EDISON

Circle Property

Increasing forecasts again

Update on interim results

Real estate

Circle Property's recent interim results show asset management initiatives continuing to drive operational progress, delivering strong growth in rental income and cash earnings, and lifting portfolio valuations. Letting progress has continued in H218, including at recently refurbished assets, but significant reversionary potential remains and capital values remain low. We are raising our estimates again but continue to see potential for further upside from faster letting of refurbished assets than we have assumed. Even before that, the shares trade at a hefty 25% discount to FY18e NAV with a yield of more than 3%.

Year end	Net rental income (£m)	Adjusted net profit* (£m)	Adjusted EPS* (p)	NAV per share (p)	DPS (p)	P/NAV (x)	Yield (%)
03/16**	1.1	0.6	2.3	153	2.4	1.04	1.5
03/17	4.4	0.9	3.1	183	5.0	0.87	3.1
03/18e	5.2	2.0	7.0	214	5.3	0.74	3.3
03/19e	5.9	2.4	8.6	232	5.5	0.69	3.5

Note: *EPS is adjusted for gains/losses on sales of investment property, revaluation movements, and non-recurring items. **Period from 4 December to 31 March 2016.

Letting progress driving income and capital gains

H118 net rental income increased 30% on H117 and 11% on H217. Letting progress in the period is yet to fully contribute to income and has continued into H218. The improving income profile of the portfolio had a significant impact on adjusted earnings and dividend-paying capacity, with the former more than tripling y-o-y and more than doubling versus H218. Meanwhile, the 11.3% gain in the portfolio value to £103.5m supported NAV per share growth to 212p. NAV total return was 17.1% during the six-month period. We have increased estimates again, with faster rental growth having a geared impact on adjusted EPS, which for FY18e goes from 5.4p to 7.0p. NAV per share forecasts also increase, though more moderately, and we have increased our FY18e DPS to 5.3p (5.2p).

Upside potential from refurbished assets

Circle specialises in acquiring short-let or part-vacant office properties in the UK's provincial cities where it can add value by undertaking lease renewals, rent reviews, lettings and refurbishments. Valuation uplift reflects these efforts and, with an additional potential rent income of more than £2m pa as recent refurbishments are let, there should be more to follow. Our near-term forecasts capture only part of this and faster letting progress could lift FY19e underlying EPS by c 50% and NAV per share towards 250p. Liquidity is thin, but management is considering options for enlarging the shareholder base, perhaps in conjunction with growing the asset base.

Valuation: Wide discount with nothing for upside

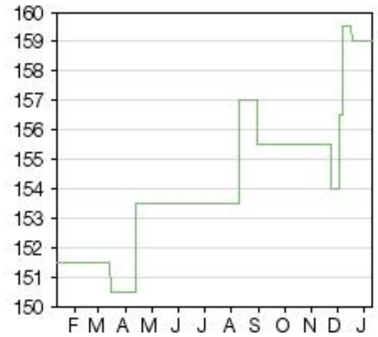
Our revised forecasts show the shares trading at a 25% discount to FY18e NAV per share supported by a fully covered dividend yield of more than 3%. Given management's experience and track record, this is a low valuation with nothing obviously being factored in for the upside potential.

10 January 2018

Price	**159p**
Market cap	**£45m**

Net debt (£m) at 30 September 2017	43.6
Net LTV at 30 September 2017	42.3%
Shares in issue (exc. Treasury)	28.3m
Free float	63.5%
Code	CRC
Primary exchange	AIM
Secondary exchange	N/A

Share price performance



%	1m	3m	12m
Abs	(0.3)	2.3	5.0
Rel (local)	(4.6)	(0.9)	(3.0)

52-week high/low	159.5p	150.5p

Business description

Circle Property is an AIM-quoted property investment company with a wholly UK portfolio, currently focused on UK office buildings, mainly 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

