



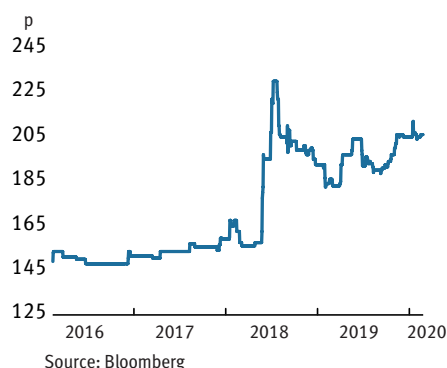
Circle Property: A deep value property play

Having outperformed its peers by a country mile since IPO four years ago, this company has real prospects of delivering bumper capital growth in the future

Circle Property (Aim:CRC)

Ticker	CRC
Current price	206p
12-month target price	287p
Market cap	£58m
52-week high	214p
52-week low	180p
Net debt	£57m
Shares in issue	28.3m
Financial year-end	31 Mar
Next event	Pre-closing trading update late April/early May 2020
Company website	circleproperty.co.uk

Circle Property share price history



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Simon Thompson's view:

Circle Property has produced a net asset value (NAV) accounting total return of almost 100 per cent since IPO in February 2016, but its shares can be purchased 30 per cent below spot NAV. That discount comes despite a raft of new leases on its office property portfolio, which is driving rental income up and underpins bumper valuation gains. With the benefit of a modestly geared balance sheet and over £40m headroom on a new low-cost banking facility, the company has the firepower to make further value-accretive property acquisitions to enhance shareholder returns. It's a win, win situation, and one that is simply being mispriced by the market.

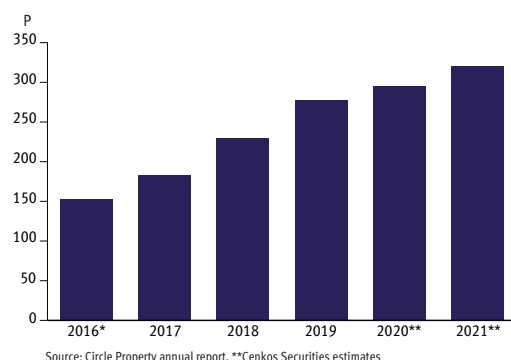
Bull points

- Trading on a 36 per cent discount to March 2021 NAV per share, even though the company has delivered NAV growth of 87 per cent since IPO in February 2016 without raising new equity.
- Portfolio offers an attractive estimated reversionary yield of 8 per cent based on historic valuations.
- Over 91 per cent occupancy rates following recent lettings with the higher rental income underpinning NAV growth estimates.
- Portfolio weighting to undersupplied regional offices and no exposure to retail assets.
- Track record of delivering strong valuation gains by purchasing under-rented offices and managing them to improve occupancy rates.
- Modest balance sheet gearing and ample headroom on £100m low-cost debt facility to fund further value-accretive acquisitions.
- Progressive dividend policy.
- Highly experienced board of directors own 24 per cent of equity, thus aligning their interests with those of other shareholders.
- Net rental income covers all annual operating costs and dividends, so property portfolio can be managed to maximise long-term total returns without the need to make short-term disposals.

Bear points

- IPO in February 2016, so short track record.
- Small-cap liquidity discount and low free float limits institutional investment.
- Property concentration risk in four UK towns and cities.
- The board continues to review options for enlarging shareholder base, so potential for an equity share issue.
- Business confidence and trading activity of tenants could be undermined if the UK fails to agree a trade deal with the EU before 2020 ends.

Circle Property net asset value almost doubles since IPO



Circle Property (CRC) is a little known internally-managed Jersey-registered property company, which floated its shares, at 149p, on the Alternative Investment Market (Aim) four years ago. Without raising any new equity, the company has doubled the value of its investment portfolio from £74m to £136m, highlighting just how successful its highly regarded management team has been in acquiring provincial office properties where it can add value by undertaking lease renewals, rent reviews, lettings and refurbishments.

The company's net asset value (NAV) per share increased by 86 per cent between IPO in February 2016 and the September 2019 half-year-end. Add on 19.8p a share of dividends, which have been paid out, and the company has delivered a total accounting return of 99 per cent, making Circle Property one of the best performing listed property companies. The company has not overly geared up the balance sheet to generate these returns as net borrowings have only increased from £35.5m to £57m in the past four years since IPO.

