EDISON

Circle Property

Value property specialist

Initiation of coverage

Real estate

Circle Property is an investor in regional UK commercial real estate, founded in 2002 and quoted on AIM since February 2016. It focuses on obtaining assets with good underlying characteristics at attractive prices, whose value can be increased through refurbishment, changes of use and other active asset management initiatives. The experienced executive team takes a hands-on approach and develops an individual management plan for each asset, minimising voids and maximising income and value. The current portfolio of £93m generates annual rents of £5.7m, supporting a c 3% prospective dividend yield, and gave an 18.1% NAV return in FY17.

Year end	Revenue (£000s)	EPS* (p)	Basic NAV/share (p)	DPS (p)	P/NAV (x)	Yield (%)
03/16**	1,260	0.0	154	0.0	1.01	N/A
03/17	5,404	5.4	183	5.0	0.85	3.2
03/18e	5,862	2.7	184	5.2	0.84	3.3
03/19e	6,741	5.0	191	5.2	0.81	3.3

Note: *EPS is normalised, excluding valuation changes on investment properties, goodwill, debt and derivatives. **Period from 4 December 2015 to 31 March 2016.

Finding overlooked value…

The management team seeks to acquire properties with short lease terms remaining, and therefore at low valuations, but which have the potential either for re-leasing on more attractive terms or refurbishment and then re-leasing. In this way it has established a portfolio with a weighted average unexpired lease term of more than seven years, producing recurring rents of £5.7m, and which is valued at £93m having been acquired and improved for a total cost of only £69m. The biggest asset in the portfolio, by value, area and income, is a campus of office buildings and a conference centre near Milton Keynes, which was acquired for £11m in 2013 but is now valued at £32m, demonstrating Circle's ability to identify and add value.

…and enhancing it

Circle has recently completed two major refurbishments and has one underway and has shown that repositioning a property to attract new tenants can significantly enhance both value and income. The projects in Birmingham, Bristol and Milton Keynes all take advantage of properties' good locations near business centres, transport hubs and similar buildings providing good valuation comparisons. Management takes advantage of those attributes by offering quality grade B accommodation to occupiers at competitive rents, minimising vacancy in the first instance and providing an opportunity for further rent growth thereafter.

Valuation: Discount to peers and NAV

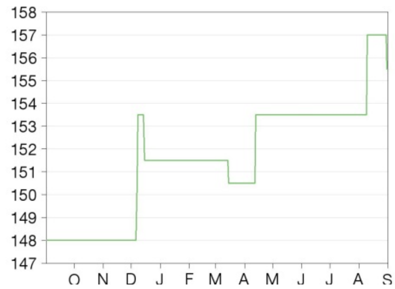
Other investors in regional commercial property trade at NAV on average, whereas Circle is now at a discount of c 15% to 31 March 2017 basic NAV/share of 183p. This may be in part due to perceived development risk, or illiquidity. Our base case forecasts do not include the potential uplift to rental income and NAV should newly refurbished space be let in FY18, and only allow for rents to increase by 2% per annum (below inflation), leaving considerable upside if new tenants are found.

4 September 2017

Price	155.5p
Market cap	£45m

Net debt (£m) at 31 March 2017	40.7
Shares in issue	28.55m
Free float	51.8%
Code	CRC
Primary exchange	AIM
Secondary exchange	N/A

Share price performance



%	1m	3m	12m
Abs	1.3	1.3	5.1
Rel (local)	1.2	2.6	(5.0)
52-week high/low		157.0p	148.0p

Business description

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

Next events

Half year end	30 September 2017

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Edison profile page

Circle Property is a research client of Edison Investment Research Limited

Investment summary

Company description: Regional refurbishment specialist

Circle is an internally managed property investment company registered in Jersey. It was founded in 2002 and has been quoted on AIM since February 2016. It specialises in acquiring short-let office properties in the UK's provincial cities. Management selects assets that would benefit from refurbishment in order to attract new tenants at higher rents on longer leases, with the aim of increasing capital value as well as income. The current portfolio of 15 assets is valued at £93m (31 March 2017) of which 11 office buildings comprise 90%. All the assets but one are outside London and significant refurbishment programmes are ongoing or recently completed at three of them, which are expected to increase rent and capital values significantly on those assets. The concentration of assets is mitigated to some extent by a more diverse lease portfolio of 113 units let to 53 tenants, ranging from major international companies such as Compass Group to local businesses. Circle's priority is to let space quickly and it is able to offer space at a discount to grade A accommodation as a result of its acquisition criteria, minimising vacant space and making it a competitive landlord in its local markets.

Financials: Simple income statement and balance sheet

At 31 March 2017, Circle had an annualised rent roll of £5.7m, which is a significant increase on a like-for-like basis since a year earlier, when passing rent stood at £5.1m, excluding the £0.8m of rental income subsequently forgone to allow the refurbishment of Somerset House in Birmingham. Circle has a relatively simple balance sheet, with a single £50m revolving credit facility from NatWest comprising all of its debt (£45.6m drawn) at a rate of 1.85% over Libor. A cash balance of £4.9m gives net LTV of 47%, a level that has been steady since admission to AIM. This is lower than when Circle was a private company, following debt reduction before the financial crisis and the introduction of a more conservative debt policy. The company has a single class of ordinary shares, of which less than 1% are held in treasury to cover any awards under the long-term incentive plan (LTIP).

Valuation: Wide discount and potential upside

Circle does not report EPRA NAV or EPS measures, so we have produced estimates of these in order to aid comparison with peers. 31 March 2017 IFRS NAV per share of 183p less deferred tax gives an estimated diluted EPRA NAV of 177.0p. On that basis the shares trade at a c 16% discount, which is higher than the average of regional UK commercial property companies (0%). We note that rental profits support a dividend prospectively yielding c 3% currently (peer average: 5%) and that the board has a progressive dividend policy. As described in the valuation section on page 9, our base case assumptions do not allow for new leases to be signed on space refurbished in FY17 and Q118, which could add £2.3m to the rent roll and significantly increase valuations. Should management achieve expected rental values on all three of those projects, our FY18 and FY19 NAV estimates would rise from 184p and 191p to 205p and 245p, respectively, and rental income would go from £5.9m and £6.7m to £6.0m and £7.3m (allowing six months after work has finished before tenants move in), with a potentially significant effect on the dividend too.