Trading update	Exp. April 2018

Analysts

Martyn King +44 (0)20 3077 5745

Andrew Mitchell +44 (0)20 3681 2500

financials@edisongroup.com

Edison profile page

Circle Property is a research client of Edison Investment Research Limited

Company description: Regional refurbishment specialist

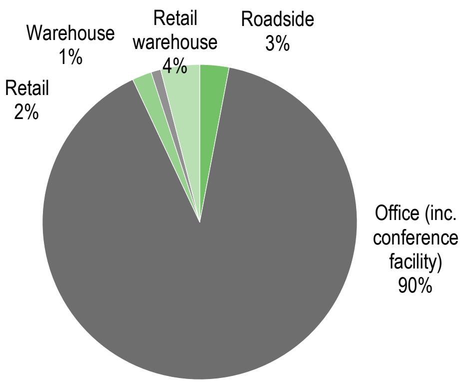
Circle is an internally managed property investment company, registered in Jersey. It was initially founded as a limited partnership in 2002, became a Jersey Property Unit Trust (JPUT) in 2006, and has been quoted on AIM since February 2016. Its focus is office properties in the UK's provincial cities, targeting assets that may be too small for most institutional investors but too large for most private investors, and where the income profile is likely to deter REIT investors. It typically targets short-let properties (or vacant properties, if the letting prospects are sufficiently strong) where it can add value by undertaking lease renewals, rent reviews, lettings and refurbishments.

Circle's senior management team includes three full-time property professionals and the company is governed by a highly experienced board. Together, the management and board own approximately 30% of the company, closely aligning their interests with external shareholders. The company has a strong track record of NAV total returns, both prior to IPO and since, and this continued through H118.

The current portfolio of 15 assets is now valued at £103.5m (30 September 2017) of which 11 office buildings comprise 90%. All the assets, with one exception (an office property in Moorgate), are outside London and significant refurbishment programmes have been 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.

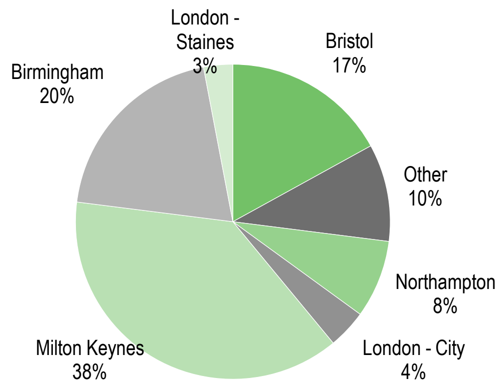
For a full description of the company and its strategy see our initiation note.

Exhibit 1: Portfolio sector split by value



Source: Circle Property 30 September 2017

Exhibit 2: Portfolio regional split by value



Source: Circle Property 30 September 2017

Highlights of the FY18 interim results

H118 results that were released in December show ongoing asset management initiatives continuing to drive operational progress, delivering strong growth in rental income and cash earnings, and lifting investment portfolio valuations. Rental income in H118 benefited from the more than £600k of lease contracts signed in H217, while the period under review saw a further 7.2% added to the annualised rent roll, which is yet to be fully recognised in income. Further leasing progress has already been made in H218 and we review this, and the implications for our forecasts, in a later section.

Exhibit 3: H118 financial summary and comparison

(£'000s)	H118	H117	Change (%)	FY17
Net rental income	2,611	2,007	30%	4,366
Administrative expenses	(801)	(856)	(6%)	(2,115)
Operating profit before revaluations & other one-off items	1,810	1,151	57%	2,251
Gains on disposal	0	0		279
Gains on revaluation	7,307	6,597		7,361
Negative goodwill & listing costs	0	0		88
Operating profit	9,117	7,748		9,979
Net finance costs	(552)	526		(13)
Profit before tax	8,565	8,274		9,966
Taxation	99	(62)		(22)
Profit after tax	8,664	8,212	6%	9,944
Adjusted earnings	1,358	288	372%	889
IFRS EPS (p)	30.6	29.0		35.1
Adjusted EPS (p)	4.8	1.0	372%	3.1
DPS (p)	2.6	2.4	8%	5.0
IFRS & EPRA NAV per share (p)	212	179		183
EPRA NAV total return	17.1%	20.1%		24.1%
Net LTV	42.3%	45.6%		43.9%

Source: Company data

The financial highlights of H118 were:

