UK Commercial Property REIT

Update
21 March 2019

Summary

UK Commercial Property Trust (UKCM) aims to generate an attractive income with the potential for income and capital growth from a diversified portfolio of commercial property.

Manager Will Fulton has focused the portfolio on sectors and locations benefitting from structural changes in the economy and society. Recently, the company announced that it is seeking permission from shareholders to widen the manager's universe into additional real estate sectors which would allow him to expand on that strategy.

Will explains these "alternative" sectors are now regarded as mainstream and include healthcare, student housing, hotels, car parks, pubs, petroleum and automotive and the commercially-managed private residential rental sector, amongst others. Representing an increasing share of the commercial property investment market Will believes they can be attractive as they are driven by demographic, urbanisation and trends in technology, together with a stability of income returns and diversification benefits, an environment he believes is set to continue.

UKCM yields 4.2%. While this is below the sector average, the portfolio has strong reversionary income potential and one of the lowest levels of gearing in the peer group. The company has also extended its borrowing facilities to be able to take advantage of opportunities emerging from what the manager anticipates could be a volatile property market.

The trust trades on a wider discount than the peer group, although the absolute number and the discount to the peer group have both narrowed in recent months. Currently it is trading on a 6% discount compared to a sector average of 4%.

Last July the trust gained REIT status, which means it is treated as a UK resident for tax purposes and will remain exempt from corporation tax on the profits and gains from its property rental business, protecting shareholder's income.

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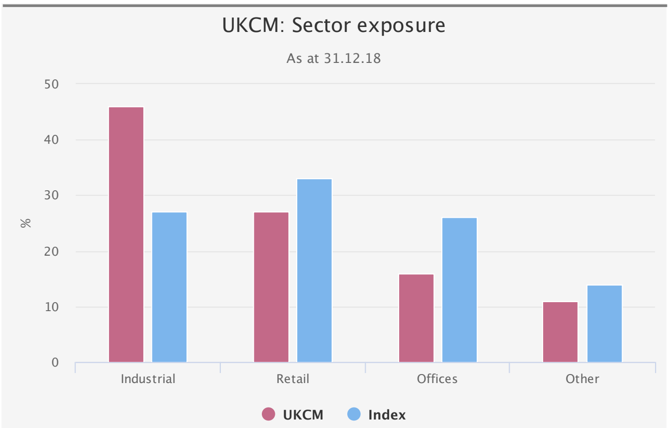
Portfolio

UK Commercial Property REIT aims to provide an attractive level of income with the potential for some income and capital growth from investing in UK commercial property. The manager, Will Fulton, seeks exposure to areas of the commercial property market with economic tailwinds behind them, and looks for properties where asset management initiatives can unlock value.

Since taking over in 2015, Will has steadily reduced the weighting to retail from 45% to 27%, and the underweight positioning has been a positive contributor to relative returns. Instead, he has increased the focus on industrial property, which is better placed to weather the changes to the economy being driven by the internet. For example, in the last quarter of 2018 the company bought a portfolio of distribution warehouses situated close to the "golden triangle" of the Midlands (defined as that area from which 90% of the population are in a four-hour drive). This £85.4m purchase increased the exposure to industrials further to 46% and plays into the increasing importance of logistics for storage and quick distribution of goods, including the increasing amount bought online. (We also note that should the Brexit negotiations result in "no deal", the need for storage of goods could increase if delays at the border become commonplace.)

The remaining retail exposure is focused on generally higher yielding bulky retail warehouse parks in strong locations. These properties offer some resilience against the shift to online consumption that at the same time is putting negative pressure on the high street and shopping centres, to which the company has less exposure. In November, the company sold a high street property in Exeter, having completed the sales of three shopping centres in Shrewsbury in January 2018, which halved its shopping centre exposure. The current exposure to the high street is just 6% and to shopping centres just 3%, with the rest of the retail exposure in retail warehouses. Most of that is in three out of town retail parks: Kew, Tunbridge Wells and at junction 27 of the M62 near Leeds. Roughly 80% of the retail exposure is in prime locations.

Fig.1: Sector Exposure



Source: Aberdeen Standard

Now, in early 2019, Will is seeking changes to the investment policy which would allow him to extend the sweeping changes he has already made, by enabling him to invest in 'alternative' real estate assets. The alternative real estate sector includes assets such as residential and social housing, primary healthcare sites, data centres and self-storage units. These assets are mostly benefitting from changes in society, from our ageing population (healthcare, social housing), urbanisation and the smaller sizes of homes (self-storage units, residential property), and technological advancement (data centres, ease of booking hotels for tourism). He is, understandably, silent on any investment ideas he has in mind and into which categories they fall, and emphasises the change is to provide flexibility rather than to expect an immediate investment. Will also tells us that some of these alternative areas are looking expensive, which makes careful stock selection important.