The share price has failed to keep pace with the eye-catching increase in the company's NAV, so much so that the discount to analysts' March 2021 NAV estimates is now 36 per cent, one of the deepest in the sector, even though likely valuation uplifts are fully supported by recent lettings, which have boosted rental income from the investment portfolio. Around 99 per cent of the portfolio is focused on the regional office sector in undersupplied geographic locations, and is highly reversionary, too.

The key to Circle Property's success is targeting well-located short-let, or partly let, property acquisitions which are close to vacant possession, so they can be redeveloped and refurbished in order to maximise the reversionary yield when they are fully let. Reversionary yield is a term used in the property market to describe the yield that should be achieved if the passing rent adjusts to the level of the estimated rental value.

Management is nimble in seeking out new tenants as soon as the refurbishment process is under way, therefore reducing void periods and locking in rental income to drive up capital values. The aim is to deliver a minimum total geared annual return of 12 per cent on the property acquisitions and 20 per cent on development projects.

Circle Property is not a real-estate investment trust (Reit), and has no plans to convert to one either. This means that it is not constrained by the Reit requirement to distribute 90 per cent of profits to shareholders as dividends, so can focus on targeting properties that require significant amounts of capital expenditure to redevelop and refurbish in order to maximise capital returns.

This strategy simply wouldn't be possible if the company adopted Reit status.

The board has still adopted a progressive dividend policy to reward shareholders with a rising income stream. The 3.6 per cent prospective dividend yield for the financial year to end of March 2021 is a couple of percentage points less than an investor can earn from a UK-focused Reit, but the income deficit is more than offset by Circle Property's NAV per share growth, to give shareholders a sector-leading total return.

Circle Property (Aim: CRC)

Ord Price: 206p Market Value: £58m
Touch: 204-208p 12-Month High: 214p Low: 180p
Discount to NAV**: 36% Dividend yield: 3.7
Investment Properties: £135m Net Gearing: 72%

12 months to 31 Mar	Net asset value (p)	Pre-tax profit (£m)	Earnings per share (p)	Dividend per share (p)
2016*	153	1.1	4.0	nil
2017	183	10.0	35.0	5.0
2018	230	14.0	51.0	5.6
2019	277	15.2	53.0	6.3
2020**	295	8.4	19.5	7.0
2021**	320	10.3	36.1	7.7
% change	+8	+23	+85	+10

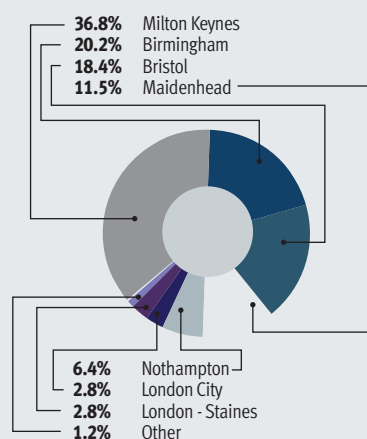
Normal market size: 750 SETSqx

*Financial reporting period from 4 December 2015 to 31 March 2016

** Cenkos Securities estimates include revaluation gains of £5.5m and £7.7m, respectively, for financial years to 31 March 2020 and 2021 (9 December 2019)

Source: Circle Property Annual Report, London Stock Exchange

Circle Property investment portfolio by geographic area (Dec 2019)



Source: Circle Property Annual Report and London Stock Exchange

Regional office benefiting from positive dynamics

Circle Property owns a portfolio of 15 office properties, of which almost 90 per cent by gross value is located in four undersupplied locations: Bristol; Birmingham; Maidenhead; and Milton Keynes. The reason for targeting these regional geographic areas is that occupier demand has remained robust, despite Brexit uncertainty subduing economic growth.

Indeed, take up of office space across the top nine UK regional office markets remained above its long-term average last year, with upward pressure on rents due to limited supply. There is also only a modest amount of new prime regional office property coming onto the market, so good quality refurbished secondary office space can command higher rent levels. Offices-to-residential Permitted Development Rights (PDRs), which were first introduced by the UK government in 2013 as a way to mitigate the country's chronic housing shortage, have further constrained the supply side for secondary office space.