- IFRS earnings of £8.7m or 30.6p per share were 6% higher than the level reported in the prior year period. Gains on the revaluation of investment properties represented a substantial share of the profits in both periods, but were slightly higher in H118 at £7.3m (H117: £6.6m).
- On an underlying basis, excluding revaluation, earnings were £1.4m or 4.8p per share, more than tripling compared with the prior year period, benefiting from operational gearing. Net rental income increased 30% to £2.6m while administrative expenses declined by 6%.
- The interim dividend of 2.6p is in line with that declared in H217, representing an 8.3% increase over H117 (2.4p).
- NAV per share (both IFRS and EPRA) benefited from the substantial revaluation gains that resulted from asset management of the portfolio (see our update note published on 27 October 2017) and increased to 212p compared with 183p at end-FY17.
- The growth in NAV per share, taken together with dividends paid per share, generated a strong NAV total return of 17.1% during the six-month period. This compares with 20.1% in H117 and 24.1% for FY17 as a whole.
- Gross balance sheet debt was £48.8m at 30 September 2017 and, allowing for cash and unamortised debt issuance costs, the net loan to value ratio (LTV) was 42.3% (end-FY17: 43.9%).

Management remains positive about the prospects for the regional office market, noting a robust occupier market and ongoing constraints on supply, with the investment market also remaining strong with little or no sign of a softening in yields. It expects the favourable demand-supply situation in the occupier market to remain as long as the ongoing conversion of office space to residential continues, or until rents rise sufficiently to encourage new development. While tenants are showing a degree of caution in making long-term leasing decisions against the backdrop of Brexit uncertainty, Circle expects the location and quality of its assets, particularly those that have been refurbished, to continue to appeal to tenants. As discussed below, there is considerable reversionary potential in the portfolio, which should support the company's ability to both attract tenants and grow rental income.

Portfolio update

The investment portfolio fair value increased by 11.3% in H118 to £103.5m (the balance sheet value of £96.3m, up from £86.1m at end-FY17, includes an adjustment for unamortised lease incentives). The fair value uplift included a 7.9% revaluation gain, with most of the balance accounted for by capex. In terms of composition, the portfolio is relatively concentrated, with 15 properties, and with a current focus on the regions (75% in Milton Keynes, Birmingham and Bristol) and offices, which represent 90% of the value (Exhibits 1 and 2). The annualised contracted rent roll excluding rent-free periods rose to £5.95m at end-H118 (end-FY17: £5.62m), still considerably below the expected rental value (ERV), which also increased to £9.34m (end-FY17: £8.89m). Around £2.0m of the reversionary potential (the potential uplift in rents to ERV) is represented by vacant space at recently completed major refurbishment projects (discussed below) and the balance by leasing events spread across the portfolio. Despite the strong gains in valuation during the period, and since IPO, there is considerable scope for further upside. Although the end-H118 valuation represents a net initial yield of 5.4%, the reversionary yield is 8.48%, while the capital value is low at an average £163 per sqft (which management indicates is below replacement value) with an average rent of £12.80 per sqft.

Exhibit 4: Portfolio valuation summary

	Value (£000s)	Initial yield	Reversionary yield
Offices	93,200	5.24%	8.54%
Industrial	1,125	6.13%	13.20%
Motor & roadside	2,950	7.00%	6.87%
High Street retail	1,700	6.90%	7.31%
Retail warehousing	4,550	6.82%	7.57%
Total portfolio	103,525	5.40%	8.48%

Source: Company data

The weighted average unexpired lease term to first break increased to 7.73 years from 7.39 years at end-FY17 and to 11.29 years to lease expiry from 11.23 years at end-FY17. Lease contracts signed during the period added £379k (gross) to the contracted rent roll, or 7.2%. The rent roll (net) increased by c 6%. Further letting progress has been made in H218 and management indicates that, should all the negotiations currently underway convert to lettings, annualised contracted rental income should exceed £6.0m by the end of FY18.

The most significant driver of income growth and asset valuation over the next 18 months or so will be progress in letting the three recently refurbished assets (the "development portfolio" assets) described below. The additional gross rent potential from fully letting remaining available space in these properties is c £2.0m pa, with the potential to lift the contracted rent roll to £8m.

