Channel Islands Property Fund

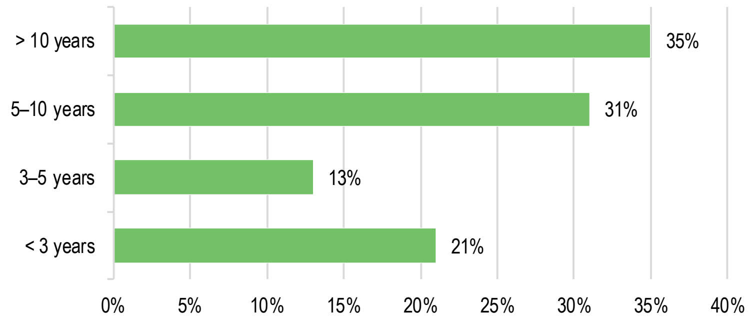
Channel Islanders working from the office

Investment companies
Real estate

10 October 2023

Channel Islands Property Fund (CIPF) recorded a 5% y-o-y increase in rental income in H123 (to end March 2023) as the fund continues to see 100% rent collection and reduced its vacancy rate to just 2.3%. The manager remains confident in CIPF's income generation, as the portfolio is characterised by long lease terms (the weighted average unexpired lease term, or WAULT, is over 11 years), and 75% of CIPF's debt is hedged against interest rate rises until 2027 to its expiry. The fund continues to distribute stable quarterly dividends, implying a 6.9% prospective dividend yield based on the current share price.

Portfolio by earliest termination date (% of contracted rent, June 2023)



Source: Channel Islands Property Fund

Attractions of investing in Channel Islands property

An investment in Channel Islands property is attractive for two main reasons. Firstly, investment assets on the islands have defensive qualities, including longer-than-average leases versus similar assets on the mainland, and the occupiers tend to be resilient finance industry companies with strong covenants. Secondly, the market is largely unaffected by slowing demand for office space, due to short commuting times (discouraging working from home arrangements) and supply constraints.

Focus on property management

CIPF offers investors a unique exposure to a defensive market, which is mostly unaffected by slowing demand for office space globally. The portfolio is fairly static (the latest portfolio addition was in September 2020) and generates a regular income stream, with long-term visibility on generating cash flow. The property manager (D2 Real Estate, D2RE) sees an ongoing shift in tenant behaviour towards more 'non-office' space and increasing emphasis on improving a building's ESG credentials. D2RE is focused on future-proofing the portfolio by carrying out refurbishments and increasing ESG transparency. While ESG considerations are already part of D2RE's management process, CIPF's first sustainability report is anticipated to be published before the end of the calendar year.

Price		**96.0p**
Market cap		**£153.5m**
NAV*		**£155.5m**
NAV per share*		97.2p
Discount to NAV		1.2%

*Including income. At 30 June 2023.

Yield		6.9%
Ordinary shares in issue		159.9m
Code/ISIN		CIP/GG00B62DS151
Primary exchange		TISE
AIC sector		Property Direct – UK
52-week high/low	103.5p	91.0p
NAV* high/low	99.7p	95.4p

*Including income.

Loan to value*	45.5%

*At 30 June 2023.

Fund objective

Channel Islands Property Fund was established with the objective of offering an investment opportunity that provides shareholders with a total return from a combination of quarterly dividends and capital growth through the acquisition and active asset management of high-quality office properties in the Channel Islands and the Isle of Man.

Bull points

- Properties are mainly multi-let to blue-chip clients. The WAULT is long at 11.2 years at 30 June 2023.
- Dividend yield of 6.9%.
- The Channel Islands and the Isle of Man have proved very attractive markets during lockdowns.

Bear points

- Core markets are capacity constrained.
- Low stock liquidity.
- NAV growth (excluding dividends) has been modest.

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Strong H123 results

CIPF's H123 results (ending March 2023) came out strong. The fund continues to collect 100% of its office rent (a trend unbroken even during lockdowns) and rental income increased by 5% y-o-y, predominantly due to an increase in rent in inflation-linked leases. CIPF's vacancy rate remains low at c 2.3% according to our calculations at end June-2023 (down from 3.6% at end-March 2023). The vacant space (c 12k sq ft) includes 6.5k sq ft of refurbished space in St Peter Port currently on offer and, if completed, would reduce the vacancy rate to c 1.0%.