The tight supply-demand helps explain why the most recent quarterly forecasts from the Investment Property Forum (a body that canvasses fund managers and sur-



Barratt Homes is a tenant at Circle Property's premier out of town Business Park, Aztec West, Bristol



Concorde Business Park, Maidenhead purchased for £14.6m in August 2019

veyors) indicate increasing expectations of both rental and capital growth in the office market. The latest surveys point towards positive total returns in the office sector of around 3 per cent in 2020 and almost 5 per cent in 2021.

Active portfolio management

Circle Property primarily targets office acquisitions between £5m and £15m. A good example is the August 2019 acquisition of Concorde Park, Maidenhead – the company's largest purchase to date. The property is well-located, has good motorway access to the M4 and is set to benefit from Crossrail, too.

Six months ago, the 71,500 sq ft park was only 36.6 per cent let to three tenants and was producing a combined rental income of £627,372 per annum, representing a modest 4 per cent net initial yield on the £14.6m purchase price, and fees and stamp duty of around £1m.

Since last summer's acquisition, 21,300 sq ft of the 45,328 sq ft vacant space has been let to serviced office group Regus (16,681 sq ft for 10 years) and Avetta, a US supply chain management software group (4,600 sq ft for five years). The lettings have increased rental income by £485,234 to over £1.1m per annum and boosted occupancy of the building to more than 70 per cent. Assuming the remaining 24,000 sq ft of space is let at current market rents, it would increase gross rental income to £1.55m, implying a net yield on cost of almost 10 per cent.

Circle Property funded £12.8m of the purchase price by drawing down part of the low-cost £60m revolving debt facility (which also has an accordion option of up to £40m) the company secured with NatWest and HSBC in February 2019. It paid an arrangement fee of 0.875 per cent. The rate of interest charged on the facility is 2.05 per cent above Libor and is payable quarterly. Circle Property also pays a commitment fee equating to 0.82 per cent on both the undrawn part of the facility and the accordion facility. There is an option to extend the banking facility to 2025, so there are no immediate refinancing requirements. The facility is secured by a first and only legal charge over all the company's investment properties.

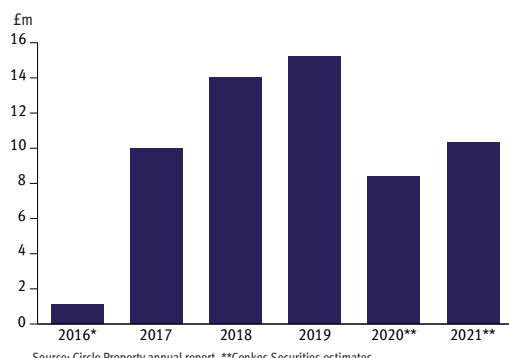
After factoring in interest payments and fees on the funds drawn down on the debt facility to finance the Concorde Park property purchase, the property's current gross rental income of £1.1m is almost three times the annual cost of the borrowings. Circle Property will be clearing nearly £1.1m of free cash from its equity investment once the office park is fully let out.

This is good for operational cash flow and is highly supportive of the board's progressive dividend policy. It also enables the recycling of excess funds into new prop-



Kents Hill Business Park has more than doubled in value since acquisition

Circle Property delivers over £40m of pre-tax profit since IPO



erty purchases or refurbishments in the existing portfolio. The increased occupancy rates at Concorde Park is one reason why analysts expect further valuation uplifts when Circle Property reports annual results for the financial years to 31 March 2020 and 2021. It's not the only smart bit of deal-making either.

Kents Hill Business Park

In December 2013, Circle Property acquired the Kents Hill Business Park, Milton Keynes, for £11m. It has been adding significant value to the property ever since. It consists of eight self-contained buildings comprising 241,000 sq ft of office, hotel, health centre and conference facilities.

The company has renegotiated the lease with its largest tenant, a subsidiary of FTSE 100 giant **Compass Group (CPG)**, a £31bn market capitalisation food and support services group, to increase the passing rent on its 172,372 sq ft of conference and hotel accommodation across six of the eight buildings. The annual rent has been hiked by £50,000 to £1.59m, two tenant breaks have been removed, and the lease now expires in 2041. It is a more valuable income stream, too, because the renegotiated lease has annual retail price index (RPI) linked uplifts, capped at 5 per cent, having previously been fixed at 3 per cent.

The other two buildings at Kents Hill (67,403 sq ft) have been refurbished and are now fully let. Recent tenants include a subsidiary of Deutsche Telecom (13,500 sq ft), and Grand Union Housing (20,462 sq ft). The latter has signed a 10-year lease subject to CPI-linked rent increases at a passing rent of £352,625 per annum (£17.23 per sq ft).