Sensitivities: Protection from high-yield regional asset base

Commercial real estate capital values tend to be more volatile than rental income, and despite the protection afforded by the relatively high-yielding portfolio and the regional focus of the portfolio, Circle is sensitive to property market cycles. In the near and medium term we view the results of its asset management initiatives as the most likely catalyst for changes in rent, NAV and share price.

Traditional play on underinvested property

Background

Circle Property was originally founded as Circle LP in 2002 with backing from James Hambro (still a non-executive director), John Arnold (CEO) and John Bodie, and had seed capital from 44 original investors from 15 families. Another entity, Circle General Partner Limited, acted as general partner with the purpose of investing the initial £7.5m in special situation properties. The first acquisition was made in May 2003. In 2006 Circle Property Unit Trust (CPUT) was formed and acquired the business and assets of Circle LP, then valued at £27.6m; a further £10.6m was raised and Edward Olins was recruited as head of investment (he is now COO). Circle Property Management Limited (CPML) was also established to manage the property portfolio on an exclusive basis. In the two years following CPUT's foundation, the financial crisis began and CPUT made several disposals in order to realise gains and to reduce debt. On 11 February 2016, CPUT and its unit holders entered into an agreement to exchange their units for ordinary shares in Circle Property on its admission to AIM, and at the same time Circle Property acquired CPML (for a consideration of 704,697 ordinary shares at £1.49 each), internalising management of the portfolio. The shares were admitted to trading on AIM on 16 February 2016 at a price of 149p.

Strategy

Circle seeks to have a diversified exposure to UK commercial property, currently weighted towards offices, by acquiring buildings that are undervalued either because they have short leases or are empty and may need to be refurbished, but are well-located and have strong letting potential. Acquisitions are typically at close to vacant possession value and allow management to use its expertise to undertake cost-efficient refurbishment and development to maximise reversionary rental values and secure new leases on the properties. Once the process of refurbishing an asset is under way, management will seek to attract tenants quickly with competitive rents in order to beat local competition, but still aims to achieve attractive yields. In this way management seeks to increase both rental income and capital values. The company will dispose of properties that are not considered to have further potential and where an attractive price can be struck. The board's strategy is to deliver annual total returns over 12% (FY17 IFRS NAV return: 18.1%), targeting returns of at least 15% on the costs of development expenditure and acquisitions. Debt and capital structure are simple, with a single revolving credit facility (RCF) from NatWest and a single share class.

Although the current portfolio is relatively small, the move to AIM in 2016 was made with the intention of providing shareholders with flexibility in managing their investment and also the opportunity to raise new equity funding for growth. While management has not quantified its pipeline of opportunities, we understand that opportunities are frequently presented to them and believe that the current environment should be favourable, with investment in new regional offices potentially subdued due to macroeconomic uncertainty, but occupier demand reported to be robust. At the current level of 47%, net LTV is above the peer average, and the existing RCF is mostly drawn, which implies that an equity raise may take place to fund additions to the portfolio. Capital recycling through disposals of assets that have been repositioned and then fully let are another possibility.

Management

By managing the portfolio internally, Circle controls costs (there is no NAV-linked annual management fee) and should benefit from economies of scale as the portfolio grows. There is a performance-related LTIP under which the senior management (CEO and COO) can earn bonuses of up to 100% of their salaries in nil cost options to acquire ordinary shares in the company. These are granted annually dependent on performance: a combination of total shareholder return (share price movement plus dividends) and total NAV return (NAV change plus dividends) is measured. The first is compared to a basket of peers selected by the Nomad (Peel Hunt) and the second is based on hurdle rates. If the performance is below the median, no awards will be made; if Circle reaches the median, a bonus equivalent to 50% of salary is earned, increasing to a maximum of 100% proportional to performance.

The senior management team consists of the CEO and founder, John Arnold, and Edward Olins, the COO. Mr Arnold joined Hambros plc in 1986 and became a director of Berkeley Hambro, its property subsidiary, in 1987 for 11 years until becoming a managing director of Berkeley Hambro when Investec bought Hambros Bank in 1998. He established Circle LP in 2002. Mr Olins joined a leading London property investment agency in 1995 and became a partner there in 2000, leaving in 2003 to join London & County Estates as investment director. He joined Circle in 2006.

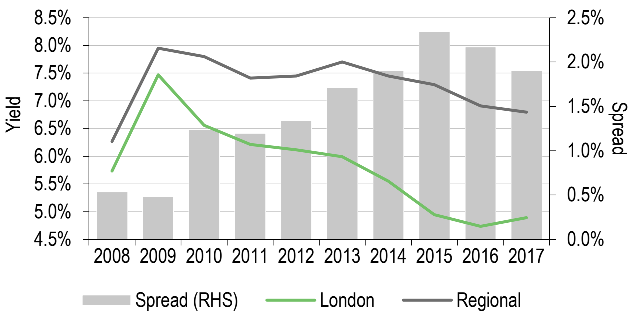
Ownership

61.05% of the shares are owned by family members of the directors and original unit holders of CPUT, and 48.2% of the shares are classified as not being in public hands, although in practice these shares are not subject to lock-in agreements. Of the 28.55m shares in issue, 0.26m (0.9%) are held in treasury to be used for the LTIP.