- **K2, Kents Hill Business Park, Milton Keynes. Reversionary potential £0.6m.** This 40,000sqft, two-storey office unit within the Kents Hill Business Park has been refurbished at a cost of £2.4m. In October 2017 management reported significant progress in letting the space, with the majority of the ground floor under offer and good interest in the first floor. The first letting (5,500 sqft) is in solicitors' hands.
- **36 Great Charles St, Birmingham. Reversionary potential £0.5m**. This 25,000sqft office building in the core office district, near to the major redevelopment of the area around the city hall, was acquired in 2015 for £2.5m (31 March 2017 value £4.6m). A rolling refurbishment was completed in June 2017 at a cost of c £2.1m, and the refurbished space is now being marketed, with one letting in solicitors' hands.
- **Somerset House, Temple St, Birmingham. Reversionary potential £0.95m.** This building, in the heart of Birmingham's financial and professional core, and a two-minute walk from the Birmingham New St rail station, was bought in January 2016 for £7.75m. Subsequently, planning permission was obtained to provide two enlarged ground floor restaurant units, for

which construction has been completed. Refurbishment of the vacant 43,700sqft of office space has just completed and will now be the subject of a wider marketing campaign. During H118, a new 20-year lease without break was signed with Latin American restaurant Las Iguanas at a rent of £220,000 pa. The second restaurant unit is now under offer.

Exhibit 5: Contracted rents and expected rental value (30 September 2017)

£000s	
Contracted rent roll at 30 September 2017	5.95
Development assets expected rent (ERV)	
K2, Kents Hill Business Park, Milton Keynes	0.60
Great Charles St, Birmingham uplift	0.50
Somerset House, Temple St., Birmingham	0.95
Potential rent including development assets	8.00
Other, rent reversion potential	1.35
Total portfolio ERV at 30 September 2017	9.35

Source: Company data

Financials

The H118 financial results were ahead of our unpublished expectations for this stage of the current year. Driven by leasing progress, net rental income was c £200k ahead of our expectations while administrative costs were c £100k lower. Given the income profile of the portfolio, with its significant exposure to asset management projects, the impact of these differences on our forecast adjusted earnings is quite material. Forecast adjusted EPS for the current year increases 31% to 7.0p (from 5.4p) and we have also increased FY19 to an expected 8.6p (from 8.2p). Given this strong profile of adjusted earnings growth we have also raised our dividend expectations and now look for 5.3p in FY18 (was 5.2p) and 5.5p in FY19 (was 5.2p).

Recent new lettings have already improved the income profile of the portfolio and we expect this to continue. Our revised estimates assume £6.2m or c 66% of ERV (end-FY18 c 64%). We allow for c 2% pa ERV growth through H218 and FY19. The effect is to lift forecast FY18 net rental income by c 5%, largely representing a pulling forward of the letting progress that we previously allowed for in FY19. Our FY19 net rental income forecast increases by just under 1% and is based on end-FY19 annualised contracted rents of £7.3m (c 76% of forecast ERV). Faster net rental income growth is the main driver of our forecast upgrades, with a lesser contribution from expected administrative costs and, in FY18, the follow through of a H118 tax credit that was not reflected in our previous forecast.

Exhibit 6: Forecast 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 (%)
03/18e	4.9	5.2	5.0	1.5	2.0	31.2	5.4	7.0	31.2	210	214	2.1	5.2	5.3	1.9
03/19e	5.8	5.9	1.3	2.3	2.4	4.8	8.2	8.6	4.8	220	232	5.5	5.2	5.5	5.8

Source: Edison Investment Research

Our NAV forecasts had already taken account of the H118 revaluation gains that were pre-announced in October. However, consistent with our assumptions for letting progress, we have increased our forward-looking revaluation gain forecasts. We believe that these remain relatively conservative and make no assumption about the general level of market valuation yields. For H218 we assume a £1m uplift, taking the total increase on the opening value in the year to 8.9% from 7.9% in H118. For FY19 we assume a £4m gain, or 3.8% of the opening value. Looked at alongside the increase in annualised contracted rents, the implied end-FY19 net initial yield actually increases to a little over 6.2% (from 5.4% at end-H118), while the implied reversionary yield declines to c 8.2% (from 8.48% at end-FY18).

