Circle Property

Interim results update

21% total return in H1 continues strong growth

Real estate

In the six months ending 30 September 2018 (H119) Circle Property continued to generate strong returns. The 21.1% H119 NAV total return takes the total return since IPO in February 2016 to 93%, a compound annual average 29.0%. Current returns reflect the benefits, in terms of rising income and capital values, of letting recently refurbished space. We forecast more gains to come from the existing portfolio, while management is seeking to replenish the refurbishment pipeline.

Year end	Net rental income (£m)	Adjusted net profit* (£m)	Adjusted EPS* (p)	NAV per share (p)	DPS (p)	P/NAV (x)	Yield (%)
03/17	4.4	0.9	3.1	183	5.0	1.05	2.6
03/18	5.5	2.5	9.0	230	5.6	0.84	2.9
03/19e	7.0	2.7	9.4	280	6.3	0.69	3.3
03/20e	7.5	3.1	11.0	290	7.0	0.67	3.6

Note: *Edison adjusted net profit and EPS is adjusted for gains/losses on sales of investment property, revaluation movements and non-recurring items.

The harvest continues

Circle targets well-located, primarily office, properties in the UK's provincial cities where it can add value by undertaking lease renewals, rent reviews, lettings and refurbishments. As a result, capital returns and NAV growth are key drivers of total returns. Due to letting progress, H119 net rental income increased 35% on H118 and NAV per share increased 20% to 275p per share, taking the total increase since IPO in February 2016 to 85%. DPS increased c 15% y-o-y, to 3.0p, 1.5x covered by Edison adjusted earnings (income earnings). Our forecast end-FY20 NAV per share is increased by 7% to 290p and our forecast DPS growth is unchanged, despite the dampening effect of mature asset disposals on income earnings (our forecasts assume no reinvestment although this is targeted).

Seeking to replenish the refurbishment pipeline

The supply-demand balance for regional offices (more than 90% of the Circle portfolio) remains positive, although management notes an increased level of hesitation by tenants in committing to new lease commitments. Our forecasts reflect management confidence in the prospects for letting the remaining vacant space in its portfolio, concentrated in two recently refurbished assets, based on their quality and location. As Circle seeks to replenish its refurbishment pipeline, the recent increase in market and economic uncertainty, in part Brexit related, may open new opportunities, particularly off-market, for reinvestment of disposal proceeds.

Valuation: Share price lagging NAV growth

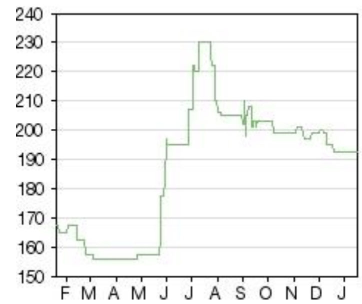
The shares have performed strongly over the past year, but have retraced from the highs reached in July, while NAV per share has continued to increase strongly. The shares trade at a c 30% discount to the recently reported H119 NAV, and our FY20e DPS (1.6x covered) provides a prospective yield of more than 3%.

17 January 2019

Price	**193p**
Market cap	**£55m**

Net debt (£m) at 30 September 2018	47.1
Net LTV at 30 September 2018	37.7%
Shares in issue	28.6m
Free float	63.6%
Code	CRC
Primary exchange	AIM
Secondary exchange	N/A

Share price performance



%	1m	3m	12m
Abs	(1.3)	(3.3)	20.3
Rel (local)	(2.2)	(0.3)	36.0
52-week high/low		230p	156p

Business description

Circle Property is a property investment company registered in Jersey and listed on AIM. The company actively manages its assets, placing an emphasis on total returns rather than maximising short-term income. It targets the acquisition of well-located regional office properties where it has identified a clear opportunity to add value by undertaking active asset management.

