

Picton Property Income

NAV update

2.6% third-quarter NAV total return

Picton produced a strong 2.6% NAV total return in Q320, with a good property portfolio performance driven by key asset management transactions and portfolio positioning (more than 80% in the well-performing industrial and office sectors). Dividend cover remains strong and increased during the quarter. Moderate gearing and significant potential to increase income by leasing refurbished space at completion are positive indicators for future performance.

Year end	Net property income (£m)	EPRA earnings* (£m)	EPRA EPS* (p)	DPS (p)	EPRA NAV/share (p)	P/NAV (x)	Yield (%)
03/18	38.4	22.6	4.2	3.43	90	1.13	3.4
03/19	38.3	22.9	4.3	3.50	93	1.10	3.4
03/20e	34.8	20.8	3.8	3.50	95	1.07	3.4
03/21e	36.8	23.1	4.2	3.50	96	1.06	3.4

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

Returns driven by asset management and positioning

The Q320 total return of 2.6% comprised a 1.7% increase in EPRA NAV per share and DPS paid of 0.875p. Q320 DPS cover increased to 114% (H120: 107%), benefiting from achieved rental growth. Like for like portfolio valuation growth of 1.4% compares favourably with the 1.0% quarterly decline registered by the MSCI Monthly Index. The previously reported sale of an office building in Croydon contributed to a reduction in LTV to 22.4% and the £15.9m sale of a distribution warehouse in January 2020 will have reduced this further, leaving the company well placed to seize acquisition opportunities. We have increased forecast EPRA NAV by 1p in each of FY20 and FY21, but although Q320 recurring net income was stronger than implied by our forecast, we have left this unchanged, assuming reinvestment of the January sales proceeds with some lag.

Reversionary potential supports growth prospects

Portfolio performance continues to benefit from an overweight position in industrial and regional office property, where positive returns continue reflect a favourable occupational supply-demand balance, and a significant underweighting of retail and leisure (with no shopping centre exposure), where rents and capital values remain under pressure. There is evidence that market conditions have improved since the December general election as political uncertainty has diminished. The gap between estimated rental value at full occupancy (ERV) and the current level of passing rent continues to represent a significant opportunity to grow income and capital values, and completion of current refurbishment projects and subsequent leasing represents a significant share of this opportunity.

Valuation: Total return with sustainable income focus

Picton shares have risen since the UK general election but continue to offer a current yield of 3.5%. Although the company has a strong income focus, its dividend yield is lower than the peer average, reflecting a fully covered position that provides scope to reinvest in the portfolio in ways designed to support occupancy and income growth, with the specific goal of enhancing long-term total return.

Real estate

3 February 2020

Price **102.0p**
Market cap **£559m**

Net debt (£m) at 31 December 2019 153.4

Net LTV at 31 December 2019 22.4%

Shares in issue 547.6m

Free float 99%

Code PCTN

Primary exchange LSE

Secondary exchange N/A

Share price performance



%	1m	3m	12m
Abs	5.2	10.0	14.6
Rel (local)	8.8	8.3	8.1

52-week high/low 102.0p 85.1p

Business description

Picton Property Income is an internally managed UK REIT that invests in a diversified portfolio of commercial property across the UK. It is total return driven with an income focus and aims to generate attractive returns through proactive management of the portfolio.

Next events

Q320 DPS paid 28 February 2020

FY20 results Expected May 2020

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Further details on the Q320 update

Exhibit 1 shows a summary of the Q320 NAV movement. The release can be found in full at www.picton.co.uk.

Exhibit 1: Summary of Q320 NAV movement			
	£m	Movement	Pence per share
NAV at 30 September 2019	510.7		93.6
Movement in property values	7.7	1.5%	1.4
Net income after tax for the period	5.5	1.1%	1
Dividends paid	(4.8)	-0.9%	(0.8)
NAV at 31 December 2019	519.1	1.7%	95.2

Source: Picton Property Income

Strong valuation performance

The 1.4% like for like weighted increase in portfolio values during the quarter was driven by gains in industrial and office assets (more than 80% of the portfolio). The industrial valuations were particularly strong and the 3.2% like for like increase was well ahead of the 0.7% quarterly capital value growth for the MSCI Monthly Index. The 1.4% like for like valuation change in Picton's office portfolio was driven by regional office assets and was also ahead of the MSCI Index (0.3%), while the 3.0% like for like decline in Picton's retail assets was below the 4.4% decline registered by the MSCI Index.