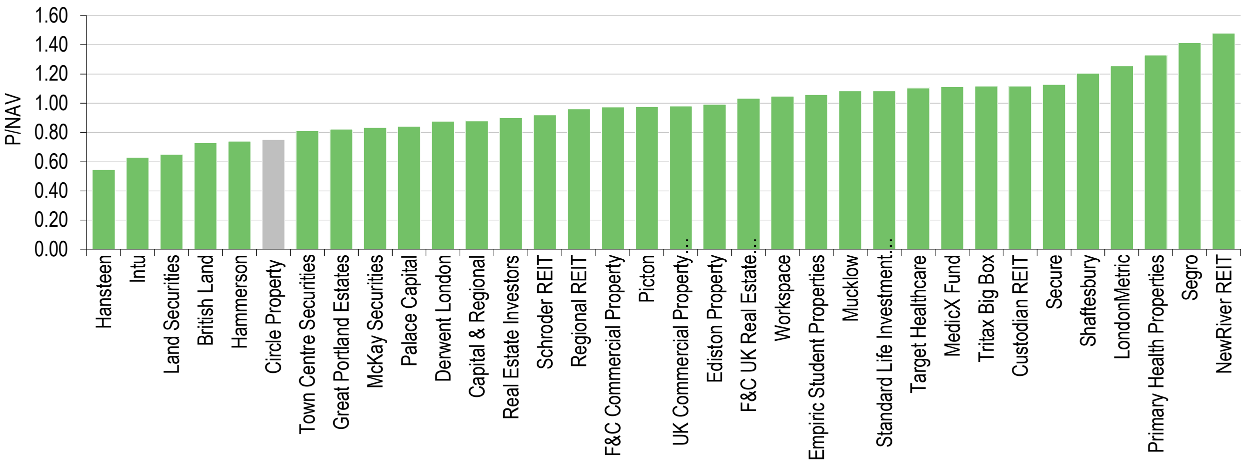
The letting of vacant space at a faster pace than we have allowed for in our estimates is a potential source of significant upside to our forecast adjusted earnings and NAV. If we were to capitalise the £8.0m of potential contracted rent including a full contribution from the development assets (but excluding the £1.35m of additional reversionary potential in the portfolio) at 7.0%, the implied value of the investment portfolio assets is £114m, which adds c 14p per share to the current NAV, without any benefit from the remaining reversionary potential or from retained operating earnings between now and end-FY19. The potential uplift is smaller than we last published because we assumed higher revaluation gains in our forecasts. On a full year basis, underlying earnings per share would increase substantially (c 50%) given the operating and financial leverage on the increased rental income (c £1.1m pa above that forecast in FY19).

Valuation

For Circle, unlike a REIT, capital returns are expected to be a significant element of overall total returns, which we think is best measured by NAV total return (the change in NAV per share plus dividends paid per share). In the 10 years to FY16, the average annual return was more than 7.5% pa. NAV total return since IPO has increased and we calculate a 24.1% annual total return for FY17 and our estimates suggest a c 19.9% annual total return in the current year and 10.6% in FY19 (on which we believe are conservative revaluation assumptions). As we have indicated in the financial section above, in current market conditions there is considerable scope for further progress in NAV, over and above that built into our near-term forecasts, as the letting of vacant space progresses, and this would further support NAV total return.

