

# Picton Property Income

Q3 NAV update

Strong total returns continue

The valuation of Picton's property portfolio showed a 2.1% like-for-like increase in the three months ending 31 December 2017 (Q318), primarily driven by asset management, continuing growth in expected rental values and yield compression on some assets. Including the dividend, NAV total return was 4.1%, with dividend cover increasing to 126%. The targeted DPS for the current year was increased by c 3% to an annualised 3.5p (a well covered 4.1% yield). Ongoing active asset management initiatives provide additional opportunities, with leasing progress continuing in Q4.

Year end	Revenue (£m)	EPRA EPS* (p)	DPS (p)	EPRA NAV/share (p)	P/EPRA NAV (x)	Yield (%)
03/16	40.8	3.68	3.30	77.2	1.12	3.8
03/17	47.9	3.81	3.33	81.8	1.05	3.9
03/18e	43.2	4.11	3.43	89.0	0.97	4.0
03/19e	44.5	4.29	3.53	91.7	0.94	4.1

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

## Income and capital gains in the quarter

The investment portfolio was valued at £665.3m at 31 December 2017, up from £652.1m in September (H118), including £13.6m in revaluation gains, £0.6m in disposal of non-core property, and capex. The valuation reflects a net initial yield of 5.7% and a reversionary yield of 6.7%. The average unexpired lease term was 5.2 years and occupancy was maintained at 95%. Lease events in the period added £0.26m to annualised contracted rent roll, 1.9% ahead of the H118 expected rental value (ERV). Lettings at the recently acquired Tower Wharf in Bristol have since added £0.54m to annualised rent roll, 4% ahead of ERV.

## Positioned for further growth

Picton's portfolio is overweight regional industrial and office property and significantly underweight retail and leisure (with no shopping centre exposure). Management expects a general supply and demand imbalance with limited development to drive further growth in regional office and industrial rents. The H118 ERV was £6m ahead of the contracted run rate, and much of this potential remains, representing significant opportunity to grow income from the existing assets through further void reduction, rent reviews and lease renewals.

## Valuation: Well covered DPS supports total returns

While Picton has a strong income focus, it also chooses to reinvest into the portfolio in ways designed to support occupancy and income growth with the specific goal of enhancing total return. It provides an attractive dividend yield in excess of 4%, which we expect to be 1.2x covered by EPRA earnings, and with continuing opportunities to grow income from the current portfolio. Despite a strong historic record of relative outperformance, Picton trades at a P/NAV discount to peers.

Real estate

26 January 2018

**Price** 86.60p  
**Market cap** £468m

Net debt (£m) at 31 December 2017	184.6
Net LTV as at 31 Dec. 2017	27.4%
Shares in issue	540.1m
Free float	100%
Code	PCTN
Primary exchange	LSE
Secondary exchange	N/A

## Share price performance



%	1m	3m	12m
Abs	3.9	3.0	8.5
Rel (local)	3.6	0.7	0.8
52-week high/low	87.20p	78.50p	

## Business description

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

## Next events

Q418 NAV & dividend update	April 2018
FY18 results	June 2018

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## Strong total returns continue through Q318

Picton's unaudited net asset value increased to £477.4m at 31 December 2017 or by 2.7p (3.1%) to 88.6p. A summary of the movement is provided in Exhibit 1, with some rounding of the per share values. The 0.825p dividend paid in the quarter was 126% covered by net income, while a 2.1% like-for-like investment property valuation contributed £13.6m (c 2.5p per share), with capex and a small disposal taking the total movement in property values to £13.2m. The "other" NAV movement of c £0.8m includes the repurchase of 1,070,000 shares for the Employee Benefit Trust to satisfy future vesting awards made under the company's long-term incentive plan and has no impact on the NAV per share movement in the period.

<b>Exhibit 1: Summary of NAV movement in the quarter</b>			
	<b>£m</b>	<b>Per share (p)</b>	<b>Movement per share (p)</b>
NAV at 30 September 2017	463.8	85.9	
Movement in property values	13.2	2.5	2.4
Net income after tax for the period	5.8	1.1	1.1
Dividends paid	(4.6)	(0.9)	(0.9)
Other	(0.8)	-	-
NAV at 31 December 2017	477.4	88.6	2.7

Source: Picton, Edison Investment Research

As previously indicated, the DPS declared in respect of Q318 has been increased by c 3% to 8.75p and will be paid on 28 February 2018. This represents an annualised DPS of 3.5p.

The company has made clear that it intends to bring forward proposals later in the year for conversion to UK REIT status and will at the same time seek to change its technical listing status to that of a commercial company. These changes are not expected to have any impact on Picton's investment or portfolio strategy, and there are no plans to change the quarterly reporting or dividend cycle. We note that prospective dividend cover under the current corporate structure is c 1.2x, which suggests to us that there may be scope for the payout to increase; for now, management is indicating that it will review dividend policy again if and when REIT conversion takes place.