The regional office market

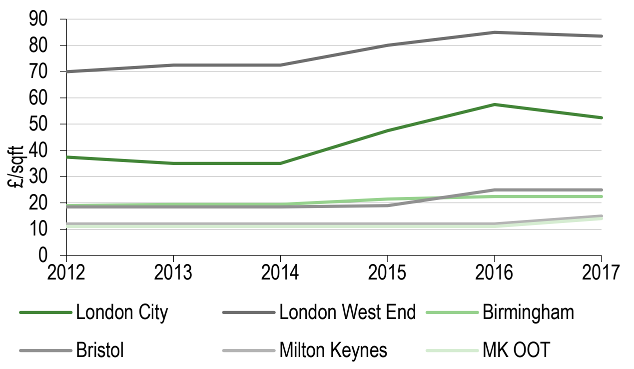
The Bank of England's recent Financial Stability Review highlights two asset classes whose prices the Financial Policy Committee believes "do not appear to reflect fully the downside risks that are implied by very low long-term interest rates". One of these is commercial real estate (CRE), and Chart E of that publication shows that prices for West End offices may be unsustainable, while aggregate CRE prices are merely at the higher end of the sustainable range. We would argue that in provincial cities, whose economies may be less sensitive to risks to the financial services sector from Brexit, the effects of changes to immigration rules for EU citizens and other macroeconomic factors, valuations are less stretched. Circle's focus on undervalued property provides further protection from a potential downturn in the property cycle.

Exhibit 1: London vs regional reported yields



Source: Company data, Edison Investment Research

Exhibit 2: Grade B rents in selected cities



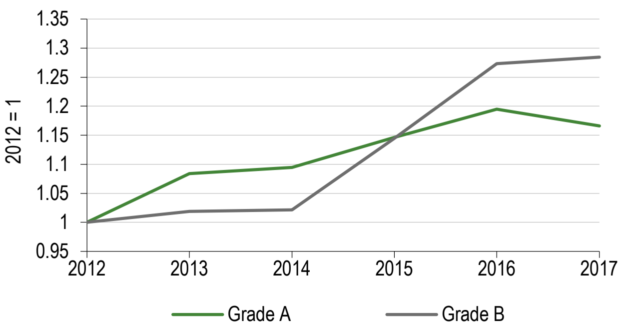
Source: Colliers

In Exhibit 1 we show the average portfolio equivalent yields for a basket of investors in London property against a smaller basket of regional investors (these report net initial yields, so the two are not directly comparable, but we believe that the chart still illustrates a valid point). For both groups a sharp increase in yields followed the financial crisis as property values fell and rents were slower to move. Since 2009 there has been a strong recovery in London values and a slower recovery in the regions. In the last year, however, London yields have actually risen for the first time since 2009, while the regions continue to see compression. In Exhibit 2 we show achievable rents for grade B offices (1990s stock) on 10-year term-certain leases in selected areas. These show that City and West End office rents softened from 2016 to 2017 while regional rents were steady or rising. For yields to have risen in London, values must have fallen further than rents, implying weakness in the grade B office market compared to the regions.

The charts above appear to show that the regional office market remains relatively healthy, and this is supported by supply data. The Deloitte London Office Crane Survey for the summer of 2017 reported that although construction levels have dipped, the pace of completions will accelerate in 2017, and that London has reached a 13-year high in terms of completed space. Although occupier demand has held up, supply may be outstripping it. The Manchester and Birmingham crane surveys show that new starts are reaching post-2007 highs, which implies that demand is still driving an increase in regional development. We note that in both cities there has been a sharp increase in residential construction (28 residential schemes underway in Manchester vs 12 office schemes, 10 and seven, respectively, in Birmingham), whereas in central London offices account for a much higher proportion of construction.

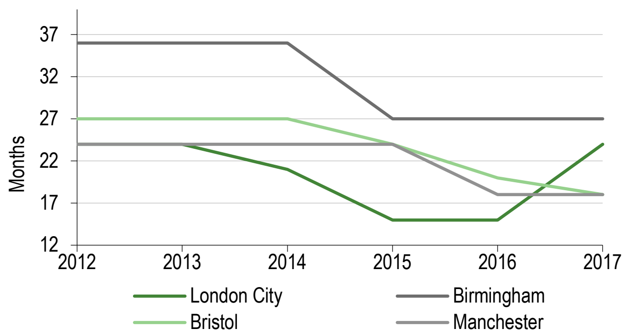
Circle operates in the grade B and C segments as opposed to the new-build segment followed by most commentators, attracting tenants and filling space quickly by offering good accommodation at competitive prices. It benefits from the undersupply of new offices, which is reported to be the case in Bristol in particular, where Colliers says city centre availability fell 10% in Q117, driven mainly by lower grade B availability.[1] It also benefits from the lack of refurbishment of older offices, which gives it a bigger market to acquire from and restricts supply for its target tenants. In both Birmingham and Bristol, only one major grade B refurbishment took place in 2016 according to Colliers, making Circle's smaller projects more likely to attract occupiers. As Exhibits 3 and 4 show, since 2014 grade B rents have outperformed grade A and regional incentives (rent-free periods at the start of a lease used to attract occupiers) have fallen or remained flat, whereas they have returned to 2012 levels in London, where they are now longer than in Bristol or Manchester.

Exhibit 3: Grade A vs grade B office rent growth index



Source: Colliers, Edison Investment Research

Exhibit 4: Incentive periods



Source: Colliers, Edison Investment Research

In broader economic terms, in Birmingham, where Circle's second-highest concentration of assets is (after Milton Keynes), the recent appointment of a metro mayor in May and Royal Assent for HS2 in February are both expected to support continued economic growth. While Manchester has recently attracted more investment in new development, it is notable that Birmingham has seen similar economic growth, has a comparable population (both cities have 2.8 million people in their metropolitan areas) growing faster (at 4% per annum vs 2% in Manchester), is closer to the UK's economic centre of gravity in the South East, and will have its HS2 connection first. Bristol also has a new mayor and is expected to stay among the leaders of UK regional economic redevelopment

[1] *Bristol Office Snapshot Q1 2017*, Colliers International, figure 1.

too. Despite the uncertainty over the UK's relationship with the EU, the government is now committed to regional infrastructure development, backed up by political reform and devolution of power, which we expect to support occupier and investor demand for regional offices.