Next events

Property valuation for 31 March 2019	Exp. April 2019
FY19 results	Exp. June 2019

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Edison profile page

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Strong returns continued in H119

Circle issued strong interim results covering the six-month period that ended 30 September 2018 (H119) in late December. Strong capital growth continued in the period, driven by the company's asset management strategy, taking the end-H119 NAV per share to a level above our previous forecasts for both end-FY19 and FY20. Income earnings (Edison 'adjusted earnings'), excluding realised and unrealised property valuation gains, was slightly lower, reflecting a rebalancing of expenses from H2 to H1 as well as the disposal of one mature asset in the period (two more properties were sold after the period end), but the declared DPS was at the same level as H218 and 15% ahead of H118, well covered by adjusted earnings. The net asset value total return during the first six months of the year was 21.1% and the aggregate return since IPO in February 2016 is now 29.0%. The disposal contributed to a reduction in net loan to value (LTV) to 37.7%. We review the interim results in more detail below, and update on the prospects later in this note. A more detailed review of the company and its strategy can be found in our last outlook report.

Exhibit 1: Summary of H119 financial performance

£000's unless otherwise stated	H119	H118	H119 v H118	FY18
Net rental income	3,524	2,611	35.0%	5,523
Administrative expenses	(1,250)	(801)	56.1%	(2,368)
Operating profit before revaluations & other one-off items	**2,274**	**1,810**	**25.6%**	**3,155**
Recurring net finance costs	(736)	(551)	33.5%	(1,145)
Edison adjusted PBT	**1,538**	**1,259**	**22.2%**	**2,010**
Tax	(227)	99		535
Edison adjusted earnings after tax	**1,311**	**1,358**	**-3.5%**	**2,544**
Edison adjustments:				
Gains on disposal	495	0		1
Gains on revaluation	11,733	7,307		11,981
Fair value movement on interest rate swaps	0	(1)		(1)
IFRS net profit	**13,539**	**8,664**	**56.3%**	**14,526**
Edison adjusted EPS	**4.6**	**4.8**	**-3.5%**	**9.0**
IFRS EPS (p)	47.8	30.6	56.3%	51.3
DPS declared (p)	3.00	2.60	15.4%	5.60
Dividend cover (Adjusted EPS/DPS)	1.54	1.85		1.61
IFRS NAV per share (p)	**275**	**212**	**29.8%**	**230**
NAV total return	21.1%	17.1%		28.3%
Fair value of investment properties (£m)	115.8	96.3		106.4
Net LTV	37.7%	42.3%		43.2%

Source: Circle Property, Edison Investment Research

- The investment portfolio at fair value increased to £115.8m from £106.4m at end-FY18. The movement included revaluation gains of £11.7m, £0.6m of investment in existing properties, £3.0m of disposals, and lease incentive adjustments. Based on a period end contracted rent roll of £7.5m (end-FY18: £6.8m) and our estimate of end-H119 estimated rental value, or ERV, of £9.8m (end-FY18: £9.9m) we calculate a net initial yield (NIY) of c 5.6% and a reversionary yield of c 7.3%. The NIY is similar to end-FY18 and the reversionary yield has reduced slightly (end-FY18: c 8.2%), primarily the result of the letting of vacant space. We estimate the disposal in the period (a petrol filling station at Amesbury) reduced H119 rent roll and ERV by c £0.2m whereas key lettings of recently refurbished space included the previously disclosed letting of the entire (36,300 sq ft) office space at Somerset House on Temple Street in Birmingham city centre announced in May, adding c £0.8m to rent roll, and two new leases (covering c 4,800 sq ft) at 36 Great Charles St in Birmingham, adding c £0.1m.
- Primarily reflecting leasing progress during H119 and previously, gross rental income increased 23.8% to £3.6m compared with H118, and net rental income by a larger 35.0% to £3.5m. The greater increase in net rental income mainly reflects the reduction in non-recoverable property

costs as a result of leasing progress. On an EPRA basis, 30 September 2018 occupancy was 92%.

