Custodian REIT

FY17 results

Forecasts revised after FY17 results

Real estate

Custodian REIT (CREI) reported a 2.2% increase in FY17 EPRA NAVPS, boosted by revaluation gains and disposal profits. With a dividend of 6.35p (+1.6%), the share price total return for the year was 10.3%. We have made minor changes to our forecasts following the results. Our EPRA NAV forecasts have increased by 1% in both FY18 and FY19, as CREI has made acquisitions worth £19m in the year to date, with another £19m under offer. Management's focus is on long-term secure income, to deliver the earnings to cover a sustainable growth in dividends and generate less volatile returns. We believe the 9% premium to FY18e 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	5.4	1.15
03/17	27.0	6.59	6.35	104	5.5	1.12
03/18e	31.7	6.95	6.45	106	5.5	1.09
03/19e	32.3	6.89	6.50	109	5.6	1.06

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

FY17 results: NAV boosted by valuation gains

FY17 EPRA NAV was up 2.2% to 103.8p per share, as the portfolio value increased 30% to £416m, following the investment of £105m in 25 acquisitions. There was a 3% fall in EPRA EPS to 6.6p per share, but reported EPS were up 48%, as net profit more than doubled to £24m, boosted by a £9m valuation gain and profits on disposal. The dividend was raised 1.6% to 6.35p per share, which was 101% covered and the target for FY18 was increased 1.7% to 6.45p.

A low geared, 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, retail warehousing and alternative sectors, plus its portfolio is institutional quality in all but lot size. The net initial yield on the portfolio at year-end was 6.9%. Recent acquisitions have averaged above 7.3%, which should make them earnings enhancing and able to meet the 6.45p dividend target for FY18.

Valuation: Premium justified by above-average yield

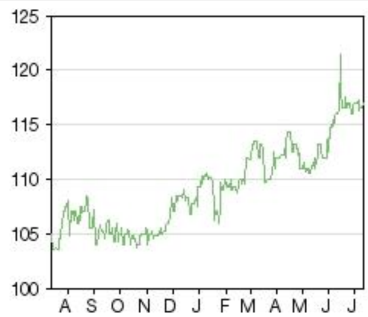
CREI trades at a premium of 9% to our forecast FY18e NAV of 106p, which is a slight premium to the more income-orientated listed peers. This premium looks justified by its dividend yield and is supported by our dividend discount model. Given the business model of focusing on all market sectors, sub £10m lot sizes and a wide tenant base, the risk profile is reduced, which again supports the premium in our view. The company became a FTSE EPRA/NAREIT index series constituent in March 2017, which should also help to support current valuations.

11 July 2017

Price	**116.25p**
Market cap	**£403m**

Net debt (£m) at FY17	58.0
Shares in issue	347m
Free float	92%
Code	CREI
Primary exchange	LSE
Secondary exchange	N/A

Share price performance



%	1m	3m	12m
Abs	0.9	3.8	15.3
Rel (local)	3.0	3.4	1.6
52-week high/low		121.5p	103.5p

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

June 2017 NAV	July 2017

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Custodian REIT is a research client of Edison Investment Research Limited

FY17 results

EPRA NAV increased 2.2%

CREI reported an 8.5% total NAV return for the year to March 2017, up from 6.4% in FY16 and well ahead of the sector benchmark of 6.5%. As previously reported, EPRA NAV was up 2.2% to 103.8p per share and the portfolio increased 30% to £416m, following the investment of £105m in 25 acquisitions. The net initial yield on the portfolio was barely changed at 6.9%. The aggregate NAV was 38% higher at £352m, as CREI raised £92m of equity, at an average premium of 5% over NAV.

The fully covered dividend was raised 1.6% to 6.35p per share, which was covered 101% and the target for FY18 was increased 1.7% to 6.45p. There was a 3% fall in EPRA EPS to 6.6p per share, but reported EPS were up 48%, as net profit more than doubled to £24m, boosted by a £9m valuation gain and profits on disposal. CREI made £19m of disposals in the year to special purchasers, including owner occupiers and those looking for secure long-term income. Partly as a result of this, net gearing fell to 14% from 19% in FY16.

Management said they expect occupational demand and a limited supply of new development to continue to drive up rental growth in the regional markets. Industrial rents increased over 7% and shops were up 5%. This should support a low vacancy rate (CREI's fell to 1.4% from over 3%), secure dividend cover and the potential for capital growth. CREI believes the occupier market should therefore have a few years still to run in the regions. However, the investment market has been more volatile and valuation increases have not followed, so the yield spread over prime and other assets is still attractive, especially in the smaller lot sizes the company focuses on.