Portfolio

Circle's portfolio has been stable since admission to AIM in February 2016, comprising 11 office buildings and four retail (or mixed retail and office) and industrial sites, valued at £93.0m as of 31 March 2017 – a 4.4% uplift since 30 September 2016 (£89.1m) and a 19.7% increase from 31 March 2016 (£77.7m), largely due to asset management initiatives. The weighted average unexpired lease term to first break is 7.8 years and 11.5 years to expiry. The exhibits below give the portfolio breakdown by location and sector, showing diversity across the UK and a focus on office property. The assets vary from small high-street office buildings valued at under £2m, to Kents Hill Park in Milton Keynes, a complex valued at £32m, which includes a conference centre and seven other office buildings. 66% of the portfolio by value is concentrated in the Milton Keynes asset (34%) and six others in Bristol and Birmingham. The tenant base is more diverse, ranging from regional solicitors to FTSE 100 companies, and supports annual passing rent of £5.7m as of 31 March 2017, with the potential to generate £8.9m at full occupancy and ERV. Occupancy was 80% at 31 March, down from 89.1% at 31 March 2016, as a result of the strategic taking back of space at Somerset House in Birmingham and other refurbishment projects. Excluding space under refurbishment, occupancy rose from 90.6% at 31 March 2016 to 96.0% at 30 September 2016 and was at 99% at 31 March 2017. The portfolio and tenants are summarised in Exhibit 7 overleaf and we look at several individual assets to illustrate management's strategy below.

Exhibit 5: Portfolio value by location

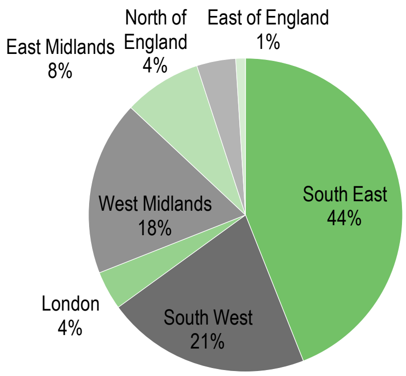
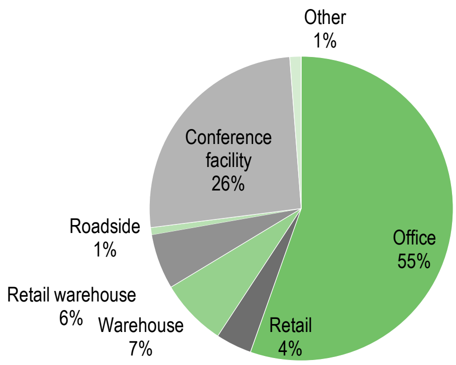


Exhibit 6: Portfolio area by sector



Source: Circle Property data as at 31 March 2017, total area 634,801sqft.

Kents Hill Business Park, Milton Keynes

Acquired in 2013 for £11.05m, the business park and conference centre were most recently valued at £32m, representing 34% of the portfolio and a capital return on the initial investment and £4.7m refurbishment spend of more than 100%. The low acquisition price was possible because at the time the lease had a very short unexpired term and it was expected that the tenant, Compass Group, might resist an increase in rent or vacate the property. Management's judgement that Compass would remain was correct and a new 10-year lease was signed at £875k per annum with an uplift to £1m in year six. This was re-geared again in September 2016 with Compass signing a 25-year lease with tenant's breaks at 15 (incurring a £2m break penalty) and 20 years. The rent is £1.5m per annum with 3% annual fixed uplifts. Compass leases six of the eight buildings on the site, including the conference centre, although Circle has the right to take one of those back without any effect on rent. The remaining two buildings have been completely refurbished and one (K1) has been let for c £400,000 pa. The remaining building, K2, is expected to be let at an ERV of over

£600,000; this would represent a 40% uplift to the rental income from Kents Hill and would therefore potentially add a significant amount to its valuation. Kents Hill is Circle's key asset and is exemplary of management's strategy of sourcing undervalued assets and increasing both income and capital value through active management.

One Castle Park, Bristol

One Castle Park is a large (c 78,000sqft) office building located within walking distance of Temple Meads and Cabot Circus, the business and retail centres of Bristol. At the time of acquisition in 2012, 39% of the building was vacant, with the lease on a further 26% expiring in 2014, meaning that Circle was able to acquire the property for £4.17m but then lease the whole building for annual contracted rent of £1.04m after spending £780,000 on refurbishment. This has increased its capital value to c £14m, again well ahead of the 15% targeted return on investment. The average rent at One Castle Park is reported to be £16.65/sqft currently, but based on a comparable building nearby, ERV is £20/sqft. This implies a potential 20% uplift in rental income, which could be realised in the near term as leases come up for review later this financial year, again with a significant potential impact on valuation.

36 Great Charles Street, Birmingham

Acquired for £2.5m in 2015, this is a 25,000sqft office building in the core office district, near to the major redevelopment of the area around the city hall. On acquisition it was c 65% vacant, enabling a rolling refurbishment with tenants being moved to the refurbished parts and their former accommodation then being worked on. The c £2.1m works are now complete, and marketing of the space was launched on 11 July 2017 at an ERV of more than £0.5m, representing a yield in excess of 9.5% on costs.

Somerset House, Temple Street, Birmingham

This building was bought in January 2016 for £7.75m and a full refurbishment was planned at a cost of c £3.7m. Permission for a change of use for the ground floor from offices to A3 restaurant has been obtained and the ground floor (10,950sqft) has an ERV of £420,000 (c £37/sqft). The northern half of the ground floor has been let to a national restaurant chain for more than half that amount and the southern unit is being marketed. Completion of the refurbishment of the six office floors above is scheduled for September 2017 with a final ERV of around £830,000, implying a c 10.5% yield on acquisition and refurbishment costs for the asset. The leasing of the whole building would add £1.25m of rental income per annum and again significantly enhance its capital value.

Cheltenham House, Temple Street, Birmingham

The property was bought in 2013 for less than £1m and, following a complete refurbishment in 2014 for £1.2m, the whole building is now let to the New World Pub Co (which operates the Botanist chain) until 2039 with the next rent review in 2020. It was valued at £3.4m in March 2016, on a net initial yield of c 7.2%, with a reversionary yield of nearer 10%.

