

Picton Property Income

Interim results

Diversified and consistent

Picton's stated ambition is to be consistently one of the best performing diversified property companies on the main market and the H118 performance supports that goal with continued property outperformance versus its benchmark as it has done over one, three, five and 10 years. This property performance translated into a 7.1% NAV total return during the period including dividends that prospectively represent an attractive and well covered 4% dividend yield. Despite Brexit uncertainties, management expects a positive supply and demand balance in regional industrial and office markets to drive further market rental growth. Ongoing active asset management initiatives provide additional opportunities.

Year end	Revenue (£m)	EPRA EPS* (£m)	DPS (p)	EPRA NAV/share (p)	P/EPRA NAV (x)	Yield (%)
03/16	40.8	3.68	3.30	77.2	1.11	3.9
03/17	47.9	3.81	3.33	81.8	1.05	3.9
03/18e	43.2	4.11	3.43	87.2	0.98	4.0
03/19e	44.5	4.29	3.53	89.9	0.95	4.1

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

Good performance in H118

Picton continued to meet its objective of consistent performance during H118. A property return of 6.3% and income return of 2.9% both outperformed the MSCI IPD Quarterly Benchmark (5.0% and 2.2% respectively). IFRS net profit was £30.7m including a net £19.9m of gains on investments with NAV per share increased by 5% on end-FY17 to 86p. Including dividends paid of 1.7p, the NAV total return was 7.1% over the six-month period. The company intends to pay an increased annual dividend of 3.5p (+3%) commencing with a quarterly DPS of 0.875p to be paid in February 2018. Mainly tracking higher rent growth than forecast our EPRA EPS estimates are increased by c 4% for FY18 and 3% for FY19.

Well positioned with further rent potential

Having reduced Central London exposure last year, Picton's portfolio is overweight regional industrial and office property and significantly underweight retail and leisure (with no shopping centre exposure). Management expects this positioning to continue to benefit from a general supply and demand imbalance with limited development, that should continue to drive industrial and office rent growth. The expected rental value is £6m ahead of the current contracted run rate, representing significant potential from further void reduction, rent reviews and lease renewals.

Valuation: Not reflecting outperformance

Picton provides an attractive 4% dividend yield that we estimate will be 1.2x covered by EPRA earnings in the current year and with continuing opportunities to grow income from the current portfolio. Income retained is invested in the portfolio to enhance total returns and despite Picton's strong historic record of relative outperformance it trades on a sector average c 1x P/NAV multiple.

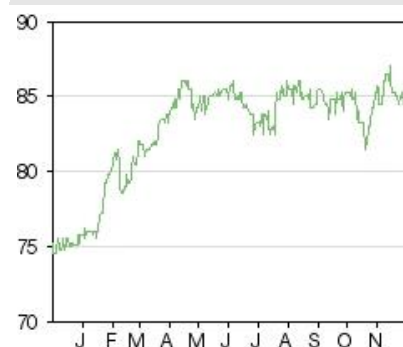
Real estate

30 November 2017

Price 85.50p
Market cap £462m

Net debt (£m) as at 30 September 2017	186.5
Net LTV (%) as at 30 September 2017	28.2
Shares in issue	540.1m
Free float	100%
Code	PCTN
Primary exchange	LSE
Secondary exchange	N/A

Share price performance



%	1m	3m	12m
Abs	1.5	1.2	11.8
Rel (local)	2.8	0.1	1.3
52-week high/low		87.0p	74.5p

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

December 2017 NAV update January 2018

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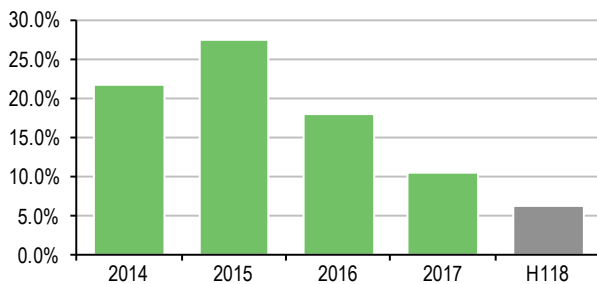
Company description: Diversified and consistent

Picton is an internally managed property investment company with the investment objective of providing shareholders with an attractive level of income, together with the potential for capital growth. It invests across the main UK commercial property sectors, actively managing its assets with a strong focus on occupiers' needs and seeking opportunities to enhance value within the portfolio. The target lot size is £10-30m which management believes is large enough to support efficient management of the portfolio and provide investment opportunities across the range of asset classes and geographies, while limiting the competition for assets from larger investors. In applying this strategy Picton has created a portfolio that is diversified by sector, geography and by income concentration. Management believes that having an internalised management structure creates alignment with shareholders as it has the capacity to generate economies of scale as the company grows. That growth has also seen a steady increase in lot size, with a tendency to reduce management complexity and contribute towards cost management. In the last financial year the ongoing charges of managing the company (which excludes the expenses directly related to the properties) was 1.2% of average net assets, and declined further to 1.1% in H118, low in a sector context.