- Administrative expenses were sharply higher but we believe this mainly reflects a rebalancing of staff costs between H2 and H1. Additionally, legal and professional costs were high in the period, which we believe reflects the amount and complexity of leasing activity.
- Despite the expense rebalancing, pre-tax Edison adjusted earnings were ahead strongly, by 22.2% y-o-y. With a prior year tax credit reverting to a more normal tax charge, after tax Edison adjusted earnings and EPS were slightly lower compared with H118.
- NAV per share increased to 275p compared with 230p at end-FY18. Including the 3.0p (FY18 final) DPS paid, NAV total return was a very strong 21.1%.
- Mainly reflecting the impact of disposals, end-H119 net LTV reduced to 37.7% (end-FY18: 43.2%). Given the strength of interest cover we believe that management remains comfortable with the current level of borrowing and that the LTV is likely to edge back up as disposal proceeds are reinvested. We do not, however, include reinvestment in our forecasts.

Disposals and leasing continuing since the half year

Since H119 ended, Circle has continued its progress with letting remaining vacant space, has sold two further mature properties, and continues to seek acquisitions to replenish its pipeline of refurbishment/redevelopment opportunities.

- In November 2018 the remaining ground floor space in the K2 building at Kents Hill Business Park in Milton Keynes was let to T-Systems, a subsidiary of Deutsche Telekom at £215k (£15.50 per sq ft) on a 10-year lease with a tenant break at five years.
- Also in November, two shops let to Morrisons and A-Plan Insurance in Maidstone were sold for £1.35m, in line with the valuation.

Management expects further income and value growth

In its outlook comments, management expresses confidence in the prospects for letting the remaining vacant space in its portfolio, concentrated in two recently refurbished assets, which it expects to further increase income and assets. This is despite observing an increased level of hesitation on the part of tenants in committing to new lease agreements and reflects both the quality and location of the assets as well as the company's strategy of seeking to attract tenants quickly for refurbished assets with competitive rents to beat local competition. This way it aims to quickly achieve an attractive yield, increasing both rental income and capital values. Although some space remains to be let, the current redevelopment and refurbishment pipeline is complete, and Circle anticipates that the recent increase in market and economic uncertainty, in part Brexit related, will open new opportunities, particularly off market, for reinvestment of disposal proceeds. We would anticipate that management will continue to target acquisitions at close to vacant possession value, with potential for cost-efficient refurbishment and development, to maximise reversionary rental values and secure new leases.

Financials

Our revised estimates are shown in Exhibit 2. Our forecasts for NAV per share are again lifted following the very strong valuation gains reported in H119. As a result of the letting progress, H119 rental income was running ahead of the level implied in our previous forecasts and this feeds through to our revised FY19 expectation. At the adjusted net profit level this is offset by slightly higher assumed costs and taxes.

For FY20 the reduction in net rental income reflects a full year impact of the property disposals recently announced and this feeds through to adjusted net profit.

We have not changed of DPS forecasts given the strength of dividend cover.

Importantly, in our forecasts we have not made any assumption of the reinvestment of the disposal proceeds, although management is clearly looking for suitable opportunities. We would expect these to be at yields that would be accretive to adjusted earnings while offering the potential for longer-term capital uplift through active asset management.

Exhibit 2: Estimate revisions

	Net rental income (£m)			Adjusted net profit (£m)			Adjusted EPS (p)			NAV per share (p)			DPS (p)		
	Old	New	Change (%)	Old	New	Change (%)	Old	New	Change (%)	Old	New	Change (%)	Old	New	Change (%)
03/19e	6.8	7.0	3.3	2.7	2.7	-0.8	9.5	9.4	-0.8	258	280	8.6	6.3	6.3	0.0
03/20e	7.7	7.5	-3.1	3.3	3.1	-6.0	11.7	11.0	-6.0	271	290	7.2	7.0	7.0	0.0

Source: Edison Investment Research

Our key forecasting assumptions are:

- **Contracted rental income.** Contracted rent at end-H119 was £7.5m and we estimated the impact of the subsequent disposal of two shops in Maidstone to reduce this by c £0.1m. The November letting at K2 adds c £0.2m, such that we estimate the current contracted rent roll to be c £7.6m. We are now assuming contracted rents of £7.9m by end-FY19 (previously £8.2m) and £8.2m by end-FY20 (previously £8.8m). The main change reflects the announced disposals which we estimate reduce contracted rent roll by c £0.4m pa. We continue to allow for the effective full letting of 36 Great Charles St and K2 over the period, although at a slightly reduced overall ERV than we had previously assumed. In addition to the upside from letting these two assets, we estimate an additional £1.6m of reversionary potential within the portfolio.