Exhibit 7: Portfolio

Asset	Tenure	Sector	Gross lettable area (sqft)	Value (£m)	Rent (£000s)	ERV (£000s)	Tenants	Notes
Kents Hill Park, Milton Keynes	Freehold	Office	244,634	32.9	1,889	2,500	Compass	Rising 3% per annum
One Castle Park, Bristol	Freehold	Office	78,478	14.0	1,060	1,250	Which?, JISC, Irwin Mitchell	
Somerset House, B'ham	Freehold	Mixed	47,433		250	1,200	Under refurbishment	
Park House, Northampton	Freehold	Office	43,577	5.8	526	575	Grant Thornton, NRG	
Power House, Milton Keynes	Freehold	Office	21,401		525	575	Urgent Technology	
36 Great Charles Street, B'ham	Freehold	Office	24,123	4.6	75	525	National Governors' Association, Allianz, refurb	
Cheltenham House, B'ham	Freehold	Mixed	16,578		225	350	New World Pub co (Botanist)	Let until 2039
Otley Road, Shipley	Freehold	Retail	37,169		300	350	B&M Bargains	
141 Moorgate, London	Leasehd	Office	11,412	4.0	182	310	Drayton Finch, Leigh Travel, MLEX, Eximbills, Equus	Listed
Victory House, Northampton	Freehold	Office	22,327		200	300	Regus	
Elizabeth House, Staines	Freehold	Office	14,834		225	275	Elliot Turbo Machinery, London Power Associates	
Aztec West, Bristol	Freehold	Office	13,000		175	260	Davies & Co Solicitors	
Solstice Park, Amesbury	Freehold	Retail	3,229		200	200	Co-op	
Great Blakenham, Suffolk	Freehold	Industrial	45,319		125	150	Anchor Safety, Willis	
69-77 Week Street, Maidstone	Freehold	Retail	7,500		125	125	Morrison's	Long leases sold on upper floors, which are being redeveloped as residential space.
Total			**631,014**	**93.0**	**5,905**	**8,920**		

Source: Circle Property data. Note: Rents and ERVs are approximate.

Financials

The results to 31 March 2017 have no direct comparator, with the prior reported period being from 5 December 2015 to 31 March 2016. Having said that, the main elements of return were considerably higher on a pro rata basis in FY17 than in the prior period, with rental income up 150% and a 9.5% gain in property valuations. We provide a summary of each element of the company's finances and the basis of the assumptions underlying our forecasts below.

Earnings

Rental income and valuation gains on investment property are the two largest contributors to reported income, with adjusted earnings excluding the latter as a non-cash and non-recurring gain. Circle also reports insurance recovery from tenants and makes an adjustment for the spreading of lease incentives across the term of a lease (which is included in rental income). Expenses are similarly straightforward with the key costs being staff, refurbishment spend (which is capitalised), repairs and maintenance (which are expensed), insurance, service charges and, when incurred or received, lease surrender premiums.

In our earnings forecasts we allow for no increase or decrease in occupancy until FY19, which is based on the assumption that it will take one year to find tenants for space that is currently being refurbished, but that existing tenants are willing to renew their leases as breaks and expiries arise, which we believe to be reasonable because of the competitive prices Circle offers and its close engagement with occupiers. We assume no rent increases (except at Kents Hill where fixed 3% increases are contracted), but note that in several cases, there is a possibility that increases occur as they did at Kents Hill. Specifically, One Castle Park is close to another building of a similar age and specification where rents are c 20% higher per square foot, implying that Circle could secure meaningful rent and valuation increases there. Other significant upside is possible should K2, 36 Great Charles Street and Somerset House in Birmingham be fully occupied sooner than we have assumed, and we would highlight the £7.4m revaluation gain on investment properties achieved in FY17, a 9.5% uplift on the portfolio's March 2016 value.

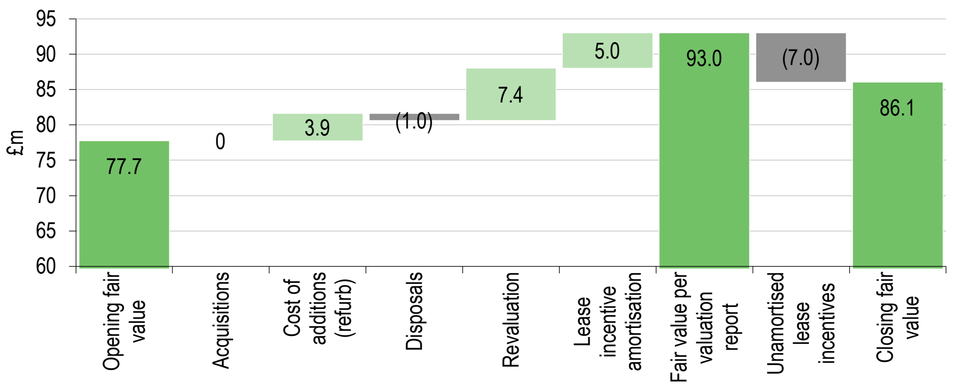
Our cost assumptions allow for increased agents' fees when properties are expected to be leased, a further £3m of refurbishment costs in FY18 and for administrative expenses to be flat. This feeds through to operating profits of £2.8m and £4.4m in FY18 and FY19.

Balance sheet

As noted above, Circle has a simple balance sheet, with net LTV of 47%, and a single source of debt in the form of a £50m RCF from NatWest. The RCF was signed on 21 June 2016 with a three-year term and options at NatWest's discretion to extend twice for a further year. While LTV is below 55%, interest is incurred at 1.85% over Libor, and over that threshold at 2.75%. Circle is well within the covenants of 1.75:1 interest cover (FY17 c 9:1) and 65% LTV. We note that some of the undrawn facility (£4.4m) will be used to complete refurbishment projects and that further additions to the portfolio may require additional funding, either from disposals or through equity increases.