This means the business park now generates around £2.66m of annual rental income, a healthy sum in relation to Circle Property's £11m purchase price and the £10m investment in upgrading the properties. Based on Savills' March 2019 valuation, the average capital value across the park was £200 per sq ft, implying an open market valuation of around £50m, or almost 2.5 times Circle Property's total investment to date. Valuation gains from Kents Hill have made a material contribution to the bumper profits the company has reported in recent years.

There is scope for further valuation upside, as the park now has an estimated rental value (ERV) of £3.75m. This is the valuers' opinion as to the open market rent, which could reasonably be expected to be obtained on a new letting or rent review of a property. This implies a reversionary yield in excess of 7 per cent and suggests that Savills' last valuation is far too conservative for what is now an institutional quality asset with a major blue-chip tenant locked into an inflation-linked lease without break clauses.



36 Great Charles Street, Birmingham offers material reversionary valuation upside

Circle Property commenced refurbishment work on the final office building at Kents Hill in November 2019. The 13,000 sq ft building had previously been let to Compass on a six-month rolling contract. Once the refurbishment work completes in the summer it will be marketed at a rent of £235,000 per annum.

Birmingham refurbishment projects

Circle Property owns two office buildings in Birmingham, 36 Great Charles Street and Somerset House, 37 Temple Street. There is further valuation upside to both properties.

Great Charles Street, a 25,787 sq ft office building located right in the centre of the city, was purchased ahead of the IPO for £2.5m. The low valuation of £100 per sq ft reflected the fact that the building was largely vacant at the time. Since then, Circle Property has invested £2.45m upgrading the property and has leased 14,400 sq ft of the space to small- and medium-sized businesses, generating a passing rent of £276,267 per annum. Tenants include The National Governors Association, The Shaw Trust and Children's Liver Disease Foundation. The property has an ERV of £528,514, implying a reversionary yield of 10 per cent on book value of £5m. Once the remaining 11,400 sq ft of vacant space is fully let – it's being marketed at £18 per sq ft – the building should be worth £7m, indicating potential for significant valuation upside.

Circle Property also acquired Somerset House shortly before its IPO. The 49,761 sq ft building comprises 38,805 sq ft of office and 10,956 sq ft of retail space. It was purchased for just £7.75m, equating to a capital value of £165 per sq ft. The tenant left the building in mid-2016, paying £450,000 in dilapidation costs, which enabled Circle Property to carry out a £3.75m refurbishment and secure planning permission for a change of use on the ground floor to provide two restaurants which have been leased to Las Iguanas and Camerons Brewery for a combined rent roll of £400,000.

The six-floor office refurbishment was leased out to serviced office provider BE Group in the summer of 2018 on a 15-year lease for £795,000 per annum, equating to £20.50 per sq ft. Based on the March 2019 valuation of £17.5m, implying a running yield of 7 per cent on the rent roll of £1.23m, Circle Property has already made an unrealised £5.5m profit on the property and a 100 per cent return on equity invested.

Strong tenant mix and recurring income

At the March 2019 financial year-end, Circle Property's portfolio had an impressive weighted average unexpired lease term (WAULT) of 9.6 years to break, up from 7.2 years 12 months earlier. The improvement is thanks to the raft of lettings in the financial year which drove up contracted rental income by almost 10 per cent on a like-for-like (LFL) basis.

The acquisition of the mainly vacant Concorde Park just before the September 2019 half-year-end resulted in WAULT declining slightly to 8.4 years, but the subsequent lettings both there and at other properties – the company reported over £950,000 of newly-contracted rents since the start of the 2019-20 financial year when it released interim results in December – should drive up WAULT again. Occupancy rates have improved from 87.7 per cent at 30 September 2019 to 91.25 per cent by mid-December 2019.

The company has 57 high-quality tenants. Compass Group accounted for 20.1 per cent of the 2019 financial year-end rent roll; serviced office provider BE Group (10.4 per cent); Which? Financial Services (4.3 per cent); Grand Union Housing (4.6 per cent); discount retailer B&M Retail (3.6 per cent); accountancy firm Grant Thornton (3.3 per cent); New World Trading, trading as The Botanist (3.2 per cent); and T-Systems, a subsidiary of Deutsche Telecom (3 per cent).