Supply-constrained market ensures demand for office property

The properties continue to see demand from tenants as the Channel Islands have been mostly unaffected by the global trend of leaving offices in favour of working from home arrangements, because commuting times are much shorter than those in major mainland cities. This demand has been exacerbated by limitations on new space development on these small islands. The property manager estimates that in St Helier there is currently around 60k sq ft of office space on offer versus 100k sq ft of as yet unsatisfied tenant demand. D2RE sees further constraints as the projected profitability of developing new properties is under pressure from higher borrowing costs, double-digit inflation, increased build costs and labour and material supply chain shortages or delays. As a result, the property manager does not expect a material increase in project development on current rent levels. Additionally, given the increasing awareness of ESG factors, D2RE sees refurbishments as more eco-friendly than new buildings. While the COVID-19 pandemic did not translate into lower demand on the Channel Islands, D2RE sees some changes in tenant behaviour post-pandemic. The occupiers are repurposing existing space to accommodate on-site gyms, more break-out areas for impromptu meetings and client drop-in suites and adding living plant walls.

CIPF is managing its cost of debt…

CIPF currently puts great emphasis on controlling its debt costs, as rising interest rates are putting pressure on margins. 75% of CIPF's debt is hedged until June 2027 (the instruments were put in place in H122) and management is confident the fund is well placed to continue to deliver projected returns. The derivative arrangements were signed with NatWest Markets and cover £90m of CIPF's overall £120m loan exposure. CIPF has an interest rate swap in place for £45m (carried out at 1.67%) and an interest rate cap with a strike rate of 1% on the other £45m. CIPF paid out £2.6m in H123 in financing expenses, representing twice the amount expensed in H122, which includes interest expense, commitment fees on its undrawn amount of debt and costs of hedging. The effective interest rate charged on borrowings also increased to 5.96%, from 2.91% a year earlier. As a result, CIPF's net income decreased from £4.6m to £4.2m.

…while other costs are limited

CIPF's ongoing charge amounted to 2.08% of average NAV over the last 12-month period to end-March 2023 (FY22: 2.10%), slightly below the peer average. The charge includes the management fee paid to the investment manager (Ravenscroft Specialist Fund Management, 0.6% of the gross asset value), as well as other ongoing costs of administration, regulators and auditors, among others. CIPF does not charge any performance fees and the majority of property management costs are covered by the service charge.

Portfolio revalued once a year

CIPF's portfolio still reflects end-September 2022 valuations, when it was down 3.2% y-o-y. The manager highlights that property valuations across the globe are under pressure, as increasing financing costs meet decreasing demand, and CIPF's portfolio is not immune to these factors. Having said that, it is positioned to withstand the pressure valuation-wise (due to the relatively strong demand on the Channel Islands) and cash flow-wise (due to the interest hedge as described above). The perception of CIPF's portfolio as robust is likely shared by the market, as CIPF trades at much narrower discount to its NAV, compared to its peers (1% vs peers average at 27%, see Exhibit 1). CIPF is a top performer in its peer group for NAV development over the last year (to end-June 2023) and second best over three- and five-year periods, although a part of the outperformance may come from an outdated valuation.

Property valuations on the Channel Islands are more defensive compared with the broader UK market. This provides comfort for investors in an environment where property valuations are under pressure, such as now (while simultaneously not capturing full bull markets). This is visible in CIPF's NAV performance versus its peer group over time (see Exhibit 2).