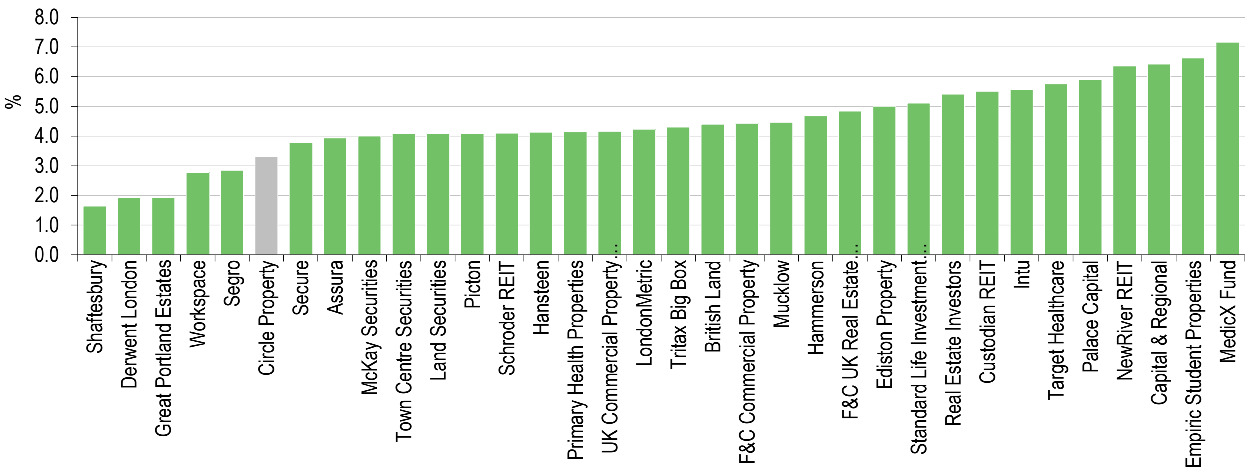
For an investor, expected future capital returns are perhaps less easy to predict than expected dividend returns driven by currently contracted rental income, and this creates a tendency for stocks with the highest yields to also trade at the higher P/NAV ratios. A strong management track record provides additional comfort on the delivery of potential capital returns, and given Circle management's experience and track record, the current 25% discount to our forecast FY18 NAV per share, supported by a dividend yield of more than 3%, continues to represent a relatively low valuation with nothing obviously being factored in for the upside potential. Some discount for Circle's relatively small market capitalisation and thin share trading liquidity, and for its above average gearing, may be anticipated. Moreover, while the relatively concentrated nature of the Circle portfolio allows the company to focus its efforts, it does not provide the risk diversification offered by some larger regional commercial property companies. However, despite these considerations and bearing in mind the potential for future NAV growth described above, the low valuation ascribed to Circle within the context of the broad UK-listed property sector is shown clearly in Exhibits 7 and 8.

Exhibit 7: Comparison of historic P/NAV



Source: Bloomberg data as at 2 January 2018, Edison Investment Research

Exhibit 8: Comparison of prospective dividend yield



Source: Bloomberg data as at 2 January 2018, Edison Investment Research

As noted above, Circle management is keen to support trading liquidity in the shares and is considering options for enlarging the shareholder base. Moreover, given the stated desire to grow the portfolio further, we would expect Circle to consider increasing its capital resources, both equity and debt, to fund future acquisitions, although an alternative option would be to recycle capital by disposing of assets that have been repositioned and then fully let. We have not included any property acquisitions in our forecasts, which indicate the net LTV trending down to c 40% by end-FY19. In our previous note we illustrated potential options for funding portfolio growth while managing gearing. Property acquisitions have the potential to enhance EPS and dividend-paying capacity, capturing the likely positive spread between asset yields and funding costs and generating scale efficiency. However, given the current discount to NAV it may be difficult to avoid some NAV per share dilution if the funding of acquisitions includes an element of equity funding. Overall, we do not believe that it would alter the conclusion that the shares are trading at a low valuation compared with the current forecasts and potential for further value creation, while any increase in Circle's market capitalisation and share trading liquidity should broaden its investor appeal.