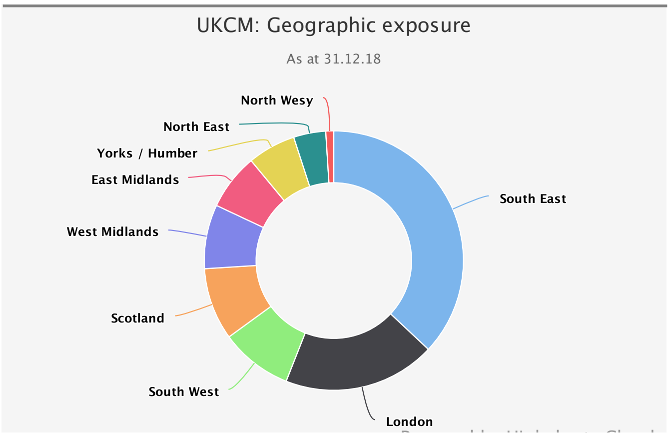
In terms of "future proofing" the company, the commitment to ESG initiatives is also significant. UKCM was awarded sector leader status as the top ESG performer in the diversified, Europe-listed commercial property peer group for 2018. The trust was particularly commended for public disclosure and improvements to monitoring and performance indication. The company also won "most improved" and Gold awards from EPRA for sustainability reporting in 2018 and has a GRESB 4 star award for sustainability. ASI aims to lead the industry on sustainability.

Will says he is likely to reduce the exposure to retail further should the right opportunity arise. On a sector level, industrials and alternatives remain his preferred areas of interest due to the potential for growing income as well as their exposure to growth trends. He is seeking assets with long leases, or otherwise sustainable income, the potential for rental growth, and limited capital expenditure.

The industrial distribution warehouses and the light industrial sites the trust favours are typically found on the outskirts of towns near to major roads, and the company typically owns a significant number of multi-tenant structures, which increases the diversification of income and risk. Proximity to a major economic hub is key for the industrial estates, and the portfolio owns sites at each point of the compass around London; at Radlett, Sunbury-upon-Thames, Gatwick Airport and the Dartford crossing, as well as a large distribution warehouse at Wembley. During 2018 the company purchased the M8 Interlink Industrial Estate outside Glasgow for £24.6m, representing a net initial yield of 5.9%. The Midlands distribution portfolio discussed above was bought on a net initial yield of 5.5% and includes sites near Stoke, Stafford, Birmingham and Leicester, or alternatively near the M6, M42 and M1.

On a geographical area, the portfolio remains concentrated in the South East of England, in line with the focus on premium assets in strong locations economically. This makes sense in the context of Aberdeen Standard Investments' house view on the late stage of the cycle and the relatively low returns to be made on a capital basis from here. The London exposure has fallen in recent years as Will has become more bearish on the central London office market, due to concerns about the impact of Brexit. During Q4 of 2018 the trust sold its largest holding (15 Great Marlborough Street, London) for £73.2m – ahead of its June valuation. The lease had the potential to be broken in November 2019.

Fig.2: Geographical Exposure



Source: Aberdeen Standard

The company has made good progress on voids in recent months. They now sit at just below 7% of the portfolio and Will believes there is scope for them to narrow further. Almost half of the voids, 3 percentage points, is at the logistics warehouse at Magna Park Lutterworth industrial park. UKCM has invested heavily in a comprehensive refurbishment of its asset known as XDock 377 and has had strong interest from potential tenants already. In all, over 50% of the voids are in the “hot” industrial sector, giving some confidence that progress will be made in filling properties this year.

The company is also in a good place regarding re-lettings. On 1 March it announced the re-letting of its Wembly180 logistics unit. This 10-year index-linked letting, with no breaks, halved the amount if income the company had to secure with re-lettings over the next 18 months, and this now stands at just 4% of the company’s income. Much of the remainder is in the retail sector, however, where there may be work to be done given the issues in that sector. One problem property has been St George’s Retail Park in Leicester, but the company has agreed three re-lettings in recent months and conducted significant improvement works on the property which have made it more attractive to potential tenants. The last remaining problem on the site is the large Toys R Us unit which the team is working on splitting and has had interest from gym groups and others in the smaller lots. A total of 1.5% of the total annual income of the trust had been lost to CVAs during 2018.

