Picton Property Income

Accretive reinvestment

Acquisition

Real estate

Picton's strategic objective is to grow both its asset base and income stream. It actively manages its portfolio and during FY17 and the early months of the current year completed the sale of £62m of non-core assets at prices above book value, reducing central London office exposure and reducing debt. The £23.15m acquisition of a Grade A office building in Bristol with significant potential from the letting of recently refurbished vacant space and rent reversion, meets the company's strategic objectives and further rebalances the portfolio geographically. We have increased our EPRA EPS estimates by c 1% for FY18 and c 4% for FY19.

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	1.10	3.9
03/17	47.9	3.81	3.30	81.8	1.04	3.9
03/18e	42.5	3.94	3.40	84.2	1.01	4.0
03/19e	44.0	4.18	3.50	84.9	1.00	4.1

Note: *EPS are normalised, excluding exceptional items.

Diversified asset and income growth

Picton has acquired a Grade A office building located in Bristol's city centre for £23.15m. Known as Tower Wharf, the building provides 70,664 sqft of office accommodation, 64% occupied by four tenants with an average lease length of 5.2 years (2.8 years to first break). The remaining vacant space is fully refurbished and available to let into an improving occupational market. With continuing high take-up and limited new supply the market for Grade A office space in Bristol city centre has continued to tighten and Picton sees significant reversionary potential in addition to letting vacant space.

Immediately accretive with significant upside

The consideration has been met partly out of cash resources and partly by drawing £12.5m on one of the two revolving credit facilities which will slightly lower the average cost of debt and increase LTV to just below 30%. The purchase price represents a net initial yield of 3.6% which managements expects to grow to 7.5% with new leasing and rent reversion. Although average occupancy will fall slightly from 96% to 94%, the transaction is immediately accretive of earnings, adding c £0.3m on annual basis and increasing dividend cover by c 2%. Although ahead of our FY19 assumptions, once fully let, management expects the additional earnings to reach £1.4m and increase dividend cover by 8%.

Valuation: Improving dividend prospects

Picton's 2% premium to NAV remains below the peer group average of c 6% and while the 4% prospective dividend yield is below the group average of 5%, improving dividend prospects suggest potential for the premium to rise closer to the average. With no changes to the assumptions in our dividend discount model (see our initiation note), which we use as a sense check, the fair value range produced by our model remains 79p to 103p.

15 August 2017

Price	**85p**
Market cap	**£459m**

Net debt (£m) at 30 June 2017	171.5
Shares in issue	540.1m
Free float	100%
Code	PCTN
Primary exchange	LSE
Secondary exchange	N/A

Share price performance

%	1m	3m	12m
Abs	2.7	0.0	24.5
Rel (local)	2.7	0.9	16.1
52-week high/low		86.0p	66.8p

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

September 2017 NAV	October 2017
H117 results	November 2017

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Edison profile page

Picton Property Income is a research client of Edison Investment Research Limited

Accretive reinvestment

Tight supply in the Bristol city centre office market

Colliers International estimates that through a combination of strong take-up and little new supply availability of office space in Bristol city centre is at its lowest level since before the global financial crisis. They estimate that Grade A availability declined by 12% in Q217 compared with Q1, and that 95% of all Grade A space is let. Q2 city centre take-up is estimated by Colliers at 142,000 sqft, 12% up on Q117, and while the H117 total of 268,000 sqft is below the level of H116, 2016 take-up was exceptionally strong (at 783,000 sqft) and 29% above the five-year average. The H117 total is just 6% below the five-year average and more broadly based with a significant increase in the number of transactions and a decline in the average transaction size. There is no new Grade A space due to complete until 2018, expected to add just over 200,000 sqft, while 170,000 sqft of refurbished space is expected to become available in 2017. Colliers expects continuing demand from the professional services, technology and service office sectors which given the tightness of supply, seems a positive indicator for rents.

Estimate changes and valuation

Having recently increased our NAV estimates (Progress continues) to take account of the 25 July NAV statement, we now add the accretive impact expected from the Tower Wharf acquisition. We have assumed that the current 64% occupancy of Tower Wharf will increase to 75% by the end of FY18 and 90% by the end of FY19. We have further assumed only a modest 2% increase in average rent per sqft from FY18 to FY19 which is materially below the reversionary potential identified by management (to more than £26 per sqft compared with the current average passing rent of £19.65) and is a potential source of additional upside to our forecasts. Our current assumptions take the end FY19 run rate of gross rents to c £1.2m or c £1.0m net of void costs, still some way short of the £1.6m (net of void costs) that management anticipates from occupancy improvement and rent reversion. Our estimated dividend cover (excluding valuation increases and realised gains on disposal) increases from 115% to 116%, broadly consistent with the 2% improvement that management estimates on a full year basis. For FY19 our estimated dividend cover increases from 115% to 119%, although for now we have made no changes to our dividend forecasts. As noted above, management sees potential for dividend cover to be enhanced by 8% over time.