Picton has a built a strong and consistent record of returns and its property returns (income and capital) have outperformed its MSCI IPD Quarterly Benchmark over the past one, three, five and 10 years. The annualised returns for various periods ending 30 September 2017 are shown in Exhibit 2 and we note that in H118, the outperformance continued with a gain of 6.3% versus the benchmark 5.0%. With the benefit of gearing, total net asset value returns have exceeded the property returns (Exhibit 2).

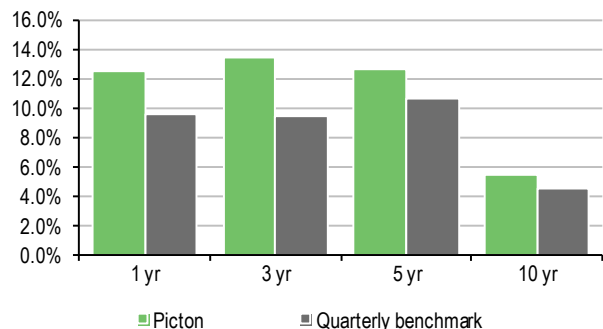
Given the UK government's intention to bring non-resident landlord companies such as Picton within the scope of UK corporation tax, the board is considering a conversion to REIT status. We discuss this on page 5 of this report.

Exhibit 1: Picton NAV total return (change in NAV per share plus dividends paid in the period)



Source: Picton

Exhibit 2: Picton property performance vs MSCI IPD Quarterly Benchmark (annualised, to 30 Sept 2017)



Source: Picton, MSCI

Highlights of the FY18 interim results

Although revenue from properties was in aggregate slightly lower than in the prior year, even after excluding £5.2m of exceptional income in H117, this actually meant that last year's portfolio rebalancing, which saw two Central London properties and four additional non-core assets sold was substantially absorbed. On a like-for-like (l-f-l) basis, rents grew by 4.4% and occupancy was increased from 94% at end-FY17 to 95%, ahead of the MSCI IPD Quarterly Benchmark of 93%. Last year's disposal proceeds were used to reduce total debt including relatively expensive zero

dividend preference shares, leading to a reduction in current year net financial expense with administrative costs well controlled (H118 ongoing charge 1.1% of average net assets).

Exhibit 3: H117 financial summary and comparison				
£000's unless otherwise stated		H118	H117	FY17
Revenue from properties		24,323	29,894	54,398
Property expenses		(5,605)	(5,324)	(12,011)
Net property income		18,718	24,570	42,387
Total operating expenses		(2,734)	(2,291)	(5,249)
Operating profit		15,984	22,279	37,138
Gains/(losses) on investments		19,850	(304)	16,934
Net finance expense		(4,894)	(5,983)	(10,823)
PBT		30,940	15,992	43,249
Tax		(286)	(334)	(499)
IFRS net profit		30,654	15,658	42,750
EPRA earnings		10,804	10,712	20,566
IFRS EPS (p)		5.7	2.9	7.9
EPRA EPS (p)		2.0	2.0	3.8
DPS (p)		1.7	1.7	3.4
NAV per share, IFRS & EPRA (p)		86	78	82
Source: Company data				

The financial highlights of H118 were:

- IFRS earnings of £30.7m or 5.7p per share, almost double the level reported in the prior year period and included £17.4m of net revaluation gains and £2.5m of gains on disposal of two non-core properties in the half.
- On an EPRA basis, excluding revaluation and disposal gains, earnings were £10.8m or 2.0p per share. This was higher than in H217 (£9.9m) and very slightly up on the prior year period.
- Two quarterly dividends of 1.7p in aggregate were paid during the period and a dividend of 0.85p was declared in respect of the quarter ending 30 September for payment on 30 November. A 3% increase in the targeted future annual dividend to 3.5p was announced, with the first quarterly payment of 0.875p planned for payment in February 2018.
- NAV per share benefitted from the revaluation and disposal gains as well as retained income earnings (dividends were covered 1.18x) and increased by 5% compared with end-FY17 to 86p per share.
- The growth in NAV per share taken together with dividends per share generated a 7.1% NAV total return during the six month period.
- Gross debt was £216.6m at 30 September 2017, and taking into account cash and equivalent balances of £30.1m, gearing as measured by the net loan to value ratio (LTV) was 28.2%.