Gearing

At 14.6% the company has by some margin one of the lowest net **gearing** ratios in its peer group and the quoted REIT sector, although the investment policy allows it to borrow up to 25% of NAV. This means the company is less exposed to a troubled market in which Brexit and the rise of internet retailing is putting capital values at risk. It also means Will has greater resources to put to work when these dislocations throw up opportunities, and the company has secured more firepower in a recent debt refinancing for him to put to work.

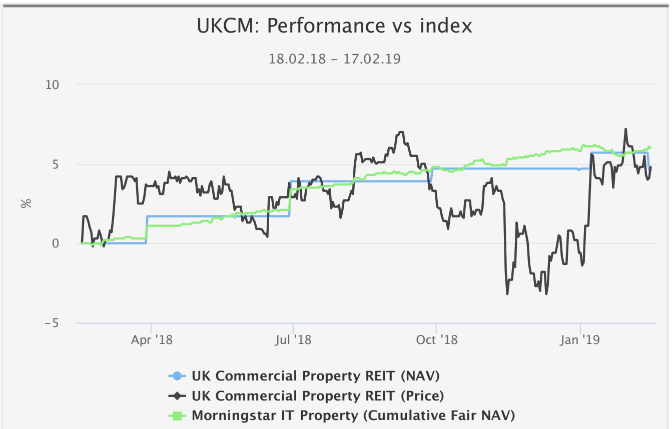
In fact, UKCM has (as of 21 February 2019) extended its blended long-term debt facilities from four years out to 10, expanded the funds available by £50m and reduced the blended cost of debt from 2.89% to 2.79%, and increased the flexibility of its debt with more weighting to a revolving credit facility. This refinancing has resulted in the company having £95m available to invest. In terms of structural debt, the company has a fully drawn £100m loan from Barings maturing in 2027 at a fixed rate of 3.03%, and a new £100m loan at a fixed rate of 2.72% maturing in 2031. The revolving credit facility is with Barclays and totals £150m of which £55m is drawn.

This sizable war chest and the substantial scale of the company (net assets of £1.2bn) gives it the ability to take advantage of a greater range of opportunities. For example, few companies would have had the power to purchase so quickly the £85m portfolio of Midlands logistics facilities which it bought in Q4 last year. This freedom of movement allowed the company to secure a good price, as illustrated by the unsolicited bids received already for some of the assets at a premium to the purchase price (not that the company is interested in selling).

Returns

The NAV total return was 4.6% in 2018, compared to 5.5% for the peer group average. The gains were made in the first three quarters, with the company´s NAV falling by 0.1% in the final quarter. This was due to investment in the portfolio in the form of the acquisition costs for the portfolio of Midlands distribution centres, refurbishment of the Lutterworth site, and pre-letting asset management initiatives undertaken to help reduce the void rate, and falls in retail values. As such, we view the last quarter as something of a “reset” period, and note that with voids reduced, rental income raised and acquisitions due to add value to the portfolio, the portfolio is much better set up for the future.

Fig.3: One-Year Performance

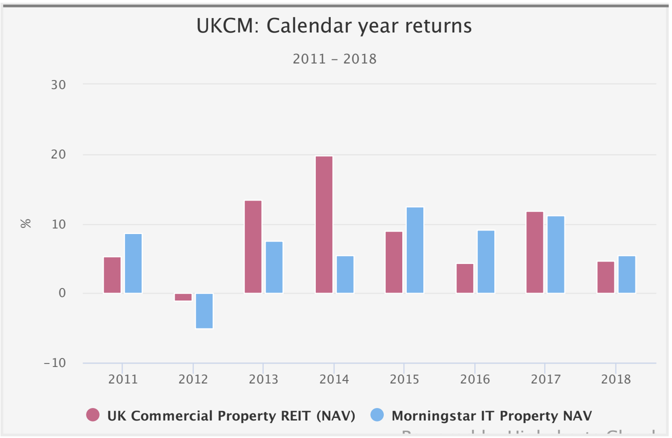


Source: Morningstar

That said, the exposure to the retail sector was highly damaging last year. Indeed, had it not been for capital falls of 12% in the trust´s holdings in that sector (versus a 5.4% fall for the sector in the benchmark), the trust would have comfortably outperformed the index, which returned 6.7%. This is particularly frustrating for the team as Will had made great strides in reducing the retail exposure, and his underweight exposure helped the trust outperform in 2016 and 2017. However, as we suggested in our **strategy piece on the commercial property sector** last November, it appears that fund managers have been surprised by the pace of deterioration in the sector, even if they correctly analysed the trend. In fact, UKCM's exposure of 27% is below the peer group average of 32%, so the positioning has been correct but the assets that haven´t been sold have still underperformed expectations.