Exhibit 1: Estimate 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	41.8	42.5	1.6%	3.90	3.94	1.1%	84.2	84.2	0.0%	3.40	3.40	0.0%
FY19e	42.8	44.0	2.8%	4.03	4.18	3.7%	84.7	84.9	0.3%	3.50	3.50	0.0%

Source: Edison Investment Research

We have previously noted Picton's smaller (c 2%) premium to NAV compared with peers (c 6%) and although its prospective yield of c 4% is below the peer average of c 5.0% improving dividend growth prospects are a positive indicator for potential revaluation. Our dividend discount model gives a valuation potential within the range of 79p to 103p assuming a 7% cost of equity and 3.0% dividend growth rate and applying a 50bp sensitivity to each.

Exhibit 2: Financial summary

Year end 31 March	£'000s	2014	2015	2016	2017	2018e	2019e
		IFRS	IFRS	IFRS	IFRS	IFRS	IFRS
PROFIT & LOSS							
Revenue		31,967	35,151	40,770	47,911	42,487	43,981
Service charge income		4,782	4,511	5,153	6,487	6,374	6,522
Total revenue		36,749	39,662	45,923	54,398	48,861	50,503
Gross property expenses		(8,992)	(9,320)	(10,001)	(12,011)	(12,059)	(12,284)
Net rental income		27,757	30,342	35,922	42,387	36,803	38,219
Administrative expenses		(1,139)	(1,194)	(1,510)	(1,613)	(1,634)	(1,672)
Operating Profit before revaluations		26,618	29,148	34,412	40,774	35,169	36,548
Revaluation of investment properties		18,422	53,163	44,171	15,087	9,600	0
Profit on disposals		5,660	412	799	1,847	588	0
Management expenses		(2,127)	(2,591)	(2,901)	(3,636)	(3,664)	(3,740)
Operating Profit		48,573	80,132	76,481	54,072	41,693	32,807
Net Interest		(10,868)	(10,930)	(11,417)	(10,823)	(9,706)	(9,734)
Profit Before Tax		37,705	69,202	65,064	43,249	31,987	23,074
Taxation		(357)	(347)	(216)	(499)	(731)	(514)
Profit After Tax		37,348	68,855	64,848	42,750	31,256	22,560
Profit After Tax (EPRA)		13,266	15,280	19,878	20,566	21,300	22,560
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	5.79	4.18
Adj EPRA EPS (p)		3.69	3.43	3.68	3.81	3.94	4.18
Dividends paid per share (p)		3.0	3.0	3.3	3.3	3.4	3.5
Dividend cover (x)		1.23	1.14	1.12	1.15	1.16	1.19
BALANCE SHEET							
Fixed Assets		421,393	536,898	649,406	618,391	642,941	646,441
Investment properties		417,207	532,926	646,018	615,170	639,720	643,220
Other non-current assets		4,186	3,972	3,388	3,221	3,221	3,221
Current Assets		42,879	84,111	37,408	49,960	50,648	51,778
Debtors		10,527	14,019	14,649	16,077	14,397	15,141
Cash		32,352	70,092	22,759	33,883	36,250	36,636
Current Liabilities		(17,369)	(17,480)	(47,521)	(21,171)	(21,014)	(21,852)
Creditors/Deferred income		(14,434)	(16,468)	(18,430)	(20,067)	(19,910)	(20,748)
Short term borrowings		(2,935)	(1,012)	(29,091)	(1,104)	(1,104)	(1,104)
Long Term Liabilities		(232,807)	(233,559)	(222,161)	(205,255)	(217,755)	(217,755)
Long term borrowings		(231,081)	(231,834)	(220,444)	(203,540)	(216,040)	(216,040)
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	454,819	458,612
Net Assets excluding goodwill and deferred tax		214,096	369,970	417,132	441,925	454,819	458,612
NAV/share (p)		56.4	68.5	77.2	81.8	84.2	84.9
EPRA NAV/share (p)		56.4	68.5	77.2	81.8	84.2	84.9
CASH FLOW							
Operating Cash Flow		23,145	24,705	33,283	36,283	33,616	32,900
Net Interest		(8,768)	(8,695)	(8,836)	(9,211)	(9,706)	(9,734)
Tax		(394)	(369)	(426)	(232)	(731)	(514)
Net cash from investing activities		(10,838)	(61,729)	(68,123)	48,691	(14,950)	(3,500)
Ordinary dividends paid		(10,711)	(13,102)	(17,822)	(17,957)	(18,361)	(18,766)
Debt drawn/(repaid)		(1,031)	(3,191)	14,591	(46,450)	12,500	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	2,367	386
Opening cash		22,906	32,352	70,092	22,759	33,883	36,250
Closing cash		32,352	70,092	22,759	33,883	36,250	36,636
Closing debt		(234,016)	(232,846)	(249,535)	(204,644)	(217,144)	(217,144)
Closing net (debt)/cash		(201,664)	(162,754)	(226,776)	(170,761)	(180,894)	(180,508)

Source: Picton, Edison Investment Research

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