The company also said it plans to continue its growth to achieve the economies of scale from the REIT's fixed cost base, especially after the recent reduction in investment manager fees discussed below. The ongoing charge ratio has fallen to 1.2% as a result. At the time of the results, CREI stated that it had made acquisitions worth £19m in the year to date, with another £19m under offer.

Exhibit 1: FY17 results

£m	FY16	FY17	Change
Gross rental income	18.56	26.98	45.4%
Re-charge income	0.45	0.63	39.7%
Revenue	**19.01**	**27.61**	**45.2%**
Property expenses	(1.02)	(1.87)	116.6%
Net rental income	**17.99**	**25.74**	**43.1%**
Net result on disposal of investment properties	0.06	1.60	2755.4%
Revaluation of investment properties	3.03	9.02	197.5%
Management fees	(2.20)	(2.67)	21.4%
Administrative expenses	(0.10)	(0.48)	375.0%
Professional and directors' fees	(0.53)	(0.50)	(5.9%)
Purchase costs	(5.77)	(6.10)	5.8%
Net operating profit	**12.48**	**26.61**	**113.2%**
Interest income	0.22	0.19	(15.8%)
Interest expenses	(1.49)	(2.59)	73.4%
Profit before tax	**11.21**	**24.21**	**116.0%**
Tax charge	0.00	0.00	0.0%
Profit after tax	**11.21**	**24.21**	**116.0%**
EPRA Earnings	**13.89**	**19.69**	**41.8%**
Average shares outstanding (m)	204.20	298.73	46.3%
Basic EPS (p)	**5.49**	**8.10**	**47.6%**
EPRA EPS (p)	**6.80**	**6.59**	**(3.1%)**
DPS (p)	**6.25**	**6.35**	**1.6%**
EPRA NAVPS (p)	**102**	**104**	**2.2%**

Source: Custodian REIT data

Renewal of investment management agreement

CREI announced that the investment management agreement with Custodian Capital had been renewed for a further three years from 1 June, with 12 months' notice, following the expiry of the initial three-year term. The fees have been amended to include a step down in the property management fee from 0.75% to 0.65% of NAV above £500m, and in the administrative fee from 0.125% to 0.08% of NAV between £200m and £500m, plus a further step down to 0.05% above £500m. The effect of these changes will be to increase the cover on target dividends for the current year ending March 2018, as the administrative fee will fall immediately. Growth in NAV above £500m will therefore reduce the ongoing charges ratio and increase dividend capacity. A three-year term will also enable the investment manager to invest in the people and systems to service the agreement.

Year-to-date portfolio update

In May, CREI announced the acquisition of a 23,000 sq ft retail warehouse in Southbrook Retail Park in Gloucester. The warehouse comprises two units near the town centre and three miles from the M5, occupied by Magnet and Smyths Toys, on leases expiring in 2024 and 2021. The passing rent of £0.37m equates to a net initial yield of 7.41% at a price of £4.725m. The transaction was funded internally, thereby increasing CREI's net gearing. Also in May, it acquired a retail site in Galashiels for £3.15m and a car dealership in York for £3.9m at net initial yields of 8.24% and 5.75% (with a 6.75% reversionary yield).

On 12 June, CREI acquired a 20,678 sq ft distribution unit in Access 26 Business Park, Langley Mill, located near Junction 26 of the M1. The unit is let to Warburtons on a lease expiring on 2 December 2022. The passing rent is £143,000 per year, so the purchase price of £2.15m produces a net initial yield of 6.29%. The acquisition was funded from existing cash resources. The company said it was a modern unit in a strong distribution location and nearby occupiers include DHL, 3663 Logistics and Travis Perkins. There is strong demand in the Midlands for good quality units with strong communication links, so management expects rental growth at the review in December this year.

On 15 June, the company acquired a 69,922 sq ft distribution unit in Eurocentral, Scotland's leading mixed-use business park on the M8 between Glasgow and Edinburgh. Nearby occupiers include DHL, Warburtons, Argos, Wincanton, Norbert Dentressangle and Morrisons. The unit is let to Next on a lease expiring on 6 March 2019. The current passing rent is £349,850 per annum, reflecting a net initial yield of 6.91%, with an expected reversionary yield of c 7.9%. The agreed purchase price of £4.75m was funded from the company's existing cash resources.

