EDISON

Custodian REIT

Q4 NAV update

Income and capital growth supporting valuation

Real estate

Custodian REIT recently provided an update on the three months ended 31 December 2017 (Q318). NAV total return in the period was a healthy 2.6%, including a 1% increase in EPRA NAV per share, in addition to a quarterly dividend paid of 1.6125p. Management's aim is to sustainably grow the fully covered dividend and generate less volatile returns than is typical for the sector over time. Its strategy is to maintain high levels of occupancy and grow income through rental growth and accretive acquisitions. The 8% premium to FY18e NAV has proven robust, justified by the conservative gearing and one of the highest dividend yields in the sector.

Year end	Net rental income (£m)	EPRA EPS* (p)	EPRA NAVPS (p)	DPS (p)	P/NAV (x)	Yield (%)
03/16	18.0	6.80	102	6.25	1.13	5.4
03/17	25.7	6.59	104	6.35	1.11	5.5
03/18e	32.7	6.84	106	6.45	1.08	5.6
03/19e	36.5	7.29	110	6.55	1.05	5.7

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

Attractive total return continued in Q3

EPRA NAV per share increased to 106.0p at 31 December 2017 (30 September: 104.9p). Total valuation gains of £4.2m were driven by asset management initiatives, which contributed £2.6m, and the sale of one property, which locked in a £0.7m gain. Six assets were acquired for £43.0m (before costs), at an average net initial yield of 6.8% and adding c £3m to the annualised rent roll, which ended the period at £37m. Gearing remains low at 22.3% net as strong continuing investor demand for the shares allowed the issue of 17.5m shares in the period at an average premium of 11.8% to the September NAV per share. Share issuance has continued on similar terms, while the manager sees a good pipeline of further accretive acquisition opportunities.

Focused on income

CREI has built a balanced portfolio of regional UK commercial real estate, diversified by sector, location, tenant and lease term. Although focused on lot sizes of less than £10m, where CREI believes it has a competitive advantage, its target is to acquire assets of institutional quality. It has low exposure to offices, a relatively high exposure to industrial, alternative sectors, and is increasing its exposure to retail warehousing. Management focus is on maintaining high levels of occupancy and growing income through rental growth and accretive acquisitions. Dividends paid since the IPO in March 2014 represent c 75% of the compound 7.1% pa total return over the period.

Valuation: Attractive, covered yield underpins P/NAV

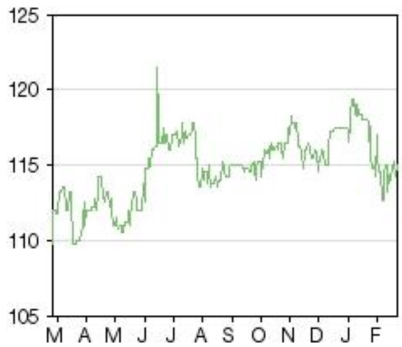
CREI's 5.6% prospective yield, with dividends fully covered by earnings, places it towards the top of our universe of property investment companies and REITs. This provides support for its premium P/NAV ratio, which has remained steady (currently at 1.08x). The manager's ability to source accretive acquisitions, the opportunities to actively manage the existing portfolio, and the prospect of continuing rental growth all suggest upside in income returns with further potential for capital growth.

22 February 2018

Price	**115p**
Market cap	**£444m**

Net debt (£m) as at 31 December 2017	115.7
Net gearing as at 31 December 2017	22.3%
Shares in issue	385.9m
Free float	92%
Code	CREI
Primary exchange	LSE
Secondary exchange	N/A

Share price performance



%	1m	3m	12m
Abs	(2.5)	(1.3)	4.6
Rel (local)	3.1	0.3	3.3
52-week high/low		121.5p	109.0p

Business description

Custodian REIT (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 (March 2018)	24 April 2018

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Custodian REIT is a research client of Edison Investment Research Limited

Income and capital growth supporting valuation

NAV total return in the three months ended 31 December 2017 was 2.6%, with NAV per share increasing by 1% to 106.0p per share (30 September: 104.9p per share) and a quarterly dividend per share of 1.6125p paid in the period.

The NAV movement in the period is summarised in Exhibit 1.

