

# Circle Property

## Lifting estimates again

Circle will publish results for the year to 31 March 2018 in June but recent updates show further strong momentum. Ongoing asset management initiatives are continuing to drive operational progress, delivering strong growth in rental income and cash earnings, and lifting investment portfolio valuations. As a result, we have increased estimates for the third time since we first initiated on Circle in September 2017. The shares are trading at a discount of c 30% to our increased FY18e NAV with a yield of more than 3% and DPS well covered by growing income.

Year end	Net rental income (£m)	Adjusted net profit* (£m)	Adjusted EPS* (p)	NAV per share (p)	DPS (p)	P/NAV (x)	Yield (%)
03/16**	1.1	0.6	2.3	153	2.4	1.03	1.5
03/17	4.4	0.9	3.1	183	5.0	0.86	3.2
03/18e	5.2	2.0	7.0	227	5.3	0.70	3.4
03/19e	6.2	2.6	9.3	245	5.5	0.64	3.5

Note: \*EPS is adjusted for gains/losses on sales of investment property, revaluation movements, and non-recurring items. \*\*Period from 4 December to 31 March 2016.

## Revaluation gains and strong rent growth

The c £114.0m external valuation of the investment portfolio as at 31 March 2018 implies revaluation gains well above what we had expected, lifting forecast NAV by more than 12p per share. Contracted rents have also shown a strong organic uplift in H2 and since, reflecting significant letting progress at refurbished assets and lease renewals in the core portfolio. A £4.2m acquisition in Bristol at a 7.9% net initial yield further lifts contracted rents to c £7.6m (end-FY17 c £5.6m), close to our end-FY17 level on which our forecasts are based. This suggests upside to our recurring earnings forecasts for FY18, but particularly so for FY19. We will review this in detail with the June results.

## Upside potential from refurbished assets

Circle specialises in acquiring short-let or part-vacant office properties in the UK's provincial cities where it can add value by undertaking lease renewals, rent reviews, lettings and refurbishments. Continuing valuation uplifts reflect these efforts and significant upside potential to rental income remains, as measured by the £2.3m gap between expected rental values and contracted rents. Of this, £1.1m is attributable to the remaining vacant space at two other recently completed major refurbishments. On an annualised basis, the letting of these two assets alone has the potential to lift our FY19e underlying EPS by c 50% and NAV per share towards 250p. Liquidity is thin, but management is considering options for enlarging the shareholder base, perhaps in conjunction with growing the asset base.

## Valuation: Wide discount with nothing for upside

Our revised forecasts show the shares trading at a 30% discount to FY18e NAV per share supported by a fully covered dividend yield of more than 3%. Given management's experience and track record, this is a low valuation that does not factor the upside potential from faster letting and possible acquisitions.

## Review of trading update

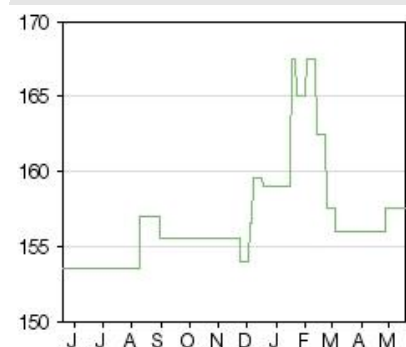
### Real estate

18 May 2018

**Price** 158p  
**Market cap** £45m

Net debt (£m) at 30 September 2017	43.6
Net LTV at 30 September 2017	42.3%
Shares in issue	28.6m
Free float	63.5%
Code	CRC
Primary exchange	AIM
Secondary exchange	N/A

### Share price performance



%	1m	3m	12m
Abs	1.0	(3.1)	2.6
Rel (local)	(6.0)	(9.1)	(1.7)
52-week high/low	167.5p	153.5p	

### Business description

Circle Property is an AIM-quoted property investment company with a wholly UK portfolio, focused on UK office buildings, mainly outside London. It seeks to increase capital value by refurbishing and re-letting assets in areas with high demand, and has a progressive dividend policy.