Portfolio activity was light during the period, with one non-core property sold for £0.6m, in line with the September (H118) valuation, but 35% ahead of the March valuation. The period saw five lettings, seven rent reviews and five lease renewals completed, securing additional annualised rent income of £0.26m, on average 1.9% of the expected rental value (ERV). Occupancy across the portfolio was maintained at 95% during the period. In September, the full occupancy ERV was £47.6m compared with the annualised contracted rental value at the time of £41.6m. Although not updated at Q3, we believe that much of this income potential remains, after allowing for ERV growth and leasing activity in the quarter and since. Picton recently announced that in Q418 it has secured two new occupiers at Tower Wharf in Bristol, the Grade A office building that it acquired for £23.15m in August 2017. These take occupancy at Tower Wharf to more than 90% from 64% at the time of the acquisition, and represent a combined annual rent of £0.54m, equivalent to £28.50 per sqft and 4% ahead of the September ERV.

The 2.1% like-for-like valuation growth in Q318 was driven by the industrial (3.5%) and office (2.2%) assets, where Picton is over-weighted, representing more than three-quarters of the portfolio. The retail and leisure assets saw a negative 0.5% valuation movement. The leasing progress at Tower Wharf is a positive indicator for the year-end valuation.

Our forecasts already anticipate some leasing progress and for now we make no change to our expected income earnings. The £13.6m Q318 revaluation movement was well ahead of the £5.0m that we had allowed for in H218 as a whole. We have increased the H218 assumption to £15.0m, with a positive impact on EPRA NAV per share.

**Exhibit 2: Forecast changes**

	Revenue (£m)			Adj. EPRA EPS (p)			EPRA NAV/share (p)			DPS (p)		
	Old	New	% change	Old	New	% change	Old	New	% change	Old	New	% change
FY18e	43.2	43.2	0.0	4.11	4.11	0.0	87.2	89.0	2.1	3.43	3.43	0.0
FY19e	44.5	44.5	0.0	4.29	4.29	0.0	89.9	91.7	2.1	3.53	3.53	0.0

Source: Edison Investment Research

The increase in the investment portfolio value in Q3 contributed towards a reduction in gearing in Q318, with the net LTV reducing to 27.4% from 28.2% in September. The company continues to look for investment opportunities and has £39m of borrowing headroom available from its revolving credit facilities.

While Picton has a strong income focus, it also chooses to reinvest into the portfolio in ways designed to support occupancy and income growth with the specific goal of enhancing total return. It has a built a strong and consistent record of property returns (income and capital) over a number of years and has outperformed its MSCI IPD Quarterly Benchmark over one, three, five and 10 years to September 2017 (a Q318 benchmark comparison is not yet available). In Exhibit 3 we show a summary valuation comparison of Picton and what we consider to be its closest peers.

**Exhibit 3: Peer comparison**

	Price (p)	Market cap (£m)	NAVPS* (p)	DPS** (p)	P/NAV (x)	Yield (%)
EPIC	109.4	230	111.0	5.75	0.99	5.3
F&C Commercial Property	141.4	1,130	140.0	6.00	1.01	4.2
F&C UK Real Estate Investments	106.0	255	104.9	5.00	1.01	4.7
Custodian REIT	115.6	437	104.9	6.45	1.10	5.6
Regional REIT	101.6	379	104.4	7.85	0.97	7.7
Schroders REIT	65.0	337	65.7	2.48	0.99	3.8
Standard Life Investment Property	96.9	383	86.0	4.76	1.13	4.9
UK Commercial Property Trust	90.0	1,169	90.4	3.68	1.00	4.1
<b>Average</b>			<b>100.9</b>		<b>1.02</b>	<b>5.0</b>
Picton Property Income	86.0	464	88.6	3.50	0.97	4.1

Source: Edison Investment Research, Bloomberg. Note: \*Last published NAV. \*\*Prospective yield. Data as at 25 January 2018.

Picton's 4.1% prospective yield compares with a c 5.0% simple average for the peer group, while its c 3% discount to last published NAV positions it at a discount. It would appear to us that Picton is being valued as if its immediate income distributions are structural (whereas they could be increased given the dividend cover), without giving obvious credit for the potential to further grow that income or to continue to enhance total returns through continued investment. The market does not appear to be anticipating a continuation of its historical relative property return outperformance and is certainly not pricing in achievement of management's goal of being sustainably one of the best performing, diversified listed property companies on the main market.