Exhibit 1: Summary of NAV movement (three months ended 31 December 2017)

	Pence per share	£m
NAV at 30 September 2017	**104.9**	**378.6**
Issue of shares, net of costs	0.4	19.8
	105.3	398.4
Valuation movements relating to:		
Profit on the disposal of investment properties	0.2	0.7
Asset management of investment portfolio	0.7	2.6
Other valuation movements	0.4	1.6
	1.3	4.9
Acquisition costs	-0.6	-2.5
Net valuation movement	**0.7**	**2.4**
Income earned in the period		
Expenses and net finance costs for the period	2.3	8.7
Dividends paid	-0.7	-2.6
	-1.6	-5.9
NAV at 31 December 2017	**106.0**	**401.0**

Source: Custodian REIT

To satisfy continued investor demand and part-fund continuing acquisitions, a total of 17.5m new shares were issued during the period under the block listing facility, generating proceeds of £20.1m before expenses of £0.3m. The average issue price of just under 115p per share represented an 11.8% premium to the unaudited NAV per share at 30 September 2017. The resulting accretion to NAV was 0.4p per share, which substantially offset the negative effect on NAV per share of the costs associated with the acquisition of investment properties, primarily stamp duty.

Acquisitions continued at a brisk pace during the period, with six properties acquired for £43.0m (9% of the opening portfolio value), before acquisition costs (details of the properties below). Acquisition costs of c £2.5m (0.6p per share) were 5.8%. One property was sold for £4.63m, generating a gain of c £700k, an approximately 25% uplift on the carrying value.

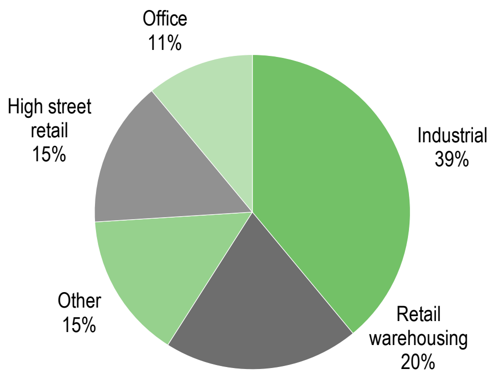
Asset management initiatives contributed c £2.6m in aggregate to the portfolio valuation, primarily reflecting the finalisation of a rent review in Southwark that both substantially increased the rent and exceeded the expected rental value or ERV, adding £2.5m to the property value. The annualised rent increased by 87% to £374k (£16.25 per sq ft) from £200k (£9.00 per sq ft) compared with an ERV of £257k (£12 per sq ft). The other valuation gains of £1.6m were primarily driven by yield tightening in industrial assets.

Portfolio continues to grow, particularly in retail warehouse

The portfolio was valued at £518.7m at the end of December 2017 (September: £474.3m), consisting of 146 properties, accounting for more than 275 individual tenancies, with an annualised rent roll of £37.0m. The valuation reflects an average net initial yield of 6.7%, down from 6.9% at end-September, with the tightening reflecting the overall strength of the portfolio and, in particular, asset management initiatives and the industrial yield shift. Income-based occupancy was 97.2%, up from 96.7% at 30 September and the weighted average unexpired lease term to first break (WAULT) increased to 5.9 years (September: 5.8 years). The increase in WAULT reflects asset management initiatives and a higher average WAULT on the acquisitions made during the period

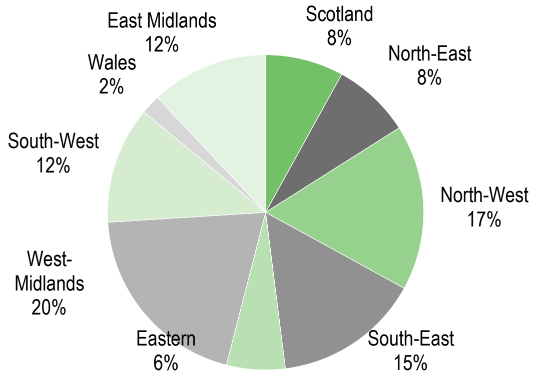
(9.2 years). Management continues to believe that, in general, the valuation of longer lease assets is unattractive and says that the longer WAULT on the acquired properties was a welcome feature of the assets, which it believes represent attractive value, rather than being a target in itself. The company continues to favour high quality properties that are likely to be re-let into a robust occupier market rather than properties that are highly priced to reflect long leases.