Industrial valuations supported by asset management

The strong capital performance of Picton's industrial portfolio compared with the wider market reflected the three significant asset management transactions disclosed in early January 2020, all in the industrial, warehouse and logistics sector. The transactions extended leases with three of the company's largest occupiers and secured £3.8m pa of income with an average combined headline rental 8% above ERV and 7% above the previous passing rent.

Nine completed new lettings across the portfolio as a whole during Q320 were on average 3% ahead of the H120 ERV, with a combined annual rent of £0.5m.

Significant reversionary potential remains

A continuing large gap between ERV and current passing rent represents a significant opportunity to lift income from the existing portfolio. At the end of H120 the ERV at full occupancy was £9.4m or 25% above the passing rent of £37.9m. £5.8m of this upside potential represented void reduction and 79% of this related to assets under refurbishment. With the Q320 occupancy rate unchanged versus H120 (88%), the completion of current refurbishment projects and subsequent leasing has the potential to significantly drive future income growth.

Financial flexibility for acquisition growth

Picton's moderate level of gearing and the availability of flexible debt funding under its revolving credit facilities (RCF) provide the resources to take advantage of acquisition opportunities that may emerge. The occupational and investment markets appear to have a somewhat firmer tone since the UK general election in December, but it is anticipated that many open-ended property funds will remain under pressure to dispose of assets. During Q320 the company completed the previously reported sale of an office building in Croydon for £18.2m and repaid £11.8m of debt. It ended the quarter with £31.5m available under the RCF and held cash balances of £21.9m.

Since the end of Q320 Picton has disposed of 3220 Magna Park, a 160k sq ft distribution warehouse in Lutterworth, Leicestershire, let to DHL, for £15.9m. The sale price reflects a net initial yield of 5.8% and represents a 4% uplift to the September 2019 valuation following a successful lease restructure during the summer. The lease restructure secured a further three-year lease term until a tenant break option in December 2022, while at the same time settling a rent review and securing an 11% uplift to £1m pa, one of the highest rents in Magna Park. In the short term the proceeds will be recycled to repay revolving credit facilities and provide funding for planned asset management initiatives.

Financials and valuation update

The Q320 valuation result (£7.7m) was ahead of our forecast for the whole of the second half of FY20, set out in detail in our [interim results note](#). As a result, we have increased our assumption for the year accordingly, assuming a further £1.0m uplift in Q4. This has a positive impact on forecast FY20 NAV (increased by 1p per share to 95p with a similar knock-on impact in FY21) and slightly lowers forecast LTV.

Q320 recurring (EPRA) net income of £5.5m and DPS cover (1.14x) was slightly ahead of our H220 forecast run rate (£10.7m EPRA earnings for H220 as a whole and 1.11x H220 DPS cover) but we have left our income forecasts unchanged for now. We expect Picton to seek opportunities to reinvest the £15.9m proceeds from the Magna Park disposal but until this occurs income will be slightly reduced.

Picton has a strong focus on income and pays fully covered quarterly dividends that currently annualise at 3.5p per share (a prospective yield of 3.5% at the current share price), while continuing to invest in the portfolio to support future income growth.

In Exhibit 2 we show Picton's NAV total return performance (change in NAV plus dividends paid) over the five-year period from IPO to 31 March 2019. Without assuming reinvestment of dividends, the aggregate NAV total return over the period was c 94% or a compound annual average 14.2%. The increase in our forecast for FY20 capital growth, driven by the Q320 result, increases our expected NAV total return for FY20 to 6.6% from 5.4% previously. We continue to believe that our FY21 forecast has been struck cautiously, reflecting an expectation that the economic and market environment is unlikely to be as supportive as it has been over the past five years while assuming a relatively modest capture of the upside potential within the Picton portfolio. Over FY20 and FY21 our forecasts imply a compound annual average return of 5.6%, two-thirds derived from well-covered DPS payments. Even on this cautious basis of forecasting there remains a material uplift compared with risk-free returns (the 10-year UK gilt yield is little more than 0.5%).