In 2017 the trust did well versus the peer group thanks to the correct positioning of underweight retail and overweight industrial and it was also helped by good stock selection. In 2016 the low levels of gearing meant the trust underperformed the peer group, although absolute returns were good. During these years the manager´s scepticism to central London property also provided a tailwind.

Fig.4: Returns



Source: Morningstar

Dividend

The trust currently yields 4.2% and pays dividends quarterly. We understand from the manager that the reversionary income potential from the portfolio is strong. The team estimate that the current portfolio rent of £69m could have £2.9m added to it by filling rent free properties, £5.6m by filling vacancies and £5.7m through renting current holdings at market rates (the reversionary potential). All this, plus the potential for £2m from property that is pre-let but still in development, as well as the potential £2.6m income boost from investing the £50m of borrowings at a yield of 5.25% would more than cancel out the estimated hit from the portfolio's remaining over-rented retail properties (£3.8m of income). Of course, it would also be fair to allow for some new vacancies as others are relet so the picture is never perfect. The total estimated rental value for the fully invested and fully occupied portfolio is currently, £84m, or 22% higher than current levels illustrating the untapped potential.

Dividend cover currently stands at 82% for the past financial year. However, incorporating the cost savings made over 2018 and the reductions in the vacancies achieved, the cover would rise to 90%, ceteris paribus. Distributable reserves were 12 times last year's dividend at the time of the last annual report, so the company has plenty of resources to maintain the payout.

Management

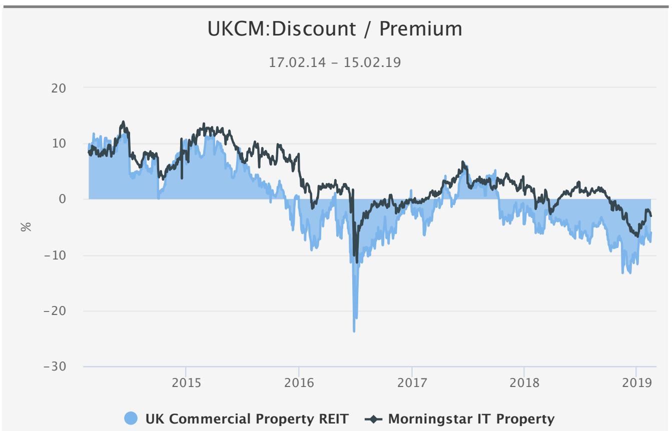
Will works as part of a team of four dedicated investment managers and the team has access to the support of the far wider real estate team at Aberdeen Standard Investments, which is broad and comprehensive.

Throughout Will Fulton's 31-year career he has held a variety of commercial real estate positions, gaining multi-disciplinary experience spanning investment, valuation, asset management, debt facility management, development and investor relations both in the UK and across continental Europe. Before focusing 100% on UK Commercial Property REIT from early 2015, he oversaw a team managing the £2.3bn Standard Life Heritage With Profits real estate fund.

Discount

The trust's discount has come in from 13% to 6% since November 2018 as sentiment has recovered somewhat towards UK assets (UK equities have also performed strongly). The discount to the sector has also reduced, from an average of 6.9% in November to an average of 3.4% in the first half of March.

Fig.5: Discount



Source: Morningstar

Looking forward, Brexit means there is considerable uncertainty around the direction that discounts in the sector will move. The board has the authority to buy back up to 14.99% of the share capital, although they have not used it in recent years. The buy back authority may be used to purchase shares (subject to the income and cash flow requirements of the Company) if the shares trade on a discount wider than 5% for a continuous period of time (as last calculated, adjusted downwards for the amount of any dividend declared by the Company upon the shares going ex-dividend). If the discount remains wider than 5% for 90 days continuously, the board is obliged to call an EGM to discuss a continuation vote, but given that at the time of writing in early February the discount is tighter than 5%, this is not currently a live issue.

Charges

The ongoing charges figure of 1.5% is cheaper than the average 1.68% charged in the AIC's Property Direct – UK sector. The board negotiated a reduction in the management fee that has been charged since January 2019: 0.6% on the first £1.75bn of gross assets and 0.475% on the remainder. This compares to the 0.65% previously charged and should result in approximately a 0.05% cut to the OCF at the trust's current size.

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