On 19 June, CREI announced the acquisition of the 23,000 sq ft Wells Green Retail Park in Sheldon, which is five miles from Birmingham city centre on the A45. The site comprises three units occupied by Dreams, Pets at Home and Halfords. Management said Halfords has recently signed a reversionary lease on its site. Other retailers nearby include Morrisons, Tesco and Aldi. The leases have expiry dates in September 2022, September 2026 and September 2027. The passing rent of £0.361m equates to a net initial yield of 6.64% on the purchase price of £5.1m. The consideration was funded from internal resources and net gearing increased to 19.6% LTV as a result.

Exhibit 2: FY18 YTD acquisitions (£m)					
Location	Date	Type	Value	Annual rental	Net initial yield
Gloucester	2 May	Retail	4.73	0.37	7.41%
York	12 May	Other	3.92	0.24	5.75%
Galashiels	15 May	Retail	3.15	0.28	8.24%
Plymouth	15 May	Retail	7.49	0.54	6.74%
Langley Mill	12 June	Industrial	2.15	0.14	6.29%
Scotland	15 June	Industrial	4.75	0.35	6.91%
Sheldon, Birmingham	19 June	Retail	5.10	0.36	6.64%
YTD total			**31.28**	**2.28**	**7.29%**

Source: Custodian REIT data

Valuation and financials

A yield premium to peers

Following its recent strong share price performance, CREI trades at a slight premium to the average of the sector peers, based on a premium of 9% to our FY18 EPRA NAVPS forecast. The sector peers are currently on an average premium of 7% for this year. However, at 5.5% CREI's dividend yield is 10% higher than the sector average. This is despite the inclusion in the average of Regional REIT, which, at 7.2%, has by far the highest dividend yield. In our view, the higher dividend yield justifies the 9% premium to NAV.

Exhibit 3: Comparative valuations, FY17e						
	Price (p)	Market cap (£m)	NAVPS (p)	P/NAV (x)	DPS (p)	Dividend yield
EPIC	112.0	147	104.8	1.07	5.5	4.9%
F&C Commercial Property	143.5	1,147	137	1.04	6.0	5.6%
F&C UK Real Estate Investment	106.3	256	98.4	1.08	5.0	4.7%
Picton Property Income	83.3	450	82	1.10	3.4	4.1%
Regional REIT	105.3	316	96	1.10	7.6	7.2%
Schroders REIT	63.3	328	63	1.01	2.4	3.9%
Standard Life Inv Property	90.5	352	81	1.11	4.9	5.4%
Tritax Big Box	144.6	1,971	133	1.09	6.4	4.4%
UK Commercial Property Trust	91.1	1,184	87	1.04	3.7	4.0%
Total/Average		**6,557**		**1.07**		**5.0%**
Custodian REIT*	116.25	403	106	1.09	6.45	5.5%

Source: Bloomberg, Edison Investment Research forecasts. Note: CREI NAVPS and DPS are FY18 forecasts, Prices as at 10 July 2017.

Forecast changes and fundraising

We have made minor changes to our forecasts following the results. Our revenue forecasts have increased 5% in both FY18 and FY19, on the back of the recent property acquisitions detailed above. Our EPRA earnings forecast has increased 0.4% for this year, to reflect the income from these additional properties. The FY18 figure has reduced slightly as we have assumed an increase in debt funding for the acquisitions, which has a knock-on effect on interest costs next year, plus there are more shares in issue, following the shares issued year to date. Nevertheless, our EPRA NAV forecasts have increased by 0.6% in both FY18 and FY19.

Exhibit 4: Forecast changes									
	Revenue			EPRA EPS			EPRA NAVPS		
	Old	New	% chg.	Old	New	% chg.	Old	New	% chg.
2018e	30.1	31.7	5.0%	6.92	6.95	0.4%	105.8	106.4	0.6%
2019e	30.7	32.3	5.0%	7.08	6.89	(2.8%)	108.7	109.4	0.6%

Source: Edison Investment Research, Custodian REIT data

CREI has continued to raise equity from existing shareholders in regular tap issues, which can be used to fund further property acquisitions. So far this year, the company has raised £9m, at an average price of 112p per share. We are not forecasting any further equity fundraising, although we believe there is likely to be more as the year progresses. In FY17, the company raised £92m of additional equity.