**Exhibit 4: Financial summary**

Year end 31 March	£'000s	2014	2015	2016	2017	2018e	2019e
		IFRS	IFRS	IFRS	IFRS	IFRS	IFRS
<b>PROFIT &amp; LOSS</b>							
Revenue		31,967	35,151	40,770	47,911	43,217	44,515
Service charge income		4,782	4,511	5,153	6,487	6,083	6,265
Total revenue		36,749	39,662	45,923	54,398	49,300	50,781
Gross property expenses		(8,992)	(9,320)	(10,001)	(12,011)	(11,422)	(11,570)
Net rental income		27,757	30,342	35,922	42,387	37,878	39,211
Administrative expenses		(1,139)	(1,194)	(1,510)	(1,613)	(1,982)	(2,116)
Operating Profit before revaluations		26,618	29,148	34,412	40,774	35,896	37,095
Revaluation of investment properties		18,422	53,163	44,171	15,087	32,362	10,000
Profit on disposals		5,660	412	799	1,847	2,488	0
Management expenses		(2,127)	(2,591)	(2,901)	(3,636)	(3,660)	(3,752)
Operating Profit		48,573	80,132	76,481	54,072	67,086	43,343
Net Interest		(10,868)	(10,930)	(11,417)	(10,823)	(9,753)	(9,718)
Profit Before Tax		37,705	69,202	65,064	43,249	57,333	33,625
Taxation		(357)	(347)	(216)	(499)	(614)	(673)
Profit After Tax		37,348	68,855	64,848	42,750	56,719	32,953
Profit After Tax (EPRA)		13,266	15,280	19,878	20,566	22,191	23,153
Average Number of Shares Outstanding (m)		359.9	445.3	540.1	540.1	540.1	540.1
EPS (p)		10.38	15.46	12.01	7.92	10.50	6.10
Adj EPRA EPS (p)		3.69	3.43	3.68	3.81	4.11	4.29
Dividends paid per share (p)		3.000	3.000	3.300	3.325	3.425	3.525
Dividend cover (x)		1.23	1.14	1.12	1.15	1.20	1.22
<b>BALANCE SHEET</b>							
Fixed Assets		421,393	536,898	649,406	618,391	671,446	684,946
Investment properties		417,207	532,926	646,018	615,170	668,279	681,779
Other non-current assets		4,186	3,972	3,388	3,221	3,167	3,167
Current Assets		42,879	84,111	37,408	49,960	47,764	49,516
Debtors		10,527	14,019	14,649	16,077	16,771	17,391
Cash		32,352	70,092	22,759	33,883	30,993	32,125
Current Liabilities		(17,369)	(17,480)	(47,521)	(21,171)	(21,163)	(21,783)
Creditors/Deferred income		(14,434)	(16,468)	(18,430)	(20,067)	(20,035)	(20,655)
Short term borrowings		(2,935)	(1,012)	(29,091)	(1,104)	(1,128)	(1,128)
Long Term Liabilities		(232,807)	(233,559)	(222,161)	(205,255)	(217,185)	(217,185)
Long term borrowings		(231,081)	(231,834)	(220,444)	(203,540)	(215,470)	(215,470)
Other long term liabilities		(1,726)	(1,725)	(1,717)	(1,715)	(1,715)	(1,715)
Net Assets		214,096	369,970	417,132	441,925	480,862	495,494
Net Assets excluding goodwill and deferred tax		214,096	369,970	417,132	441,925	480,862	495,494
NAV/share (p)		56.4	68.5	77.2	81.8	89.0	91.7
EPRA NAV/share (p)		56.4	68.5	77.2	81.8	89.0	91.7
<b>CASH FLOW</b>							
Operating Cash Flow		23,145	24,705	33,283	36,283	32,055	34,083
Net Interest		(8,768)	(8,695)	(8,836)	(9,211)	(9,381)	(9,718)
Tax		(394)	(369)	(426)	(232)	(530)	(673)
Net cash from investing activities		(10,838)	(61,729)	(68,123)	48,691	(18,278)	(3,524)
Ordinary dividends paid		(10,711)	(13,102)	(17,822)	(17,957)	(18,497)	(19,037)
Debt drawn/(repaid)		(1,031)	(3,191)	14,591	(46,450)	11,741	0
Proceeds from shares issued		18,043	100,121	0	0	0	0
Other cash flow from financing activities							
Net Cash Flow		9,446	37,740	(47,333)	11,124	(2,890)	1,132
Opening cash		22,906	32,352	70,092	22,759	33,883	30,993
Closing cash		32,352	70,092	22,759	33,883	30,993	32,125
Closing debt		(234,016)	(232,846)	(249,535)	(204,644)	(216,598)	(216,598)
Closing net (debt)/cash		(201,664)	(162,754)	(226,776)	(170,761)	(185,605)	(184,473)
Net LTV				34.6%	27.3%	27.4%	26.7%

Source: Company accounts, Edison Investment Research

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