Exhibit 9: Financial summary

Year ending 31 March	FY16	FY17	FY18e	FY19e
£000s	IFRS	IFRS	IFRS	IFRS
INCOME STATEMENT				
Rental income	664	5,266	5,980	6,735
Other income	595	138	93	0
Total income	1,260	5,404	6,073	6,735
Property expenses	(123)	(1,037)	(920)	(870)
Net rental income	1,137	4,366	5,152	5,865
Administrative expenses	(293)	(2,115)	(2,116)	(2,202)
Operating profit before valuation gains	844	2,251	3,036	3,663
Gains on disposal of investment properties	0	279	0	0
Revaluation of investment properties	0	7,361	8,307	4,000
Exception items	374	88	0	0
Operating profit	1,217	9,979	11,343	7,663
Net finance costs	(112)	(13)	(1,120)	(1,136)
Profit before tax	1,106	9,966	10,223	6,527
Tax	(32)	(22)	73	(101)
Net profit	1,073	9,944	10,295	6,426
Adjusted for:				
Gain/(loss) on disposal of investment property	0	(279)	0	0
Revaluation of investment property	0	(7,361)	(8,307)	(4,000)
Fair value movement on interest rate swaps	2	(96)	1	0
Exceptional items	(374)	(88)	0	0
Adjustment for effective interest rate on borrowings	(54)	(1,232)	0	0
Adjusted earnings	648	889	1,989	2,426
Shares ('000s) exc. own shares held	28,297	28,297	28,297	28,297
IFRS EPS (p)	3.8	35.1	36.4	22.7
Diluted adjusted EPS (p)	2.3	3.1	7.0	8.6
Dividend declared (p)	2.4	5.0	5.3	5.5
BALANCE SHEET				
Investment properties	75,781	86,054	97,788	102,788
PPE	22	29	26	26
Trade and other receivables	1,771	6,518	6,737	6,737
Deferred tax	915	1,142	1,142	1,142
Financial instruments at FV through P&L	0	1	0	0
Total non-current assets	78,490	93,744	105,693	110,693
Trade and other receivables	2,555	1,195	1,350	1,481
Deferred tax	105	128	322	322
Cash and equivalents	4,516	4,894	4,541	4,770
Total current assets	7,176	6,217	6,212	6,572
Total assets	85,665	99,962	111,905	117,265
Borrowings	(40,028)	(45,590)	(48,831)	(48,891)
Financial liability at FV through P&L	(95)	0	0	0
Total non-current liabilities	(40,123)	(45,590)	(48,831)	(48,891)
Trade and other payables	(2,306)	(2,550)	(2,429)	(2,803)
Total current liabilities	(2,306)	(2,550)	(2,429)	(2,803)
Total liabilities	(42,430)	(48,140)	(51,260)	(51,693)
Net assets	43,236	51,822	60,646	65,572
Basic and diluted IFRS NAV per share (p)	153	183	214	232
CASH FLOW				
Profit before tax	1,106	9,966	10,223	6,527
Adjusted for				
Net finance expense	112	1,245	1,120	1,136
Depreciation	1	7	6	7
Share-based payments	0	0	0	0
Gains on revaluation	0	(7,361)	(8,307)	(4,000)
Gains on disposal of investment properties	0	(279)	0	0
Amortisation of loan arrangement fees	7	40	59	60
Goodwill, interest rate ans swap valuation movements	(1,751)	(1,523)	1	0
Working capital movements	1,132	(3,512)	(566)	243
Cash from operations	607	(1,416)	2,536	3,972
Tax paid	0	0	(26)	(101)
Net interest (paid)/received	(56)	(1,346)	(1,120)	(1,136)
Net cash from operations	551	(2,763)	1,389	2,736
Net cash from investing	3,610	(2,255)	(3,452)	(1,007)
Net cash used in financing	356	5,396	1,710	(1,500)
Net increase/(decrease) in cash and equivalents	4,516	378	(353)	229
Opening cash	0	4,516	4,894	4,541
Closing cash	4,516	4,894	4,541	4,770
Debt	(40,028)	(45,590)	(48,831)	(48,891)
Net debt	(35,512)	(40,697)	(44,290)	(44,121)
Net LTV	45.7%	43.9%	42.2%	40.1%

Source: Company accounts, Edison Investment Research

Frankfurt +49 (0)69 78 8076 960
Schumannstrasse 34b
60325 Frankfurt
Germany

London +44 (0)20 3077 5700
280 High Holborn
London, WC1V 7EE
United Kingdom

New York +1 646 653 7026
295 Madison Avenue, 18th Floor
10017, New York
US

Sydney +61 (0)2 8249 8342
Level 12, Office 1205
95 Pitt Street, Sydney
NSW 2000, Australia