Although there is tenant concentration risk with the Compass lease, this is mitigated by the fact that the lease has 21.5 years remaining to expiry and the next break is not for another 15 years and has a £2m early exit penalty. Excluding the top eight tenants, just under half of the rent roll is spread across 49 tenants, diversifying default risk.

Circle Property portfolio summary, 30 September 2019

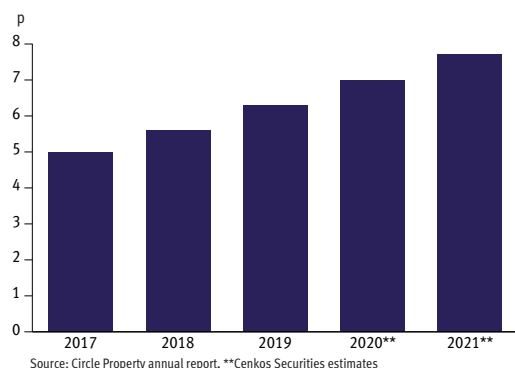
Portfolio valuation	£135.6m
Number of properties	15
Average lot size	£9m
Gross lettable area	642,500 sq ft
Number of tenants	57
Annualised contracted rental income (incl. lettings post-Sept 2019 half-year-end)	£9.1m
Weighted average unexpired lease term (WAULT) to first break	8.4 years
Occupancy by area	91.25%
Estimated rental value (ERV) at full occupancy	£10.8m

Source: Circle Property Annual Report; London Stock Exchange RNS; Cenkos Securities; Edison Investment Research

A strong and improving recurring income stream

Overall, there was an 18 per cent increase in contracted rental income to £7.6m in the 2018/19 financial year and a 7.2 per cent uplift to £8.2m in the first six months of the 2019-20 financial year. Annualised gross rents have since increased to £9m (net rents of £8.4m) based on recent lettings of refurbished properties. ERV is estimated at

Circle Property's progressive dividend policy



£10.8m, highlighting potential for rental income to climb further.

Based on Circle Property's current gross rental income, the £900,000 increase in net rents expected in the 2020-21 financial year (which only takes into account contracted new lettings), easily covers the forecast £300,000 rise in Circle Property's annual administration costs (from £2.8m to around £3.1m) and a £200,000 higher interest charge, thus leaving surplus profits to be recycled back to shareholders in dividends.

In turn, the dividend per share is expected to increase from 6.3p to 7p in the 12 months to 31 March 2020, rising to 7.7p the year after. The annual cost of this year's annual dividend is around £2m, a sum covered 1.5 times by forecast post-tax profits of £3m after stripping out an estimated £5.5m of unrealised revaluation gains.

Jersey-domiciled Circle Property pays a modest amount of corporation tax, so shareholders rather than HMRC are the major beneficiary of the profits the company makes both in terms of NAV accretion and income returns.

Assuming the 8.75 per cent of vacant space in the portfolio is fully let out at current market rates, Circle Property's net profits (excluding £7m of estimated revaluation gains) will rise to £4.5m (16p a share), or 50 per cent higher than analysts are predicting in the 2020-21 financial year. It's worth stressing that the ongoing increase in rental income is the key driver of NAV growth rather than yield compression, so the company is not reliant on investment demand to drive investment yields.

The company has the firepower to make further value enhancing acquisitions to augment NAV per share growth. Circle Property's net borrowings of £57m equate to a modest 42 per cent of the property portfolio valuation of £135.6m (before accounting for March 2020 year-end revaluation gains which house broker Cenkos Securities estimates at £5.5m). That's well within the 60 per cent loan-to-value banking facility financial covenant. Also, net rents are more than four times higher than annual interest costs, so interest cover is very comfortable. The banking facility has a covenant that interest cover must be at least two times looking both forward and backward. In addition, Circle Property must ensure that the total market value of the charged properties does not fall below £50m at any time and that no single tenant represents more than 25 per cent of the total contracted rents. On both scores, it comfortably meets these covenants.

Management team

The board is led by 76-year-old non-executive chairman Ian Henderson, a stalwart of the property industry. Mr Henderson was formerly chief executive of FTSE 100 REIT, **Land Securities Group (LAND)**, and has been widely involved in the UK property industry, including being a past president of the British Property Federation.