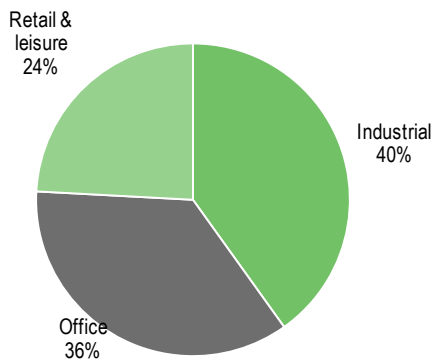
In the following section we provide an update on the portfolio and operational performance.

Portfolio update: Well positioned

Picton believes in a diversified portfolio with a focus on occupiers and their needs to drive income growth. The portfolio was valued at £661.4m at the end of September 2017, consisting of 52 properties with annualised rental income of £41.6m and valued at a net initial yield of 5.7%. Occupancy was 95% at 30 September with a weighted average unexpired lease term (WAULT) of 5.3 years. The portfolio has a strong overweighting to regional industrial property and to a lesser extent, regional office property. Central London office exposure was substantially reduced in 2016. Retail and leisure exposure is significantly below the benchmark and within this there is no shopping centre exposure.

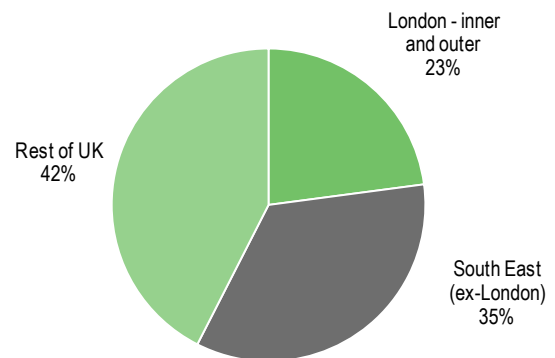
The property return was 6.3% in H118, of which the income return was 2.9%, compared with returns for MSCI IPD Quarterly Benchmark of 5.0% and 2.2% respectively, continuing Picton's outperformance achieved over previous years. The H118 outperformance can be attributed to being overweight in the better performing sectors in combination with property specific active management and leasing activity. Passing rent increased by 4.4% on a I-f-I basis (with lettings at what was the largest office vacancy, 50 Farringdon Road in London EC1, making a significant contribution) and the expected rental value (ERV) increased by 1.7% on the same basis. During H118, the portfolio value increased by 3.4% on a I-f-I basis. Mirroring the general market trend, the strongest gains achieved within the industrial portfolio (6.0%), followed by the office portfolio (3.1%), with no change in the retail and leisure portfolio.

Exhibit 4: Portfolio sector split by value



Source: Company data, as at 30 September 2017

Exhibit 5: Geographical split by value



Source: Company data, as at 30 September 2017

Two disposals were completed in H117 (non-income producing office assets in Bracknell) for a combined consideration of £9.9m and a significant acquisition of a Grade A waterfront office building in Bristol city centre (Tower Wharf) was completed for a consideration of £23.2m. The Bristol office market is experiencing strong occupier demand with limited availability. The property is currently 64% occupied by four tenants at rents well below market levels while the remaining vacant space is fully refurbished and available to let into the improving occupational market. Since the reporting date, Picton has agreed one small non-core disposal.

Generally, management believes that the portfolio remains well positioned in the current market environment and while continuing to search for opportunities to grow the portfolio further, has no current plans for material changes. Despite the ongoing post-Brexit uncertainty, reflected in weaker sterling, inflationary pressures and a reduction in overall economic growth estimates, the commercial property market continues to hold up well. The recovery in prices since 2009 has been skewed towards London, particularly Central London offices, yet despite this overall commercial property values (measured by the MSCI IPD All Property Capital Growth Index) are on average 21% below the 2007 peak. Looking outside of Central London, development activity has generally remained muted over the past 10 years and is likely to stay so without an increase in rents, such

that while growth continues there are many areas where supply is tight. Management believes that the supply and demand imbalance, combined with a lack of development activity, should continue to support rental growth in the office and industrial sectors in particular.