Exhibit 3: Estimated contracted rents and ERV

£000's	
Contracted rent roll at 30 September 2018	7.5
Maidstone disposal*	(0.1)
K2 T-Systems let (November)	0.2
Adjusted contracted rent roll	**7.6**
Development assets expected rent (ERV)	
K2, Kents Hill Business Park, Milton Keynes*	0.2
Great Charles St, Birmingham uplift*	0.4
Potential rent including development assets	**8.2**
Other, rent reversion potential	1.6
Total portfolio estimated ERV*	**9.8**

Source: Circle property. Note: *Edison estimates.

- Improving occupancy translates into lower void costs and a small decrease in overall property costs.
- Our forecast for administrative expenses in FY19 is affected by relatively high legal and professional fees in H119, we believe related to the high level and complexity of leasing activity. We expect this to 'normalise' in FY20 and otherwise assume expense growth broadly in line with inflation.
- Finance costs are forecast slightly higher in FY19, tracking higher LIBOR on broadly unchanged floating rate borrowings of c £50.1m. As we assume no reinvestment of disposal proceeds there is a slight benefit to interest received, apparent in FY20.
- **Property revaluation gains.** The £11.7m revaluation gain reported in H119 was significantly ahead of the £7m that we had assumed for the year as a whole. Our assumptions are based on the expectation that continuing underlying rental growth and the further letting progress that we forecast will have a positive impact on property values, without assuming any effect from changes in the general level of market valuations. Given the scale of the H119 movement, we have slightly reduced our revaluation assumptions through to end-FY20, to an aggregate

£2.5m over the 18-month period. In combination with our contracted rent and ERV growth assumption (2.0% pa), this implies an increase in the portfolio NIY from c 5.6% at end-H119 (a similar level to end-FY18) to c 6% at end-FY20. As more of the reversionary potential is captured in contracted rents the implied reversionary yield declines slightly from c 7.4% at end-H119 (c 8.2% at end-FY18) to c 7.3%. The H119 revaluation gain added 41p to NAV and our assumptions add 4p in H219 and 6p per share in FY20. A 0.25% increase in the FY20 NIY would reduce forecast NAV by c 20p per share, and a 0.25% reduction would add 18p.

- We have applied a 15% tax rate to adjusted earnings, although the effective rate of tax since listing has been much lower, primarily benefiting from capital allowances. Circle Property and its main subsidiaries are Jersey registered and pay no tax. From 1 April 2020, non-resident landlord companies (such as Circle) are to be brought into the scope of UK corporation tax rather than income tax, and additionally from 1 April 2019, capital gains made by a non-resident on the disposal of commercial property will be subject to UK tax. Both changes are likely to have an impact on the company's tax position.

Valuation

Circle is not a REIT and, unlike most REITs, capital returns are a significant element of overall total returns generated by the company. Although the company aims to increase rental income through leasing and rental growth, it is not focused on income maximisation over the short term, and cash flow is deployed for reinvestment in the portfolio with the aim of optimising longer-term total returns, as well as for dividend distributions. The recent strong capital uplifts are the result of letting assets, at increased rents, which were previously held vacant for a period of refurbishment. Given its total-return strategy, we think Circle's value creation is best illustrated by the NAV total return (the change in NAV per share plus dividends paid per share). NAV total return from IPO to end-H119, has been an aggregate 93.4%, or a compound annual average 29.0% pa, well above the minimum 12% pa targeted by management. Our FY19 full-year estimates imply a total return of 24.6% and for FY20 our estimates imply 5.6%, although there remains considerable scope for Circle to do better than this if market conditions remain favourable and it is successful in continuing to let remaining vacant refurbished space and capturing reversionary potential through lease renewals. Management also continues to seek accretive acquisitions, which are similarly not reflected in our forecasts.