### Next events

Results to 31 March 2018	June 2018
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## Strong trading in H218 and beyond

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Circle recently provided a trading update ahead of the June publication of results for the year to 31 March 2018. It has followed that with news of a significant letting of recently refurbished vacant space at Somerset House in Birmingham. Ongoing asset management initiatives are continuing to drive operational progress, delivering strong growth in rental income and cash earnings, and lifting investment portfolio valuations. As a result, we have increased our estimates for the third time since we first initiated on Circle in September 2017.

The highlights of the trading update are:

- The portfolio valuation has increased to c £114.0m from c £93.0m at the end of March 2017 and c £103.5m at 30 September 2017. We estimate that c £12m of the increase reflects revaluation movements, with capex and a recent acquisition in Bristol (see below) accounting for the balance.
- Annualised contracted rent has increased to c £6.8m from c £5.6m at the end of March 2017 and c £6.0m at 30 September 2017. Since 31 March 2018, Circle has let 36,300 sq ft of office space covering six floors, at Somerset House in Birmingham (see below) increasing the contracted rent roll by a further 11.6% to c £7.6m.
- The majority of the FY18 increase in rent roll was organic, with half of the 21.5% gain being attributable to progress with leasing refurbished space from within the development assets, representing recently completed major refurbishment projects, and 21% attributable to lease renewals within the core stabilised portfolio where occupancy has remained high at c 99%. The balance of contracted rent growth in FY18 came from the Bristol acquisition.
- The estimated rental value (ERV) on the portfolio increased by 12.45% during FY18 to c £9.9m. Adjusting for the Bristol acquisition, we estimate that the underlying increase in ERV during the year is c 7%, a strong result given market levels of rental growth.
- Circle has acquired numbers 710 and 720 Aztec West business Park in Bristol for £4.2m, where it already owns the 13,285 sqft number 135. All three of the properties are fully occupied, with numbers 710 and 720 being acquired on a net initial yield of 7.9%, with a weighted average unexpired lease term of 4.85 years, and generating £351,573 pa of additional passing rent. The acquisition has been funded through a £5m extension to the existing £50m loan facility with RBS. Management continues to review a strong pipeline of acquisition opportunities that it is keen to progress.
- The letting of vacant office space takes occupancy at Somerset to 100%, with the two ground floor restaurant units having been let during FY18. The property will generate total rental income of c £1.2m per year (after rent fees and incentives expire), with upwards-only five-year rent reviews.
- The remaining upside potential to rental income, as measured by the gap between ERV and contracted rents remains significant at c £2.3m, of which we estimate c £1.1m is attributable to the potential from letting the remaining vacant space at two other recently completed major refurbishments (K2, Milton Keynes, and 36 Great Charles Street, Birmingham).

**Exhibit 1: Edison estimated contracted rents and ERV**

£m	
<b>Contracted rent roll at 31 March 2018</b>	<b>6.8</b>
Somerset House, Temple St., Birmingham	0.8
<b>Adjusted contracted rent roll</b>	<b>7.6</b>
<b>Development assets expected rent (ERV)</b>	
K2, Kents Hill Business Park, Milton Keynes	0.6
Great Charles St, Birmingham uplift	0.5
<b>Potential rent including development assets</b>	<b>8.7</b>
Other, rent reversion potential	1.2
<b>Total portfolio ERV at 31 March 2017</b>	<b>9.9</b>
Source: Edison Investment Research, company data	

## Lifting estimates again

The continued progress in ERV and leasing has lifted the externally assessed valuation of the portfolio above the level that we had assumed, with a positive impact on forecast NAV per share. Adjusting the fair value of c £114.0m for our estimate of lease incentives gives a balance sheet value of £106.5m compared with £92.3m at 30 September. Adjusting this movement for estimated capex and the Bristol acquisition (including acquisition costs) implies a H218 revaluation gain of c £4.5m, higher than the £1.0m we had previously allowed for. This adds a little over 12p per share to our end-FY18 NAV per share estimate.