Exhibit 2: Historical and forecast EPRA NAV total returns

Year ending 31 March	Reported					Cumulative FY15-19	Forecast		Cumulative FY20-21e
	FY15	FY16	FY17	FY18	FY19		FY20	FY21	
Opening EPRA NAV per share (p)	56	69	77	82	90	56	93	95	93
Closing EPRA NAV per share (p)	69	77	82	90	93	93	95	96	96
DPS paid (p)	3.00	3.30	3.30	3.40	3.50	17	3.50	3.50	7.00
EPRA NAV total return	26.9%	17.6%	10.2%	14.7%	6.4%	93.8%	6.6%	4.7%	11.4%
Compound annual total return						14.2%			5.6%

Source: Picton Property Income data, Edison Investment Research forecasts

In Exhibit 3 we show a summary performance and valuation comparison of Picton and what we consider to be its closest diversified income-oriented peers. Picton shares have risen more strongly than the peer group since the UK general election in December and performance is ahead of the peer group over three and 12 months. The valuation comparison is based on last-reported EPRA NAV per share and trailing 12-month DPS declared. On this basis the Picton yield is below the peer average and the P/NAV slightly above. We believe the outperformance of Picton shares and the

share price rating reflect the company's strong track record of property level performance, the future income and valuation growth potential embedded in its portfolio, its good level of dividend cover and relatively modest gearing.

Exhibit 3: Peer group comparison								
	Price (p)	Market cap. (£m)	P/NAV * (x)	Yield** (%)	Share price performance			
					1 month	3 months	12 months	From 12M high
Ediston Property	86	181	0.79	6.7	-4%	-3%	-15%	-22%
BMO Real Estate Investments	86	207	0.83	5.8	2%	0%	-4%	-10%
BMO Commercial Property Trust	112	895	0.84	5.4	-3%	-5%	-14%	-14%
Custodian	114	469	1.09	5.8	0%	-1%	-1%	-6%
Regional REIT	117	504	1.02	7.0	3%	11%	15%	-1%
Schroder REIT	53	275	0.78	4.9	-4%	-4%	-9%	-11%
Standard Life Investment Property	97	393	1.06	4.9	6%	10%	6%	-1%
Average			0.91	5.8	0%	1%	-3%	-9%
Picton	101	554	1.08	3.5	4%	9%	14%	-6%
UK property index	1,909			3.6	-2%	4%	13%	-3%
FTSE All-Share Index	4,102			4.5	-2%	3%	7%	-4%

Source: Company data, Refinitiv, Edison Investment Research. Note: *Last reported EPRA NAV per share. **Trailing 12-month DPS declared. Prices at 30 January 2020.