In Exhibit 8 we show the change in investment property valuation in FY17, illustrating the significant valuation gain and also the amortisation of lease incentives. These are recognised as an integral part of the net consideration of the lease and are amortised in a straight line throughout the term of each lease. Unamortised incentives are deducted from the fair value of investment properties in the balance sheet, but not in the portfolio valuation report. Because we assume no acquisitions or disposals, the only increases in portfolio value are due to ERV rising (we assume 2% per annum, which we believe to be conservative compared with inflation of c 3%) at a steady valuation yield and capitalised refurbishment expenditure. A table showing the sensitivity of NAV per share to different ERV increase assumptions is shown in the valuation section below. It should be noted that the biggest changes in ERV are likely to be one-off movements due to refurbishment work or new leases on comparable buildings near Circle's assets. The potential increase in rental income in FY18 is £2.3m just from new leases at the three assets that have recently been/are being refurbished, nearly doubling the current income they generate. The valuations of those assets could therefore rise very significantly, and we provide an illustration of the possible change in the valuation section below, although our forecasts use more conservative assumptions.

Exhibit 8: Investment properties in FY17



Source: Circle Property data

Valuation

We value Circle on an NAV basis because it aims to provide capital value increases and because its assets are valued in part according to the rental income streams they generate. Not being a REIT, the company is free to make distributions as the board sees fit, without the restrictions of REIT property income distribution (PID) rules, so we have not used the dividend discount approach we have taken with some REITs. We make the assumption that valuation yields remain flat, and therefore that ERV growth drives asset values. Our base case uses the assumption that rental growth is 2% per annum, which we believe is conservative compared with inflation of c 3%. 31 March 2017 basic NAV per share stood at 183p, putting the shares (155.5p) at a 15% discount. Our FY18 basic NAV estimate is 184p, and we have assumed that future dividends will be the same as the 2.6p final dividend declared in August 2017. If we assume that ERVs rise in line with current inflation of c 3% and that feeds through to the valuations of occupied space (currently 82.1% of gross lettable area), our FY18e basic NAV increases to 186p (Exhibit 9). We note that this does not take into account any yield movement, nor any increase in occupancy in FY18, both of which are possible and contributed to the 18.1% NAV return in FY17.

Exhibit 9: NAV sensitivity to annualised ERV growth (p/share)

Annualised ERV growth	Basic 2018e NAV	Basic 2019e NAV
0.0%	181	181
0.5%	182	183
1.0%	182	186
1.5%	183	188
2.0%	**184**	**191**
2.5%	185	193
3.0%	186	196
3.5%	187	199
4.0%	188	201

Source: Edison Investment Research. Note: Base case estimates in bold.

Upside scenario

To illustrate the potential upside to our conservative estimates, we provide a scenario analysis using the assumption that the portfolio reaches its reversionary rental levels and that it is valued on a 7% yield (close to the peer average equivalent yield and above Savills' most recent estimate for regional prime offices at 5.25%). As noted above, this could see the portfolio's value rise to c £106m, taking NAV from the current level of £51.8m to £69.4m, or 183p per share to 245p at the end of FY19, a 34% increase over two years.

The changes to rental income assume that leases for £2.1m of the £2.3m of additional rent from refurbished space are signed, spread evenly across H218, H119 and H219, and that ERVs on existing space rise 2% per annum (below current inflation) with 3.2% of existing rent reverting to this level each half year. The figure of 3.2% is reached by assuming that 50% of rents will revert in the weighted average unexpired lease term (WAULT) of 7.81 years, and spreading the reversion evenly over that period. This brings passing rent to £8.1m at the end of FY19, which would value the portfolio at £115.7m using a 7% yield. This would add £17.6m to NAV, taking it to £69.4m (including adjustments), or 245p per share at 31 March 2019, after adjusting for lease incentives and capex. Given the unpredictability of valuation yields, the occupier market, potential lease incentives, etc, this should be regarded as a potential upside scenario. We will review our estimates as news of lettings and valuations emerges.

Exhibit 10: Upside scenario				
£000s	FY16	FY17	FY18e	FY19e
Total income	**1,260**	**5,404**	**6,037**	**7,394**
Revaluation gains	0	7,361	6,140	10,668
Operating profit	1,217	9,979	8,690	14,243
Net profit	1,073	9,944	7,521	12,952
EPRA earnings	700	1,554	1,381	2,283
EPRA EPS (p)	**0.0**	**5.4**	**4.8**	**8.0**
Dividend (p)	0.0	5.0	5.2	5.2
Portfolio fair value	**77,735**	**93,025**	**103,506**	**115,665**
Unamortised lease incentives	(1,954)	(6,971)	(8,232)	(9,722)
Investment properties	**75,781**	**86,054**	**95,274**	**105,943**
Other assets	9,884	13,907	10,737	11,549
Total liabilities	(42,430)	(48,140)	(48,140)	(48,140)
NAV	**43,236**	**51,822**	**57,871**	**69,352**
NAV/share (p)	**154**	**183**	**205**	**245**

Source: Edison Investment Research

In Exhibits 11 and 12 we compare Circle to other investors in regional commercial real estate. Circle trades at a considerably higher discount to NAV than the peer average, which may be connected with its willingness to take on development risk (which it shares with Palace Capital, also on a c 15% discount to NAV).

Exhibit 11: Peer comparison – valuation metrics							
	Market cap (£m)	Price (p)	NAV/share (p)	Price/NAV (x)	Adj. EPS (p)*	EPS yield on NAV (%)	Dividend yield (%)
Circle Property	**44.0**	**155.50**	**181.5**	**0.86**	**5.4**	**3.0%**	**3.2**
Custodian REIT	407.5	115.00	103.8	1.11	8.1	7.8%	5.5
A&J Mucklow	307.5	485.75	446	1.09	39.9	8.9%	4.5
Palace Capital	96.8	385.00	443	0.87	36.6	8.3%	4.8
Picton Property Income	461.7	85.50	81.8	1.05	3.8	4.6%	3.9
Real Estate Investors	106.3	57.00	65	0.88	4.3	6.7%	4.8
Regional REIT	308.8	102.75	106.4	0.97	4.9	4.6%	7.0
Schroders REIT	326.7	63.00	64.1	0.98	4.4	6.9%	3.9
Average ex Circle	**287.9**	**184.9**	**187.2**	**1.0**	**14.6**	**6.8%**	**4.9**

Source: Bloomberg, company data, Edison Investment Research. Note: *EPS is adjusted for non-recurring items including revaluation uplifts and changes in the value of financial instruments. Prices as at 30 August 2017. NAV/share is taken from Bloomberg for consistency of comparison and is IFRS diluted NAV.