Exhibit 4: NAV total return since IPO

	FY16*	FY17	FY18	H119	Since IPO
Opening NAV per share (p)	149	153	183	230	149
Closing NAV per share (p)	153	183	230	275	275
Dividends per share paid (p)	0	4.8	5.2	3.0	13
NAV total return	2.5%	23.0%	28.3%	21.1%	93.4%
Compound annual return					29.0%

Source: Circle Property data, Edison Investment Research. Note: *16 February 2016 to 31 March 2016.

This focus on NAV total return and the significant growth in Circle's NAV and adjusted earnings per share since IPO highlights the difficulty of making a simple P/NAV or yield comparison with the broader sector, not least because many of those companies have a deliberate focus on recurring income generation rather than total return.

In Exhibit 5, we show a summary valuation and performance comparison of Circle with a peer group of regional property investors, a group of companies with a broad range of income versus total return strategies. The P/NAV ratios shown are based on the last published data, and so include the H119 NAV growth at Circle. The yields are based on dividends declared on a trailing 12-month basis.

Exhibit 5: Peer comparison

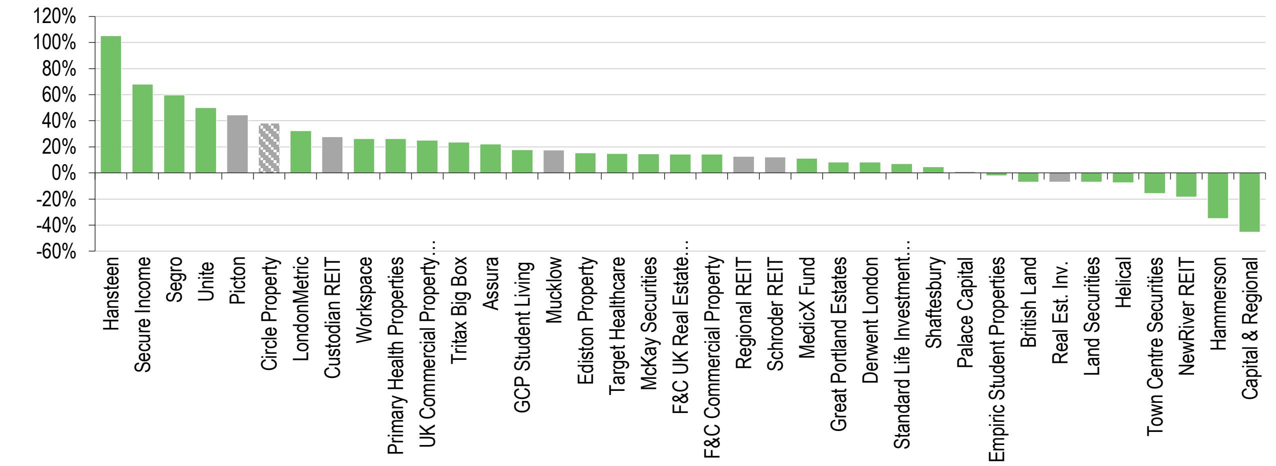
	Price (p)	Market cap. (£m)	P/NAV* (x)	Yield (%)	Share price performance			
					One month	Three months	12 months	From 12 month high
Custodian REIT	117	460	1.08	5.6	0%	-2%	-2%	-6%
Mucklow	497	315	0.89	4.6	5%	-5%	-1%	-11%
Palace Capital	304	139	0.72	6.3	2%	-3%	-9%	-19%
Picton	85	455	0.92	4.1	4%	-1%	-1%	-9%
Real Est Inv	53	98	0.75	6.7	-4%	-4%	-1%	-15%
Regional REIT	93	348	0.82	8.5	3%	-6%	-8%	-8%
Schroder REIT	56	290	0.81	4.5	1%	-6%	-11%	-17%
Median			**0.82**	**5.6**	**2%**	**-4%**	**-2%**	**-11%**
Circle Property	**193**	**54**	**0.69**	**2.9**	**-1%**	**-3%**	**15%**	**-25%**
UK property index	1,625			5.3	2%	-4%	-11%	-14%
FTSE All-Share Index	3,769			4.7	2%	-3%	-12%	-13%