Exhibit 4: Financial summary

Year end 31 March	£'000s	2016	2017	2018	2019	2020e	2021e
		IFRS	IFRS	IFRS	IFRS	IFRS	IFRS
PROFIT & LOSS							
Rents receivable, adjusted for lease incentives		39,663	40,555	41,412	40,942	38,833	40,509
Other income		1,107	7,356	1,443	1,073	1,658	1,000
Service charge income		5,153	6,487	5,927	5,718	6,172	6,000
Revenue from properties		45,923	54,398	48,782	47,733	46,663	47,509
Property operating costs		(3,308)	(3,501)	(2,578)	(2,342)	(2,592)	(2,500)
Property void costs		(1,540)	(2,023)	(1,830)	(1,373)	(3,076)	(2,200)
Recoverable service charge costs		(5,153)	(6,487)	(5,927)	(5,718)	(6,172)	(6,000)
Property expenses		(10,001)	(12,011)	(10,335)	(9,433)	(11,840)	(10,700)
Net property income		35,922	42,387	38,447	38,300	34,823	36,809
Administrative expenses		(4,411)	(5,249)	(5,566)	(5,842)	(5,800)	(5,945)
Operating Profit before revaluations		31,511	37,138	32,881	32,458	29,023	30,864
Revaluation of investment properties		44,171	15,087	38,920	10,909	13,041	1,832
Profit on disposals		799	1,847	2,623	379	0	0
Operating Profit		76,481	54,072	74,424	43,746	42,064	32,696
Net finance expense		(11,417)	(10,823)	(9,747)	(9,088)	(8,246)	(7,783)
Debt repayment fee					(3,245)		
Profit Before Tax		65,064	43,249	64,677	31,413	33,818	24,913
Taxation		(216)	(499)	(509)	(458)	68	0
Profit After Tax (IFRS)		64,848	42,750	64,168	30,955	33,886	24,913
Adjust for:							
Investment property valuation movement		(44,171)	(15,087)	(38,920)	(10,909)	(13,041)	(1,832)
Profit on disposal of investment properties		(799)	(1,847)	(2,623)	(379)	0	0
Exceptional income /expenses		0	(5,250)	0	3,245	0	0
Profit After Tax (EPRA)		19,878	20,566	22,625	22,912	20,845	23,082
Fully diluted average Number of Shares Outstanding (m)		540.1	540.1	539.7	541.0	546.3	547.6
EPS (p)		12.01	7.92	11.89	5.75	6.23	4.57
EPRA EPS (p)		3.68	3.81	4.19	4.25	3.83	4.23
Dividends declared per share (p)		3.300	3.325	3.425	3.500	3.500	3.500
Dividend cover (x)		112%	115%	122%	121%	109%	120%
EPRA cost ratio including direct vacancy costs)		22.8%	26.1%	23.7%	22.9%	29.1%	25.9%
BALANCE SHEET							
Fixed Assets		649,406	615,187	670,679	676,127	679,731	689,563
Investment properties		646,018	615,170	670,674	676,102	679,708	689,540
Other non-current assets		3,388	17	5	25	23	23
Current Assets		37,408	49,424	50,633	39,477	29,196	26,459
Debtors		14,649	15,541	19,123	14,309	14,091	15,077
Cash		22,759	33,883	31,510	25,168	15,104	11,383
Current Liabilities		(47,521)	(20,635)	(22,292)	(23,342)	(22,079)	(23,557)
Creditors/Deferred income		(18,430)	(20,067)	(21,580)	(22,509)	(21,246)	(22,724)
Short term borrowings		(29,091)	(568)	(712)	(833)	(833)	(833)
Long Term Liabilities		(222,161)	(202,051)	(211,665)	(192,847)	(166,626)	(166,996)
Long term borrowings		(220,444)	(200,336)	(209,952)	(191,136)	(164,911)	(165,281)
Other long term liabilities		(1,717)	(1,715)	(1,713)	(1,711)	(1,715)	(1,715)
Net Assets		417,132	441,925	487,355	499,415	520,222	525,469
Net Assets excluding goodwill and deferred tax		417,132	441,925	487,355	499,415	520,222	525,469
NAV/share (p)		77	82	90	93	95	96
Fully diluted EPRA NAV/share (p)		77	82	90	93	95	96
CASH FLOW							
Operating Cash Flow		33,283	36,283	35,088	34,756	27,959	30,865
Net Interest		(8,836)	(9,211)	(9,125)	(8,630)	(7,899)	(7,413)
Tax		(426)	(232)	(328)	(845)	11	0
Net cash from investing activities		(68,123)	48,691	(17,811)	10,251	9,429	(8,008)
Ordinary dividends paid		(17,822)	(17,957)	(18,487)	(18,860)	(19,076)	(19,166)
Debt drawn/(repaid)		14,591	(46,450)	9,183	(22,616)	(26,595)	0
Net proceeds from shares issued/repurchased		0	0	(893)	(398)	6,107	0
Other cash flow from financing activities							
Net Cash Flow		(47,333)	11,124	(2,373)	(6,342)	(10,064)	(3,722)
Opening cash		70,092	22,759	33,883	31,510	25,168	15,104
Closing cash		22,759	33,883	31,510	25,168	15,104	11,383
Debt as per balance sheet		(249,535)	(200,904)	(210,664)	(191,969)	(165,744)	(166,114)
Un-amortised loan arrangement fees		0	(3,740)	(3,376)	(2,700)	(2,330)	(1,960)
Closing net (debt)/cash		(226,776)	(170,761)	(182,530)	(169,501)	(152,970)	(156,691)
Net LTV		34.6%	27.3%	26.7%	24.7%	22.2%	22.4%

Source: Picton Property Income data, Edison Investment Research forecasts

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