The company's chief executive is 64-year-old John Arnold. He spent seven years at St Quintin Chartered Surveyors (now CBRE) and joined Hambros plc in January 1986. He became a director of Berkeley Hambro plc, its property subsidiary, in 1991. He remained until Investec's acquisition of Hambros Bank in 1998, when he was appointed managing director of Investec Property plc. He founded Circle Property Limited Partnership (LP) in 2002, the forerunner to the company, and holds a 3.6 per cent stake.

Circle Property's chief operating officer is 46-year-old chartered surveyor Edward Olins. He was previously investment director at London & County Estates before joining Circle Property LP in 2006 to take control of new business acquisitions and assist Mr Arnold in the running of the company. He holds a 0.5 per cent stake.

Circle Property has three other non-executive directors: 70-year-old James Hambro holds a 11.4 per cent shareholding, and he is chairman of James Hambro & Partners. He was chairman of Hansteen, a FTSE 250 industrial property company, and a director of Primary Health Properties. The second is 65-year-old Michael Farrow, a senior independent director of FTSE 250 property group RDI REIT, chairman of STANLIB (a Jersey regulated open-ended investment company), and a non-executive director of Aim-traded RedT Energy (formerly Camco Clean Energy). Third is Damian Jepson, a chartered accountant at Oak Group (Jersey) Limited's Corporate and Fund, a Jersey licensed trust and fund services company for high net worth individuals.

Combined, the directors have over 100 years of experience in the property industry. The board was paid a combined basic salary of £579,000 in the 2018-19 financial year and received bonus payments of £399,000 and a further £300,000 under LTIP awards. Their total remuneration of £1.35m was less than the £1.7m cash dividends paid to shareholders and equates to only 9 per cent of the pre-tax profit of £15.2m reported by the company that year.

There is clearly an incentive for the board to maintain Circle Property's progressive dividend policy given their large shareholdings, thus aligning their interests with those of outside shareholders.

Major shareholders

Circle Property's shares are tightly held. The top 13 shareholders effectively control almost 80 per cent of the 28.2m shares in issue, and 36.5 per cent of the shares are not in public hands as defined by Aim rules, including director holdings and extended family interests.

As a result, the free float is lower than ideal, but the shares can still be traded on a bid-offer spread of 4p and in bargain sizes well above the London Stock Exchange's Normal Market Size of 750 shares. For example, last week a trade of 11,500 shares went through at the offer price, and there have been even larger trades in recent months.

One issue with a more restricted free float is that share price movements are accentuated in both directions. The liquidity factor should work in investors' favour given that Circle Property is expected to continue to deliver revaluation gains driven by ongoing growth in rental income as new leases are signed to reduce voids in the portfolio. Also, with the benefit of a modestly geared balance sheet, there is scope for the management team to make more acquisitions which are likely to be well received by investors. Of course, any negative news flow such as tenant defaults or rising investment yields (which reduce capital values) would have the opposite effect, which is worth considering.

Circle Property's board continues to consider options to enlarge the company's shareholder base. There is no point issuing new shares when the share price is trading on a deep discount to book value (as is the case right now) as it would dilute the economic interest of existing shareholders, including the directors. If Circle Property's shares were to re-rate closer to NAV, then this could be the catalyst for the board to consider a fundraise to widen the shareholder base. The effect of this would be to increase the appeal of the shares to a wider pool of investors in light of the company's larger market capitalisation and liquidity.

As a hypothetical example, if the share price traded closer to analysts' March 2020 NAV per share estimate of 295p, then Circle Property would have a market capitalisation of £84m. A placing of 5.7m new shares, or 20 per cent of the existing share capital, at that price would raise around £16m net of expenses, increase the company's market capitalisation to £100m and provide funds to accelerate portfolio growth.

Clearly, the company is looking to reduce the share price discount. At the end of 2018, Cenkos Securities was appointed corporate broker and nominated advisor (Nomad) to the company following completion of the broking house's acquisition of the Nomad and corporate broking business of Smith & Williamson. Both Cenkos and Edison Investment Research produce equity research on the company.