Exhibit 2: Portfolio sector split by income



Source: Custodian REIT as at 31 December 2017

Exhibit 3: Portfolio regional split by income



Source: Custodian REIT as at 31 December 2017

The diverse nature of the portfolio, both by asset type and by geography, is shown in Exhibits 2 and 3. Exposure to office properties remains relatively low, reflecting the manager's view that pricing often underestimates the cost of obsolescence. The strong exposure to industrial properties continued to be beneficial in the period, delivering £4.8m in gross revaluation gains.

Exhibit 4: Valuation movement by sector (three months to 31 December 2017)

Sector	Period end valuation (£m)	Gross valuation movement (£m)
Industrial	203.5	4.8
Retail Warehouse	107.4	(0.2)
Other	78.9	0.4
High Street retail	76.6	(0.1)
Office	52.3	(0.7)
Portfolio total	**518.7**	**4.2**

Source: Custodian REIT

The assets added to the portfolio in the quarter are listed in Exhibit 5. The assets acquired are substantially within the retail warehouse sector (£27.3m), and were acquired at an average net initial yield of c 6.8%.

Exhibit 5: Summary of acquisitions (three months ended 31 December 2017)

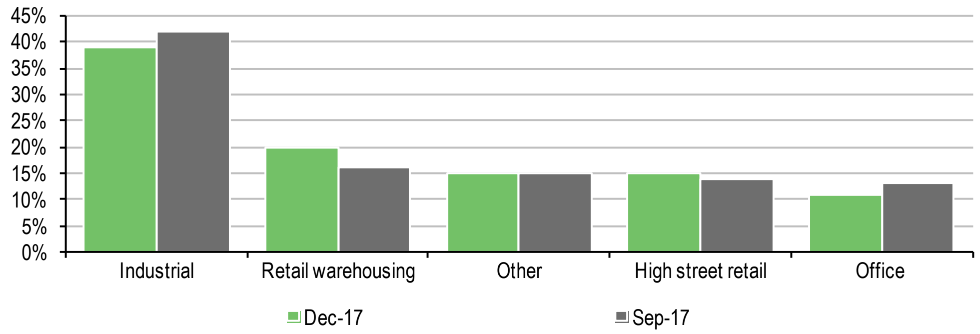
Location	Date	Type	Value (£m)	Annual passing rent (£m)	Net initial yield (%)
Burton-Upon-Trent	5 October	Retail warehouse	8.5	0.58	6.45
Cardiff	5 October	High street retail	5.2	0.41	7.46
Worcester	24 November	High street retail	5.5	0.38	6.50
Derby	19 December	Other	5.1	0.34	6.28
Carlisle	22 December	Retail warehouse	12.1	0.89	6.89
Leicester	22 December	Retail warehouse	6.7	0.50	7.36
Total			**43.0**	**3.11**	**6.82**

Source: Custodian REIT

CREI has gradually increased its exposure to retail warehouse from 11% at the start of the year to 16% in H118 and now 20% at the end of Q3. Retail warehousing vacancy rates are close to historical lows with development activity constrained by restricted planning policy among other factors, while retailers continue to target larger format stores, easy parking, and 'click and collect' capability. The property disposed of during the period under review was an industrial property in Chepstow which had undergone intensive asset management, delivering significant rental growth. Demand for industrial assets has remained strong, with constraints on the supply of available stock;

the manager considered these optimum market conditions in which to crystallise a significant valuation gain of this asset. The change in relative sector weights in the three months under review can be seen in Exhibit 6.

Exhibit 6: Change in portfolio weightings (three months to 31 December 2017)



Source: Custodian REIT

Little change to earnings estimates

We have updated our estimates to reflect the Q4 NAV update, recent property acquisitions and share issuance. Overall, there is very little change in our forecasts for earnings, dividend cover and NAV per share.