The FY18 period-end contracted rent income was higher than we have been forecasting and, depending upon the timing of the H218 leasing progress (not disclosed in the trading update) may indicate upside to our FY18 estimated income earnings. We estimate that the subsequent letting of vacant office space at Somerset House takes contracted rental income to c £7.6m, a similar level to our existing forecast for end-FY19, adjusted for the Bristol acquisition.

We have adjusted our FY19 recurring earnings forecast for the accretive impact of the Bristol acquisition and will review it again once we have seen the detail of the FY18 results and management comments on the expected pace of further letting during the year. The risk to our current FY19 estimate is firmly on the upside.

**Exhibit 2: Estimate revisions**

	Net rental income (£m)			Adjusted net profit (£m)*			Adjusted EPS (p)*			NAV per share (p)			DPS (p)		
	Old	New	Change (%)	Old	New	Change (%)	Old	New	Change (%)	Old	New	Change (%)	Old	New	Change (%)
03/18e	5.2	5.2	0.0	2.0	2.0	0.0	7.0	7.0	0.0	214	227	5.7	5.3	5.3	0.0
03/19e	5.9	6.2	6.0	2.4	2.6	8.2	8.6	9.3	8.2	232	245	5.6	5.5	5.5	0.0

Source: Edison Investment Research. Note: \*Adjusted for gains/losses on sales of investment property, revaluation movements, and non-recurring items.

As we have previously [noted](#), the letting of vacant space at a faster pace than we have allowed for in our estimates is a potential source of significant upside to our forecast adjusted earnings, dividend paying capacity and NAV. Our FY19 forecast is struck on the basis of contracted rents being no higher at year end than they are today (c £7.6m), whereas full letting of the vacant space at the other two recently completed refurbishments has the potential to add c £1.1m to this figure. That would still leave upside to ERV of £1.2m across the portfolio as a whole.

On an annualised basis, full letting of the two refurbishment assets alone has the potential to increase our FY19e underlying EPS of 9.3p by c 50% and NAV per share towards 250p.

## Discount to NAV remains wide; income earnings building

For Circle, unlike a REIT, capital returns are expected to be a significant element of overall total returns, which we think is best measured by NAV total return (the change in NAV per share plus dividends paid per share). In the 10 years to FY16, the average annual return was more than 7.5% pa. NAV total return since IPO has increased and we calculate a 24.1% annual total return for FY17

and our revised estimates suggest a 26.6% annual total return in the current year (previously 19.9%).

For an investor, expected future capital returns are perhaps less easy to predict than expected dividend returns driven by contracted rental income. However, given Circle management's experience and track record, the discount of c 30% to our upwardly revised forecast FY18 NAV per share supported by a dividend yield of more than 3%, with DPS well covered by a growing income stream, continues to represent a relatively low valuation; nothing is obviously being factored in for the upside potential to income and NAV.

Some discount for Circle's relatively small market capitalisation and thin share trading liquidity, and for its above-average gearing, may be anticipated. Moreover, while the relatively concentrated nature of the Circle portfolio has allowed the company to successfully focus its efforts, it does not provide the risk diversification offered by some larger regional commercial property companies. Circle remains keen to grow the portfolio, with the potential for earnings accretion in addition to scale and diversification benefits. Moreover, management has previously stated it is considering options for enlarging the shareholder base and growth through an expansion of capital resources, both equity and debt, could provide a welcome boost to liquidity.