The ERV of Picton's portfolio is now £47.6m, some £6.0m ahead of the current annualised rental income and representing significant potential upside from further occupancy gains (£2.6m of the total), rent reviews, and lease renewals. During H218 there are 70 lease events across the portfolio representing an aggregate ERV of £7.1m:

- Industrial – 23 events with an ERV of £2.0m; 15% ahead of the passing rent
- Office – 37 events with an ERV of £3.0m; 5% ahead of the passing rent
- Retail – 10 events with an ERV of £2.1m; 20% ahead of the passing rent

Potential REIT conversion: no impact on strategy

The UK government has for some time made clear its interest in bringing non-resident landlord companies, such as Picton, within the scope of UK corporation tax. Alongside changes to capital gains tax, in the November 2017 UK budget the government announced that this will become effective from April 2020, somewhat later than Picton management had expected.

In anticipation, during H118 Picton continued to plan for a potential conversion to REIT status which would have the effect of exempting the company from corporation and income tax, subject to REIT qualification requirements. With the interim results it indicated that subject to clarification of the government's stance in the budget, it was likely to hold an EGM in early 2018, seeking shareholder approval for any corporate changes that may be required for REIT conversion to proceed. While Picton would remain Guernsey registered post-conversion, it would be necessary for management control to move to the UK. The company is also appraising the benefits of retaining its current technical stock market listing status as an investment company as opposed to the commercial company status more common among internally-managed UK REITs. We note that LondonMetric Property and Redefine have similarly changed from investment company status to commercial company status in the past.

We suspect that given the delay in bringing non-resident landlord companies into the corporation tax regime, Picton will wish to study its position further before making any decision. Importantly, if and whenever it may happen, REIT conversion or a change in listing status is 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.

Financials

Our revised forecasts are shown in Exhibit 6. Our revenue forecast benefits from stronger rental growth during H118 than we had previously allowed for, particularly within the industrial portfolio, feeding through to future periods. With some operational gearing effects, the EPRA EPS forecast increases at a slightly higher pace. Our dividend forecasts (shown as the aggregate quarterly dividends declared during the period) reflect the increase in dividends signalled by management, to an annual 3.5p commencing with a first quarterly payment, barring unforeseen circumstances, of 0.875p in February 2018. If it decided to convert to REIT status we would expect the dividend policy to be reviewed when the transition is complete. Given Picton's focus on income and its relatively full dividend pay-out we would not expect any material change and with forecast dividend cover of c

1.2x, there is room within our forecasts for the dividend to move higher. Despite increased dividends, forecast EPRA NAV per share also increases, mainly as a result of the higher revaluation gain than we had expected in H118 and our decision to explicitly include future revaluation gains within our forecasts. Following the £17.4m gain recorded in H118 we have included an aggregate £15.0m gain over the next 18 months which effectively maintains the valuation yield on the portfolio after adjusting for modest like-for-like rental growth assumed of c 1.6% pa.

Exhibit 6: Forecast revisions

	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	42.5	43.2	1.7%	3.94	4.11	4.2%	84.2	87.2	3.5%	3.4	3.43	0.7%
FY19e	44.0	44.5	1.2%	4.18	4.29	2.6%	84.9	89.9	5.9%	3.5	3.53	0.7%

Source: Edison Investment Research

The net LTV ended H118 at 28.2%, little changed from end-FY17, and below the 30% medium-term target that management believes to represent an appropriate balance between the current potential benefits and risks, particularly given post-Brexit uncertainties. That said, the company maintains a desire to grow the asset base selectively provided suitably attractive opportunities can be sourced and market conditions remain favourable. Given the less than full dividend pay-out of earnings, and the assumption of modest revaluation gains, we forecast net LTV to decline to a little over 27% by the end of FY19, providing some room for asset growth from existing capital resources.

Picton has two fully drawn term loan facilities with Canada Life and Aviva, maturing in 2022 and 2032 respectively. It also has two revolving credit facilities (RCF) with Santander, both now maturing in 2021 after the maturity of one of the facilities was extended during H118. In aggregate, the RCFs provide a debt facility of £51m, of which £12.5m was drawn during H118 as part payment for the Bristol acquisition, leaving c £38m available. It is intended for use on a tactical basis, allowing management to act opportunistically and facilitating a short-term increase in gearing that may be paid down at a later stage with equity issuance or asset sale proceeds. We estimate that full utilisation of the RCF would increase the net LTV to c 32%.