We also note that Circle currently has the highest net LTV ratio (but lowest cost of debt) and lowest dividend yield of the group. It has the highest equivalent yield of the group though, and the widest spread between that and net initial yield, so potentially the highest rental increase (Exhibit 12).

Exhibit 12: Peer comparison – performance metrics					
	LTV (%)	Average cost of debt (%)	Vacancy (%)	Net initial yield (%)	Equivalent yield (%)
Circle	**46.7**	**2.4**	**18.9**	**6.0**	**9.2**
Custodian REIT	14.9	3.1	1.4	6.4	6.8
Mucklow	20.7	3.1	4.1	6.3	7.2
Palace	40.3	2.9	9.0	5.9	7.6
Picton	28.0	4.2	4.0	5.9	6.9
Real Estate Investors	39.4	4.1	5.5	6.4	8.6*
Regional REIT	40.7	3.7	17.2	6.7	-
Schroders REIT	30.3	4.4	6.2	5.2	6.7
Average ex Circle	**30.6**	**3.6**	**6.8**	**6.1**	**7.3**

Source: Company data. Note: *Reversionary yield.

As explained in the previous section, these estimates do not assume that all leases revert to ERVs and we would emphasise the fact that Circle's portfolio has the highest reversionary yield of the peer group. A 9.2% yield of the current portfolio valuation of £93.0m implies rental income of £8.56m per annum. If that were to be achieved, but the portfolio was valued on a 7% yield – close to the peer average reversionary yield – the implied value is £115.7m, a 24% increase on the current portfolio.

Finally, the illiquidity of the shares in recent months may be a factor. Given Circle's focus on increasing capital value and attracting new tenants, and therefore income, as soon as possible after completing a refurbishment, NAV may increase ahead of our forecasts, having a knock-on effect on the share price if the discount remains steady, and both earnings and dividends could also exceed current market expectations.

Sensitivities

As with all property investments, Circle is sensitive to market cycles, with capital values historically being more volatile than rental income. Circle's focus on non-prime and non-London properties should provide some protection from any cyclical downturn as illustrated above. The same factors should also mitigate the impact of a weaker pound due to Brexit, and we note that several commentators (Colliers, JLL and Savills among them) expect higher levels of foreign investment in UK regional property as a result of the weaker pound, which may be beneficial for sterling valuations should local investor demand weaken. We would also highlight the fact that Circle's strategy of acquiring cheaper assets and improving their value should also protect against valuation downside. Company-specific sensitivities include:

- **Rent and valuation uplift:** As described above, new leases, especially at K2, 36 Great Charles Street and Somerset House, could add £2.3m to the rent roll and would positively affect the values of those assets. These are not allowed for in our estimates and represent a sensitivity to the upside.
- **Development risk:** Refurbishment projects may overrun in time or cost, delaying revenues and increasing expenses. This is mitigated by the team's extensive experience in managing such projects and the careful selection of assets where improvements can be made quickly and economically.
- **Concentration risk:** As noted above, much of the portfolio's value and rental income is concentrated in a few assets; this concentration will diminish as new leases are signed on space that is currently vacant or under refurbishment. We would also note that the largest lease on the most valuable asset, at Kents Hill, has a 15-year term certain with fixed 3% uplifts every year, and is with Compass Group, a FTSE 100 company. The covenant on that lease is therefore of a high quality and, in the event that the tenant did terminate early, would likely result in a sizeable one-off lease surrender payment.
- **Key man risk:** The CEO and COO have been in place for 15 and 11 years, respectively, and are important to the development of the company. We understand that another property professional is being sought to help expand the portfolio and share the work of finding new tenants and potential acquisitions. Management's wide network of property agents and the board's expertise also help mitigate this risk.
- **Low liquidity:** The shares are relatively tightly held and their illiquidity may weigh on the price. Any future equity capital raise might help alleviate that restriction, as well as allowing further portfolio growth.