Exhibit 5: Equity fund-raising (FY18)

Capital increases	Price (p)	Shares (m)	Total (£m)
04/04/2017	110.0	1.00	1.10
09/05/2017	111.0	1.50	1.67
17/05/2017	111.0	1.00	1.11
23/05/2017	111.5	1.50	1.67
01/06/2017	112.5	1.00	1.13
12/06/2017	115.0	0.50	0.58
19/06/2017	116.0	0.50	0.58
26/06/2017	116.0	0.50	0.58
03/07/2017	116.0	0.50	0.58
Year to date	**112.3**	**8.00**	**8.99**

Source: Custodian REIT data

Exhibit 6: Financial summary

Year end 31 March	£000s	2015	2016	2017	2018e	2019e
		IFRS	IFRS	IFRS	IFRS	IFRS
PROFIT & LOSS						
Gross rental income		11,228	18,561	26,980	31,651	32,284
Re-charge income		342	451	630	741	776
Total revenue		**11,570**	**19,012**	**27,610**	**32,392**	**33,060**
Gross property expenses		(715)	(1,023)	(1,869)	(1,757)	(1,813)
Net rental income		**10,855**	**17,989**	**25,741**	**30,635**	**31,247**
Administrative expenses		(785)	(628)	(972)	(1,054)	(1,066)
Operating Profit before revaluations		**10,070**	**17,361**	**24,769**	**29,580**	**30,182**
Revaluation of investment properties		6,083	3,031	9,016	8,316	9,034
Costs of acquisitions/profit on disposals		(5,575)	(5,712)	(4,504)	(1,643)	0
Management fees		(1,542)	(2,200)	(2,671)	(3,316)	(3,455)
Operating Profit		**9,036**	**12,480**	**26,610**	**32,938**	**35,868**
Net Interest		(289)	(1,273)	(2,405)	(2,425)	(2,823)
Profit Before Tax		**8,747**	**11,207**	**24,205**	**30,512**	**33,045**
Taxation		(2)	0	0	0	0
Profit After Tax		**8,745**	**11,207**	**24,205**	**30,512**	**33,045**
Profit After Tax (EPRA)		**8,237**	**13,888**	**19,693**	**23,839**	**23,904**
Average Number of Shares Outstanding (m)		146.1	204.2	298.7	343.0	347.0
EPS (p)		**5.99**	**5.49**	**8.10**	**8.90**	**9.52**
EPRA EPS (p)		**5.64**	**6.80**	**6.59**	**6.95**	**6.89**
Dividend per share (p)		**5.25**	**6.25**	**6.35**	**6.45**	**6.50**
Dividend cover (x)		1.1	1.1	1.0	1.1	1.1
BALANCE SHEET						
Fixed Assets		**207,287**	**318,966**	**415,812**	**457,048**	**466,189**
Investment properties		207,287	318,966	415,812	457,048	466,189
Other non-current assets		0	0	0	0	0
Current Assets		**1,921**	**9,973**	**12,996**	**13,492**	**15,148**
Debtors		1,072	4,518	7,189	8,435	8,610
Cash		849	5,455	5,807	5,057	6,538
Current Liabilities		**(5,411)**	**(8,165)**	**(12,572)**	**(13,471)**	**(13,779)**
Creditors/Deferred income		(5,411)	(8,165)	(12,572)	(13,471)	(13,779)
Short term borrowings		0	0	0	0	0
Long Term Liabilities		**(23,811)**	**(65,714)**	**(64,359)**	**(87,817)**	**(87,817)**
Long term borrowings		(23,811)	(65,143)	(63,788)	(87,246)	(87,246)
Other long term liabilities		0	(571)	(571)	(571)	(571)
Net Assets		**179,986**	**255,060**	**351,877**	**369,252**	**379,741**
Net Assets excluding goodwill and deferred tax		**179,986**	**255,060**	**351,877**	**369,252**	**379,741**
NAV/share (p)		**101**	**102**	**104**	**106**	**109**
EPRA NAV/share (p)		**101**	**102**	**104**	**106**	**109**
CASH FLOW						
Operating Cash Flow		**6,936**	**8,177**	**23,066**	**24,274**	**26,860**
Net Interest		(204)	(1,285)	(2,200)	(2,425)	(2,823)
Tax		0	0			
Net cash from investing activities		(123,944)	(107,853)	(92,126)	(32,920)	0
Ordinary dividends paid		(5,546)	(12,220)	(18,493)	(22,124)	(22,556)
Debt drawn/(repaid)		23,811	41,700	(1,000)	23,458	0
Proceeds from shares issued		99,796	76,087	91,105	8.988	0
Other cash flow from financing activities		0	0	0	0	0
Net Cash Flow		**849**	**4,606**	**352**	**(750)**	**1,481**
Opening cash		0	849	5,455	5,807	5,057
Other		0	0	0	0	0
Closing cash		**849**	**5,455**	**5,807**	**5,057**	**6,538**

Source: Custodian REIT data, Edison Investment Research

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