Valuation

Picton pays annual dividends that represent a 4% yield at the current share price. We estimate that the dividends paid in the current year will be 1.2x covered by EPRA/income earnings. 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. We have shown the recent NAV total return performance and long-term property return outperformance versus the MSCI IPD Quarterly Benchmark in Exhibits 1 and 2 above.

Turning to a comparison of Picton with other listed property vehicles, Exhibits 7 and 8 show prospective dividend yields and historical P/NAV ratios for a broad universe of property investment companies and REITs. This universe is quite diverse, including specialist investors such as the healthcare property REITs and others focused on long duration income streams, as well as a range of companies with more mainstream commercial portfolios with varying focus on income and capital growth.

Picton's 4% yield compares with a c 4.5% simple average for the entire universe, whereas its P/NAV of c 1x is in line with the simple average for the universe. Those companies more reliant on capital growth, especially when combined with a greater Central London focus are generally afforded lower valuations currently. Given the paucity of yield opportunities available to investors, the market is currently valuing the visibility of long duration income returns more highly. A more significant move in interest rate expectations, particularly at the longer end of the yield curve could have an impact on this and companies with diversified business models, such as Picton, will have more opportunity to adapt their investment strategies across property types.

Exhibit 7: Universe by prospective dividend yield

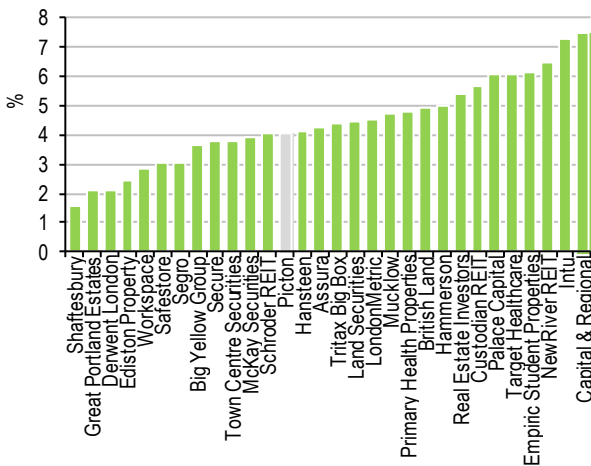
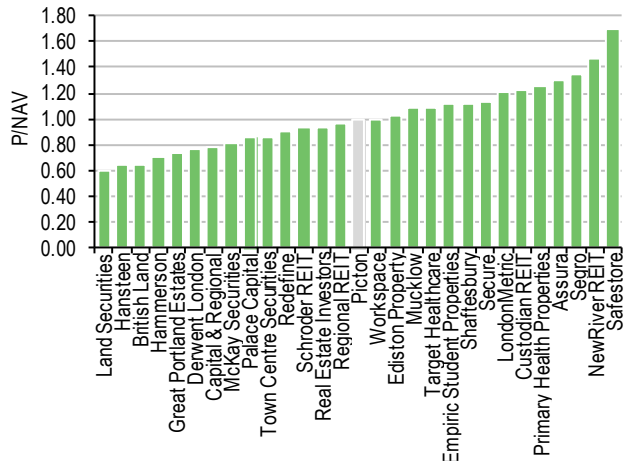


Exhibit 8: Universe by P/NAV



Source: Bloomberg, data as at 22 November 2017

It would appear to us that the market's relative valuation of Picton is not anticipating a continuation of its historical relative property return outperformance and is certainly not pricing in achievement of management's goal of being sustainably the one of best performing, diversified listed property companies on the main market.

Exhibit 9: 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	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	22,362	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	57,086	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	47,333	33,625
Taxation		(357)	(347)	(216)	(499)	(614)	(673)
Profit After Tax		37,348	68,855	64,848	42,750	46,719	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	8.65	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
BALANCE SHEET							
Fixed Assets		421,393	536,898	649,406	618,391	661,446	674,946
Investment properties		417,207	532,926	646,018	615,170	658,279	671,779
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	470,862	485,494
Net Assets excluding goodwill and deferred tax		214,096	369,970	417,132	441,925	470,862	485,494
NAV/share (p)		56.4	68.5	77.2	81.8	87.2	89.9
EPRA NAV/share (p)		56.4	68.5	77.2	81.8	87.2	89.9
CASH FLOW							
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%	27.8%	27.1%

Source: Company, Edison Investment Research

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