Circle Property major shareholders

Name	Percentage
Hastings Limited	12.9%
James Hambro	11.4%
Hendref Limited	8.8%
The estate of the 10th Duke of Roxburghe	8.8%
David Jeffrey Fisher	5.8%
Palace Capital plc	5.0%
Richard Moore	4.9%
Downing LLP	4.4%
The 3rd Earl of Halifax Discretionary Trust	4.1%
John Arnold (CEO)	3.6%
The Butterfly Trust	3.5%
The Estate of the Late Mary Christine Hambro	3.5%
Judith Brodie	3.2%
Total	79.9%

Source: Circle Property 2019 Annual Report, London Stock Exchange RNS

Peer group comparison

Circle Property is a small-cap company, so you have to factor in a liquidity discount into its rating. However, the current share price discount is extreme.

Based on the 18 UK commercial real estate companies covered by brokerage Liberum Capital, the average share price discount to NAV is less than 4 per cent, ranging from a premium of 11.9 per cent for LXI REIT and Warehouse REIT (market capitalisations of £698m and £279m, respectively), to a discount of 22.4 per cent for Schroders REIT and AEW UK Long Lease REIT. Circle Property is priced on a 30 per cent discount to spot NAV estimate of 295p a share for the March 2020 financial year-end.

Circle Property peer group analysis

Company	Market capitalisation	Premium/discount	Dividend yield	Percentage NAV return	
				1-year	3-year
AEW UK REIT	£150m	4.0%	8.1%	3.0%	26.5%
AEW UK Long Lease REIT	£59m	-22.3%	7.5%	2.9%	na
Conygar Investment Co	£81m	-15.3%	0.0%	-11.5%	-9.5%
Custodian REIT	£474m	11.0%	5.8%	2.8%	21.2%
Drum Income Plus REIT	£30m	-7.3%	7.7%	-0.6%	7.8%
Ediston Property Investment Co	£183m	-16.3%	6.7%	-4.6%	12.8%
BMO Commercial Property	£867m	-16.9%	5.5%	-2.1%	10.6%
BMO Real Estate Investment	£206m	-16.6%	5.8%	1.5%	23.6%
LXI REIT	£698m	11.9%	4.3%	11.2%	na
Picton Property Income	£557m	6.9%	3.4%	0.0%	0.0%
Regional REIT	£513m	3.8%	6.9%	1.2%	28.2%
Schroders REIT	£275m	-22.4%	4.9%	1.6%	25.7%
Standard Life Investment Property Income	£385m	5.2%	5.0%	4.1%	29.9%
Stenprop	£380m	-10.4%	5.2%	na	na
Supermarket Income REIT	£363m	10.4%	5.2%	4.1%	na
Tritax Big Box REIT	£2,434m	-2.8%	4.8%	0.4%	30.0%
UK Commercial Property Trust	£1,123m	-3.8%	4.3%	0.2%	17.9%
Warehouse REIT	£279m	11.9%	5.2%	5.3%	na
Average		-3.8%	5.4%	1.7%	17.3%
Circle Property	£58m	-30.4%	3.4%	6.5%	61.2%

Source: Liberum Capital (closing prices on 10 February 2020); Circle Property targeted returns for financial year to 31 March 2020 based on Cenkos Securities estimates (9 December 2019); Conygar 1-year and 3-year NAV returns taken from company accounts.

The share price discount to NAV is even more anomalous once you consider that the company has posted NAV per share growth of 6.5 per cent over one year and 61.2 per cent over three years, handsomely outperforming its peers over both periods. The three-year return is more than double that of the two best performing property companies within Liberum's coverage: Standard Life Investment Property Income; and Tritax Big Box REIT.

True, the company's dividend yield of 3.4 per cent for the current financial year is a full two percentage points below that of the peer group average. However, Circle Property is not a Reit, so instead of focusing on recurring income it aims to maximise total NAV return. It's been successful, too, as the company has outperformed its peer group by a country mile on this measure over the past three financial years. Forfeiting a couple of percentage points of dividend yield seems reasonable for such stellar NAV per share outperformance.

The NAV total return outperformance has not been achieved by taking undue financial risks. A loan-to-value ratio of 42 per cent on the portfolio, and interest cover of four times suggests a conservative balance sheet approach and one aligned to maximising valuation gains through active asset management.

Target price

Having taken into account all the risk factors on pages 13-15, the below average free float and applied a small-cap liquidity discount, I feel that there is material scope for a significant re-rating of the shares. The obvious catalyst is the pre-close trading update in May ahead of the release of the annual results. It should make for a good read.

Having traded in a tight channel between 180p and 214p for the past 12 months, the share price is edging back up towards the top of the trading range and looks poised to break-out on positive news flow towards the July 2018 all-time high of 230p, and well beyond.

