managing Director of Custodian Capital: Richard Shepherd-Cross

Richard Shepherd-Cross is the managing director of Custodian Capital and the fund manager of Custodian REIT. From joining Mattioli Woods in 2009 he was responsible for the syndicated property initiative, which was the precursor to CREI. He was instrumental in establishing Custodian REIT and raising £55m at IPO.

Company Secretary: Nathan Imlach

Nathan Imlach qualified as a chartered accountant with Ernst & Young, specialising in providing mergers and acquisitions advice to a broad range of quoted and unquoted clients in the UK and abroad, latterly as a director and associate of Johnston Carmichael. He is a fellow of the Chartered Institute for Securities & Investment, and a member of the Institute of Chartered Accountants in Scotland.

Business Development Manager: Ben Aspell

Ben Aspell has been at Custodian Capital since 2011. His role is to identify new clients, including IFAs and wealth managers, who advise high net worth and pension investors, to promote property partnerships.

Principal shareholders

	(%)
Mattioli Woods AM	7.9
BMO Global AM	4.7
Canaccord Genuity Wealth	3.9
Investec Wealth	2.9
Legal & General IM	2.0
Heartwood Wealth	1.7
Vartan & Son AM	1.0

Companies named in this report

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