Source: Company data, Edison Investment Research. Note: *Last reported EPRA NAV per share. ** Trailing 12-month DPS declared. Prices as at 17 January 2019.

Circle's share price has performed strongly over the past 12 months, with the shares rising by 15% compared with declines across the narrow peer group, broad sector and FTSE All Share Index. This continues the trend since IPO in February 2016, which we show in Exhibit 6, with Circle generating one of the highest share price total returns (dividends reinvested) across the broad UK property sector, a group that includes may different strategies and a number of specialist sector REITs. We have highlighted the performance of the narrow peer group stocks in grey.

However, Circle's share price has failed to keep pace with the growth in NAV per share, and the c 30% share price discount to NAV is much wider than the peer average. Reflecting the nature of Circle's strategy, with a strong focus on reinvestment in the portfolio to drive total returns, its dividend yield is lower than the average for the peer group, and the broader sector, but dividend cover is relatively high (we estimate 1.4–1.5x over FY19 and FY20).

Exhibit 6: Share price total return since Circle IPO*



Source: Thomson Reuters. Note: *Circle IPO 16 February 2016.

Taken as a whole, and given the strong historical track record of total return generation, Circle's valuation appears very undemanding and may in part reflect:

- The relatively low market capitalisation and free float of the stock is likely to have a limiting impact on institutional investment. We note that management is continuing to review options for enlarging the shareholder base, perhaps in conjunction with growing the asset base, which has the potential not only to broaden the appeal of the shares, but to capture potential economies of scale.
- Continuing signs of investor preference for recurring income, historically a less volatile component of total property return, compared with the sharp swings in property valuations

observed across the cycle. We note that while there are a number of uncertainties surrounding the economic outlook, occupier and investor demand for regional office assets has continued to be robust while rental and capital values do not look stretched in historical terms. Factors such as business relocation from London to the UK regions and the conversion of empty offices to residential use are positive for the supply-demand balance, and there is no sign of the speculative over-development that generally accompanies a cycle peak. Against this background, Circle has continuing opportunities to drive further returns from the existing portfolio (continued letting at Great Charles St and K2, and £1.6m reversionary potential elsewhere in the portfolio), while creating new asset management potential through acquisitions.

Supporting our view that the valuation is undemanding, on 20 November 2018 Circle was notified that Palace Capital, a UK property investment company listed on the Main Market of the LSE, had become a significant shareholder, with a 5.04% disclosable shareholding, deploying surplus liquidity.