Exhibit 7: Estimate revisions

	Net rental income (£m)			EPRA EPS (p)			DPS (p)			EPRA NAV/share (p)			Net LTV		
	Old	New	Change (%)	Old	New	Change (%)	Old	New	Change (%)	Old	New	Change (%)	Old	New	Change (%)
03/18e	32.1	32.7	1.9	6.81	6.84	0.4	6.45	6.45	0.0	106	106	0.0	20.8%	22.1%	N/A
03/19e	35.4	36.5	3.1	7.30	7.29	(0.1)	6.50	6.55	0.8	109	110	0.5	20.8%	20.8%	N/A

Source: Edison Investment Research

Since listing in March 2014, CREI has grown its portfolio significantly, deploying c £10m per month on acquisitions. The manager says that an active pipeline of new acquisition opportunities that both fit with the company's investment strategy and offer further diversification benefits, are being considered. After a seasonally quiet start to the year, activity is expected to pick up, while share issuance to part-fund growth has continued into 2018. Since 1 January 2018, an additional 7.5m shares have been issued at around 115p per share, generating gross proceeds of £8.6m. These shares are reflected in our forecasts and we have allowed for an additional acquisition spend of £10m in the final quarter of FY18 in view of the funds raised and the pipeline referred to by the manager. We expect acquisitions to exceed this amount and continue in FY19, but have not included this in our forecasts given the obvious uncertainty over the timing and financial details of any transactions. For the notional £10m of acquisition spend that we have included, we assume a net initial yield of 6.8%, in line with the Q3 average.

Net gearing was 22.3% at 31 December 2017, still below management's conservative target level of 25%. From debt facilities of £150m, including a £35m revolving credit facility, and cash, management says that it has £34m of funds available for deployment.

Valuation: Attractive, covered yield underpins P/NAV

The targeted 6.45p dividend per share for the current financial year, paid in equal quarterly instalments, is covered 106% by our forecast EPRA EPS. It represents an attractive dividend yield of 5.6%. CREI has a strong focus on income and dividends paid have on average represented 75% of the total NAV returns generated since listing (an annualised 7.1% pa to 31 December 2017). Management's strategy is aimed at sustainably growing fully covered DPS and our forecasts for FY19 look for an increase to 6.55p per share, 90% of forecast EPRA EPS. Although the commercial property market as a whole has historically displayed significant volatility in returns, and is likely to do so in the future, income returns have been considerably more stable than capital values. It is this relative consistency of income returns, backed by high levels of occupancy, that CREI is targeting.

CREI's prospective dividend yield places it towards the top of a peer group of companies within the sector that we think should be considered as its closest comparators. This yield premium provides the support for a continuing P/NAV ratio premium to the group.

Exhibit 8: Direct peer comparison

	Price (p)	Market cap (£m)	NAVPS (p)	DPS (p)	P/NAV (x)	Yield (%)	Share price performance			
							One month	Three months	12 months	From 12-month high
EPIC	113	237	111.0	5.75	1.01	5.1%	2%	1%	6%	2%
F&C Commercial Property	141	1,126	141.2	6.00	1.00	4.3%	-1%	-2%	2%	4%
F&C UK Real Estate Investments	103	248	104.9	5.00	0.98	4.9%	-3%	-1%	1%	0%
Picton Property Income	85	457	88.6	3.50	0.95	4.1%	-3%	0%	4%	1%
Regional REIT	101	376	104.4	7.85	0.97	7.8%	-1%	-4%	-2%	-2%
Schroders REIT	62	324	66.6	2.48	0.94	4.0%	-4%	2%	5%	3%
Standard Life Investment Property	93	370	87.6	4.76	1.06	5.1%	-4%	3%	7%	-1%
UK Commercial Property Trust	87	1,127	92.8	3.68	0.93	4.2%	-5%	0%	6%	-2%
Average		**483**			**0.98**	**4.9%**	**-2%**	**0%**	**4%**	**1%**
Custodian REIT	115.20	446	106.0	6.45	1.09	5.6%	-2%	-1%	5%	-2%
FTSE All-Share Index							-6%	-3%	0%	-6%

Source: Edison Investment Research, Bloomberg (data as at 22 February 2018)

In terms of price performance, the stocks shown in Exhibit 8 have slightly outperformed the FTSE All-Share Index in recent weeks, and have done so more clearly over 12 months. Custodian REIT is very slightly weaker over one month versus the peer group average, but this is little more than rounding, and its P/NAV premium is maintained.