Exhibit 13: Financial summary

Year end 31 March	FY16*	FY17	FY18e	FY19e
£000s	IFRS	IFRS	IFRS	IFRS
INCOME STATEMENT				
Rental income	664	5,266	5,862	6,741
Other income	595	138	0	0
Total income	1,260	5,404	5,862	6,741
Property expenses	(123)	(1,037)	(1,161)	(1,335)
Net rental income	1,137	4,366	4,701	5,406
Administrative expenses	(293)	(2,115)	(2,898)	(2,898)
Operating profit before valuation gains	844	2,251	1,803	2,508
Gains on disposal of investment properties	0	279	0	0
Revaluation	0	7,361	1,000	1,919
Negative and impaired goodwill	1,700	196	0	0
Listing costs	(1,326)	(107)	0	0
Operating profit	1,217	9,979	2,804	4,428
Net finance costs	(112)	(13)	(999)	(999)
Profit before tax	1,106	9,966	1,805	3,429
Tax	(32)	(22)	(40)	(76)
Net profit	1,073	9,944	1,765	3,353
Less revaluation	0	(7,361)	(1,000)	(1,919)
Less adjustments for effective interest rate on borrowings, fair value of swaps and goodwill	(374)	(1,029)	0	0
EPRA earnings	700	1,554	765	1,434
Shares (thousands)	28,166	28,297	28,297	28,297
LTIP shares (thousands)	0	255	255	255
EPS (p)	0.0	35.1	6.2	11.8
EPRA EPS (p)	0.0	5.4	2.7	5.0
Dividend paid (p)	0.0	4.7	5.2	5.2
Dividend declared (p)	0.0	5.0	5.2	5.2
BALANCE SHEET				
Non-current assets				
Investment properties	75,781	86,054	90,134	92,054
PPE	22	29	29	29
Trade and other receivables	1,771	6,518	5,257	3,767
Deferred tax	915	1,142	1,142	1,142
Financial instruments at FV through P&L	0	1	1	1
Total non-current assets	78,490	93,744	96,563	96,992
Current assets	0	0	0	0
Trade and other receivables	2,555	1,195	1,195	1,195
Deferred tax	105	128	128	128
Cash and equivalents	4,516	4,894	2,369	3,821
Total current assets	7,176	6,217	3,692	5,145
Total assets	85,665	99,962	100,255	102,137
Non-current liabilities				
Borrowings	(40,028)	(45,590)	(45,590)	(45,590)
Financial liability at FV through P&L	(95)	0	0	0
Total non-current liabilities	(40,123)	(45,590)	(45,590)	(45,590)
Current liabilities	0	0	0	0
Trade and other payables	(2,306)	(2,550)	(2,550)	(2,550)
Total liabilities	(42,430)	(48,140)	(48,140)	(48,140)
Net assets	43,236	51,822	52,115	53,997
Basic NAV per share (p)	154	183	184	191
Diluted NAV per share (p)	154	182	183	189
EPRA net assets	42,216	50,552	50,845	52,727
EPRA NAV per share (p)	150	177	178	185
CASH FLOW				
Profit before tax	1,106	9,966	1,805	3,429
Adjusted for				
Net finance expense	112	1,245	999	999
Depreciation	1	7	0	0
Share-based payments	0	0	0	0
Gains on revaluation	0	(7,361)	(1,000)	(1,919)
Gains on disposal of investment properties	0	(279)	0	0
Amortisation of loan arrangement fees	7	40	0	0
Goodwill, interest rate ans swap valuation movements	(1,751)	(1,523)	0	0
Working capital movements	1,132	(3,512)	1,262	1,490
Cash from operations	607	(1,416)	3,065	3,998
Tax and interest	(56)	(1,346)	(1,039)	(1,074)
Net cash from operations	551	(2,763)	2,026	2,924
Cash flows from investing activities				
Net cash from investing	3,610	(2,255)	(3,080)	0
Cashflows from financing				
Net cash used in financing	356	5,396	(1,471)	(1,471)
Net increase/(decrease) in cash and equivalents	4,516	378	(2,525)	1,452
Opening cash	0	4,516	4,894	2,369
Closing cash	4,516	4,894	2,369	3,821
Net debt	(35,512)	(40,697)	(43,222)	(41,769)

Source: Company data, Edison Investment Research. Note: *FY16 was only the period from 4 December 2015 to 31 March 2016.

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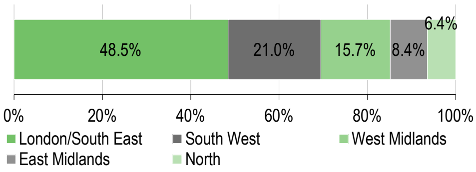
Revenue by geography



Management team

Non-executive chairman: Ian Henderson

Mr Henderson is a fellow of the Royal Institution of Chartered Surveyors and is a consultant to Capital and Counties plc (CAPC) and The Natural History Museum. He was formerly the CEO of Land Securities and president of the British Property Federation.

Non-executive director: James Hambro

Mr Hambro is the chairman of James Hambro & Partners, and was an executive director of Hambros Bank, co-founder of the original J O Hambro Group and director of J O Hambro Magan before founding J O Hambro Capital Management. He is chairman of Wilton Holdings and a director of I Hennig & Co.

Chief Executive Office: John Arnold

Mr Arnold is a fellow of the Royal Institution of Chartered Surveyors and worked at what is now CBRE from 1979 to 1986, when he joined Hambros plc. He became a director of the property subsidiary, Berkeley Hambro, in 1991, and a managing director of Investec Property plc in 1998 when it acquired Hambros Bank in 1998. He left Investec in 1999 and founded CPML in 2002.

Chief Operating Officer: Edward Olins

Mr Olins is a member of the Royal Institution of Chartered Surveyors. He joined DE & J Levy LLP as a graduate surveyor and became a partner in 2000, leaving in 2003 to join London & County Estates as investment director. He joined CPML in 2006 to manage new business acquisitions and to assist Mr Arnold.

Non-executive director: The Duke of Roxburghe

His Grace has been a director of Circle Property Management since 2006, and runs the Roxburghe Estate, comprising a large tenanted sector, the Roxburghe Hotel and Golf Course and various other property interests. He is a director of Kelso Races and a golf course management company. He is chairman of the disciplinary panel of the British Horseracing Authority and a steward of the Jockey Club.

Non-executive director: Richard Hebert

Mr Hebert has 30 years' experience in the trust and corporate services sector in Jersey working at several large firms associated with law firms and banks. In 2011, he became a director of Consortia Partnership, which provides Circle with financial services and a full accounting function. He is a fellow of the: Association of Chartered and Certified Accountants, Association of Accountancy Technicians and Chartered Institute of Secretaries and Administrators.

Non-executive director: Michael Farrow

Mr Farrow is a founding director of Consortia Partnership, a Jersey licensed trust and fund services company. He is currently the senior independent director of Redefine International, a FTSE 250 property company, the chairman of Bellzone Mining (AIM listed), the chairman of STANLIB Funds (a Jersey regulated open-ended investment company), and a non-executive director of redT energy plc (AIM listed). Between 1997 and 2004, Mr Farrow was an executive director and Trustee of a family office with diversified investment and trading portfolios, primarily focused on real estate in Europe and California. Mr Farrow holds a master of science in corporate governance and is a fellow of the Chartered Institute of Secretaries and Administrators.

Principal shareholders	(%)		(%)
Hastings	13.14	Delta Securities Holdings	3.5
Hendref	8.92	The Butterfly Trust	3.5
David Fisher	5.32	Mary Christine Hambro	3.5
Richard Moore	4.62	Charles Stone	3.3
Andrew Stone	4.27	Nicola Farquhar	3.3
The Third Earl of Halifax Discretionary Trust	4.12		

Companies named in this report

Custodian REIT (CREI), A&J Mucklow (MKLW), Palace Capital (PCA), Picton Property Income (PCTN), Real Estate Investors plc (RLE), Regional REIT (RGL), Schroders REIT (SREI).