Exhibit 7: Financial summary

Year ending 31 March	2016	2017	2018	2019e	2020e
£000s	IFRS	IFRS	IFRS	IFRS	IFRS
INCOME STATEMENT					
Rental income	664	5,266	6,212	7,500	8,036
Other income	595	138	143	207	100
Total income	1,260	5,404	6,354	7,707	8,136
Property expenses	(123)	(1,037)	(831)	(678)	(660)
Net rental income	1,137	4,366	5,523	7,030	7,476
Administrative expenses	(293)	(2,115)	(2,368)	(2,489)	(2,454)
Operating profit before valuation gains	844	2,251	3,155	4,540	5,022
Gains on disposal of investment properties	0	279	1	495	0
Revaluation of investment properties	0	7,361	11,981	12,733	1,500
Exception items	374	88	0	0	0
Operating profit	1,217	9,979	15,137	17,769	6,522
Net finance costs	(112)	(13)	(1,146)	(1,423)	(1,375)
Profit before tax	1,106	9,966	13,991	16,345	5,148
Tax	(32)	(22)	535	(464)	(547)
Net profit	1,073	9,944	14,526	15,881	4,600
Adjusted for:					
Gain/(loss) on disposal of investment property	0	(279)	(1)	(495)	0
Revaluation of investment property	0	(7,361)	(11,981)	(12,733)	(1,500)
Fair value movement on interest rate swaps	2	(96)	1	0	0
Other non-recurring items	(427)	(1,320)	0	0	0
Edison adjusted earnings	648	889	2,544	2,653	3,100
Shares ('000s) exc. own shares held	28,297	28,297	28,297	28,297	28,297
IFRS EPS (p)	3.8	35.1	51.3	56.1	16.3
Diluted Edison adjusted EPS (p)	2.3	3.1	9.0	9.4	11.0
Dividend declared (p)	2.4	5.0	5.6	6.3	7.0
Dividend cover (adjusted earnings/DPS declared)	0.96	0.63	1.61	1.49	1.57
BALANCE SHEET					
Investment properties	75,781	86,054	106,373	115,901	118,401
Trade and other receivables	1,771	6,518	7,202	8,524	8,524
Deferred tax	915	1,142	1,728	1,142	1,142
Financial instruments at FV through P&L	22	30	56	50	50
Total non-current assets	78,490	93,744	115,359	125,617	128,117
Trade and other receivables	2,555	1,195	1,141	1,694	1,750
Deferred tax	105	128	0	506	506
Cash and equivalents	4,516	4,894	2,640	4,401	4,758
Total current assets	7,176	6,217	3,781	6,600	7,013
Total assets	85,665	99,962	119,140	132,217	135,130
Borrowings	(40,028)	(45,590)	(51,816)	(50,121)	(50,161)
Financial liability at FV through P&L	(95)	0	0	0	0
Total non-current liabilities	(40,123)	(45,590)	(51,816)	(50,121)	(50,161)
Trade and other payables	(2,306)	(2,550)	(2,325)	(2,734)	(2,874)
Total current liabilities	(2,306)	(2,550)	(2,325)	(2,734)	(2,874)
Total liabilities	(42,430)	(48,140)	(54,141)	(52,855)	(53,035)
Net assets	43,236	51,822	64,999	79,362	82,095
Basic and diluted IFRS NAV per share (p)	153	183	230	280	290
CASH FLOW					
Profit before tax	1,106	9,966	13,991	16,345	5,148
Adjusted for					
Net finance expense	112	1,245	1,146	1,423	1,375
Depreciation	1	7	7	13	13
Share-based payments	0	0	123	0	0
Gains on revaluation	0	(7,361)	(11,981)	(12,733)	(1,500)
Gains on disposal of investment properties	0	(279)	(1)	(495)	0
Amortisation of loan arrangement fees	7	40	44	55	40
Goodwill, interest rate and swap valuation movements	(1,751)	(1,523)	1	0	0
Working capital movements	1,132	(3,512)	(152)	(1,548)	84
Cash from operations	607	(1,416)	3,178	3,060	5,159
Tax paid	0	0	0	(237)	(547)
Net interest (paid)/received	(56)	(1,346)	(1,113)	(1,381)	(1,375)
Net cash from operations	551	(2,763)	2,065	1,442	3,237
Net cash from investing	3,610	(2,255)	(9,028)	3,586	(1,013)
Net cash used in financing	356	5,396	4,710	(3,448)	(1,868)
Net increase/(decrease) in cash and equivalents	4,516	378	(2,254)	1,581	357
Opening cash	0	4,516	4,894	2,640	4,221
Closing cash	4,516	4,894	2,640	4,221	4,578
Debt	(40,028)	(45,590)	(51,816)	(50,121)	(50,161)
Un-amortised loan arrangement costs & other	1,062	(130)	(86)	(31)	9
Net debt	(34,450)	(40,827)	(49,262)	(45,930)	(45,574)
Net LTV	44.3%	43.9%	43.2%	36.7%	35.7%

Source: Circle Property, Edison Investment Research

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