Offering 40 per cent upside to my 287p target price – representing a 10 per cent discount to March 2021 NAV estimates of 320p a share – I rate Circle Property's shares a solid **buy**.

Risk assessment

Of course, no investment is without risk and there are several to consider in the case of Circle Property.

■ **Tenant default:** The rental income and market value of properties may be affected by the operational performance of the tenants' businesses. In the event of material default of lease obligations by a tenant or its guarantor, the company may suffer a rental shortfall and/or incur additional expenses (legal and surveyor's costs, maintenance costs, insurance, rates and marketing costs) and interest costs until the property is re-let. The company may also experience difficulty in attracting new tenants on suitable terms, thus impacting the market valuation of the properties owned. If vacancies continue for long periods, the company may suffer lower revenues and have less income available to distribute to shareholders.

To mitigate tenant default risk, Circle Property seeks parent company guarantees and rent deposits as security, maintains regular close contact with tenants to assess any occupational issues, and only acquires properties in established business locations so to minimise void periods in the event of a default. The company closed the 2019 financial year with rent receivables of £275,000, and had no bad debts.

■ **Refurbishment risk:** In order to maintain the attractiveness and profitability of the portfolio, the company undertakes refurbishment works and is reliant upon the performance of third-party service providers and contractors to carry out these projects. Failure by them to carry out their obligations in accordance with their appointed terms could result in the refurbishment works being more expensive than anticipated and taking longer to complete, thus delaying the rental stream from the property. The ability of contractors to carry out refurbishment works on schedule may also be adversely affected by a number of factors including constraints of location, planning legislation, the need to obtain other consents and approvals, and the existence of restrictive covenants.

■ **Financing and cash flow:** Circle Property has granted security to lenders in the form of mortgages over investment property and fixed and floating charges over other assets. Should any decline in asset values or contracted rental income result in a breach of banking covenants, the company may be required to pay higher interest costs and/or make early repayment of such borrowings, together with any costs of terminating interest rate hedging arrangements. In these circumstances, the lenders will have the right to

enforce their security, forcing the company to sell sufficient assets which by their nature are illiquid. In a forced sale scenario, it is highly unlikely that the company will be unable to realise the open market value of the assets.

To mitigate these risks, interest rate hedging strategies are continually reviewed, management makes sure that the core portfolio generates strong cash flow to meet interest payments, and maintains strong relationships with lenders. The loan-to-value ratio has a natural reduction mechanism in place, too. That's because when newly refurbished properties are leased out, the extra income generated supports a higher open market valuation.

■ **Economic and political:** The company acquires well located vacant or part-vacant real-estate investments in the UK. Accordingly, future performance may be affected by events beyond its control; such as deterioration in the state of the economy (including fluctuations in interest rates and inflation and reduced availability of credit); the financial condition of tenants and their guarantors and the markets in which they operate in, changes in regulatory requirements; and political developments. Such events could reduce rental income and/or capital values, and impact liquidity in the investment market for the company's properties. Also, changes in tax policy such as an increase in stamp duty land tax rates could have a material impact on the price at which UK land can be sold, and on asset values.

To mitigate these risks, the company focuses on debt reduction and letting vacant development stock to secure income streams as quickly as possible on newly refurbished properties, thus maintaining a high occupancy rate with a stable income.

■ **Property valuation:** Circle Property is a long-term investor in commercial real estate, so is exposed to movements in property valuations and the overall performance of the commercial property sector. Property values will vary as a result of a variety of factors, many of which are outside the control of the company such as movement in investment yields, and changes in government legislation. In the event of downward movements in property values, NAV and loan-to-value ratios could be adversely affected.

The valuation of property is inherently subjective, so there is no assurance that surveyors' valuations will reflect actual sale prices or rental yields, even where any such sales or entry into leases occur shortly after the relevant valuation date. Circle Property's portfolio is valued by Savills, an independent valuer, who assesses the fair value of each of the properties.

■ **Personnel risk:** Circle Property is reliant on two key personnel: chief executive John Arnold, and chief operating officer Edward Olins. The retention of their services cannot be guaranteed and loss of key management, particularly to competitors, could have adverse consequences on the company's future trading prospects. This risk is mitigated by the fact that both directors are major shareholders, and rewarded through long-term incentive plans.

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ISSN 0261-3115.