**Exhibit 3: Financial summary**

Year ending 31 March	FY16	FY17	FY18e	FY19e
£000s	IFRS	IFRS	IFRS	IFRS
<b>INCOME STATEMENT</b>				
Rental income	664	5,266	5,980	7,087
Other income	595	138	93	0
Total income	1,260	5,404	6,073	7,087
Property expenses	(123)	(1,037)	(920)	(870)
Net rental income	1,137	4,366	5,152	6,217
Administrative expenses	(293)	(2,115)	(2,116)	(2,202)
Operating profit before valuation gains	844	2,251	3,036	4,015
Gains on disposal of investment properties	0	279	0	0
Revaluation of investment properties	0	7,361	11,772	4,000
Exception items	374	88	0	0
Operating profit	1,217	9,979	14,807	8,015
Net finance costs	(112)	(13)	(1,120)	(1,261)
Profit before tax	1,106	9,966	13,687	6,754
Tax	(32)	(22)	73	(128)
Net profit	1,073	9,944	13,760	6,626
Adjusted for:				
Gain/(loss) on disposal of investment property	0	(279)	0	0
Revaluation of investment property	0	(7,361)	(11,772)	(4,000)
Fair value movement on interest rate swaps	2	(96)	1	0
Exceptional items	(374)	(88)	0	0
Adjustment for effective interest rate on borrowings	(54)	(1,232)	0	0
Adjusted earnings	648	889	1,989	2,626
Shares ('000s) exc. own shares held	28,297	28,297	28,297	28,297
IFRS EPS (p)	3.8	35.1	48.6	23.4
Diluted adjusted EPS (p)	2.3	3.1	7.0	9.3
Dividend declared (p)	2.4	5.0	5.3	5.5
<b>BALANCE SHEET</b>				
Investment properties	75,781	86,054	106,488	111,488
PPE	22	29	26	26
Trade and other receivables	1,771	6,518	7,037	7,037
Deferred tax	915	1,142	1,142	1,142
Financial instruments at FV through P&L	0	1	0	0
Total non-current assets	78,490	93,744	114,693	119,693
Trade and other receivables	2,555	1,195	1,350	1,586
Deferred tax	105	128	322	322
Cash and equivalents	4,516	4,894	4,005	5,084
Total current assets	7,176	6,217	5,677	6,992
Total assets	85,665	99,962	120,370	126,685
Borrowings	(40,028)	(45,590)	(53,831)	(53,891)
Financial liability at FV through P&L	(95)	0	0	0
Total non-current liabilities	(40,123)	(45,590)	(53,831)	(53,891)
Trade and other payables	(2,306)	(2,550)	(2,429)	(3,103)
Total current liabilities	(2,306)	(2,550)	(2,429)	(3,103)
Total liabilities	(42,430)	(48,140)	(56,260)	(56,994)
Net assets	43,236	51,822	64,110	69,691
Basic and diluted IFRS NAV per share (p)	153	183	227	245
<b>CASH FLOW</b>				
Profit before tax	1,106	9,966	13,687	6,754
Adjusted for				
Net finance expense	112	1,245	1,120	1,261
Depreciation	1	7	6	7
Share-based payments	0	0	0	0
Gains on revaluation	0	(7,361)	(11,772)	(4,000)
Gains on disposal of investment properties	0	(279)	0	0
Amortisation of loan arrangement fees	7	40	59	60
Goodwill, interest rate and swap valuation movements	(1,751)	(1,523)	1	0
Working capital movements	1,132	(3,512)	(866)	438
Cash from operations	607	(1,416)	2,236	4,520
Tax paid	0	0	(26)	(128)
Net interest (paid)/received	(56)	(1,346)	(1,120)	(1,261)
Net cash from operations	551	(2,763)	1,089	3,131
Net cash from investing	3,610	(2,255)	(8,688)	(1,007)
Net cash used in financing	356	5,396	6,710	(1,500)
Net increase/(decrease) in cash and equivalents	4,516	378	(889)	624
Opening cash	0	4,516	4,894	4,005
Closing cash	4,516	4,894	4,005	4,629
Debt	(40,028)	(45,590)	(53,831)	(53,891)
Net debt	(35,512)	(40,697)	(49,826)	(49,261)
Net LTV	45.7%	43.9%	43.8%	41.4%

Source: Edison Investment Research

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