Exhibit 9: Financial summary

Year end 31 March	£'000s	2014	2015	2016	2017	2018e	2019e
		IFRS	IFRS	IFRS	IFRS	IFRS	IFRS
PROFIT & LOSS							
Gross rental income			11,228	18,561	26,980	33,900	37,949
Re-charge income			342	451	630	677	775
Total revenue			11,570	19,012	27,610	34,577	38,723
Gross property expenses			(715)	(1,023)	(1,869)	(1,886)	(2,255)
Net rental income			10,855	17,989	25,741	32,692	36,469
Administrative expenses			(2,327)	(2,828)	(3,643)	(4,480)	(4,522)
Operating Profit before revaluations			8,528	15,161	22,098	28,211	31,946
Revaluation of investment properties			6,083	3,031	9,016	8,947	10,669
Costs of acquisitions			(5,844)	(5,768)	(6,103)	(6,532)	0
Profit on disposal			269	56	1,599	1,679	0
Operating Profit			9,036	12,480	26,610	32,305	42,615
Net Interest			(289)	(1,273)	(2,405)	(3,460)	(3,810)
Profit Before Tax			8,747	11,207	24,205	28,845	38,805
Taxation			(2)	0	0	0	0
Profit After Tax			8,745	11,207	24,205	28,845	38,805
Net revaluation of investment property/costs of acquisition			(239)	2,737	(2,913)	(2,415)	(10,669)
Gains/(losses) on disposal			(269)	(56)	(1,599)	(1,679)	0
Profit After Tax (EPRA)			8,237	13,888	19,693	24,751	28,136
Average Number of Shares Outstanding (m)			146.1	204.2	298.7	362.1	385.9
IFRS EPS (p)			5.99	5.49	8.10	7.97	10.06
EPRA EPS (p)			5.64	6.80	6.59	6.84	7.29
Dividend per share (p)			5.25	6.25	6.35	6.45	6.55
Pay-out ratio of EPRA EPS			0.93	0.92	0.96	0.94	0.90
BALANCE SHEET							
Fixed Assets			207,287	318,966	415,812	529,444	540,113
Investment properties			207,287	318,966	415,812	529,444	540,113
Other non-current assets			0	0	0	0	0
Current Assets			1,921	9,973	12,996	14,927	18,578
Debtors			1,072	4,518	7,189	10,259	9,202
Cash			849	5,455	5,807	4,668	9,376
Current Liabilities			(5,411)	(8,165)	(12,572)	(14,643)	(15,035)
Creditors/Deferred income			(5,411)	(8,165)	(12,572)	(14,643)	(15,035)
Short term borrowings			0	0	0	0	0
Long Term Liabilities			(23,811)	(65,714)	(64,359)	(119,193)	(119,493)
Long term borrowings			(23,811)	(65,143)	(63,788)	(118,622)	(118,922)
Other long term liabilities			0	(571)	(571)	(571)	(571)
Net Assets			179,986	255,060	351,877	410,535	424,163
NAV/share (p)			101	102	104	106	110
EPRA NAV/share (p)			101	102	104	106	110
CASH FLOW							
Operating Cash Flow			12,780	13,945	23,066	23,726	33,395
Net Interest			(204)	(1,285)	(2,200)	(3,262)	(3,510)
Tax			0	0	0	0	0
Acquisition/disposal of investment property			(129,788)	(113,621)	(92,126)	(105,838)	0
Ordinary dividends paid			(5,546)	(12,220)	(18,493)	(22,927)	(25,177)
Debt drawn/(repaid)			23,811	41,700	(1,000)	54,423	0
Proceeds from shares issued (net of costs)			99,796	76,087	91,105	52,738	0
Other cash flow from financing activities							
Net Cash Flow			849	4,606	352	(1,139)	4,708
Opening cash			0	849	5,455	5,807	4,668
Closing cash			849	5,455	5,807	4,668	9,376
Debt			(23,811)	(65,143)	(63,788)	(118,622)	(118,922)
Closing net debt			(22,962)	(59,688)	(57,981)	(113,954)	(109,546)
Net LTV			11.4%	19.1%	14.4%	22.1%	20.8%

Source: Custodian REIT, Edison Investment Research

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