Exhibit 1: Selected peer group at 9 October 2023*

% unless stated	Market cap (£m)	NAV TR 1 year	NAV TR 3 year	NAV TR 5 year	Discount (ex-par)	Ongoing charge ex perf fee	Perf. fee	Net gearing (ex par)	Income-only yield (%)
Channel Islands Property	**153.5**	**4.6**	**25.8**	**46.4**	**(1.2)**	**2.1**	**No**	**171**	**6.9**
abrdn Property Income Trust	187.6	(22.3)	17.3	15.5	(40.6)	2.0	No	127	8.1
AEW UK REIT	154.8	(9.4)	44.3	61.3	(7.0)	4.6	No	114	8.2
Alternative Income REIT	45.1	(7.5)	20.9	18.3	(31.9)	2.0	No	151	10.8
Balanced Commercial Property	456.0	(18.3)	7.0	(2.5)	(44.3)	1.4	No	129	7.4
CT Property Trust	192.4	(24.8)	10.5	8.2	(13.2)	1.5	No	129	5.3
Custodian Property Income REIT	367.7	(15.3)	18.2	20.8	(14.2)	2.1	No	124	6.6
Ediston Property Investment Co	145.0	(13.1)	5.0	(7.9)	(14.7)	1.4	No	115	7.3
LXI REIT	1,537.9	(12.2)	11.4	42.8	(25.0)	1.1	No	105	7.4
Regional REIT	136.7	(22.4)	(15.0)	(11.2)	(58.6)	5.8	Yes	192	19.8
Schroder Real Estate Invest	203.5	(18.6)	20.7	8.1	(31.5)	3.0	No	144	7.8
Supermarket Income REIT	926.0	(14.5)	9.0	29.1	(18.8)	1.3	No	139	8.2
UK Commercial Property REIT	700.4	(24.4)	7.7	3.5	(32.8)	1.4	No	118	6.2
Value and Indexed Property Income	80.5	(14.6)	4.7	(15.1)	(22.0)	1.5	No	136	6.9
Peers' average	**394.9**	**(16.7)**	**12.4**	**13.1**	**(27.3)**	**2.2**		**133**	**8.5**
Rank	**10**	**1**	**2**	**2**	**1**	**4**		**2**	**10**

Source: Morningstar, Edison Investment Research. Note: *Performance at 30 June 2023 based on ex-par NAV. TR, total return. NAV TR is on a cumulative basis. Net gearing is total assets less cash and equivalents as a percentage of net assets. 100 = ungeared.

D2RE believes valuation pressure is most visible for buildings in poor locations, which require capital expenditure to meet new environmental standards and the cost of this will not be recouped by rental income. CIPF's portfolio, however, consists of Grade A properties but the all-in borrowing costs, even for good-quality property assets, typically start above 7% for both new loans and those needing to be refinanced.

Exhibit 2: NAV performance over the last five years

%	FY18	FY19	FY20	FY21*	FY22
Channel Islands Property	9.5	5.3	8.5	8.7	9.4
Peer group median	8.6	5.0	(5.6)	15.3	12.4

Source: Morningstar, Edison Investment Research. Note: *11-month period.

The board is confident that CIPF will continue to pay a stable dividend

CIPF has distributed a stable 6.6p dividend per share every year in equal quarterly instalments since 2017. Based on the current share price, this implies a 6.9% dividend yield. CIPF's dividend payout is in line with its peers based on the value of its portfolio but, as its peers trade on higher discount to their NAVs, they offer a higher yield for investors (current average 8.5%, see Exhibit 1).

Over the last few years, CIPF has distributed virtually all its income in the form of dividends and, amid rising financing costs, the dividend cover is being tested. However, part of CIPF's rental income is linked to inflation, as highlighted in H123 rental income growth, and most of its interest expense is hedged, confirming the manager's confidence in the ability to continue to pay stable dividends.

As valuations remained unchanged, CIPF's loan-to-value ratios are broadly stable (the loan-to-market-value ratio stood at 45.5% at end-June 2023). We calculate that the portfolio has room for a c 11% downward revaluation before breaching the most restrictive covenant on its debt. The covenants related to income coverage improved on the back of increased revenues and are far removed from their limits. CIPF's gearing is relatively high compared to its peers (see Exhibit 1) and any downward revaluation of the portfolio would be more pronounced on its NAV performance than for its peers. However, CIPF's higher leverage versus its peers is mitigated by the more defensive nature of the market it operates in.

Portfolio positioning

The composition of the portfolio has remained unchanged since our April 2023 note and consists of over 500k sq ft of high-quality property split (by value) between Guernsey (63%), Jersey (25%) and the Isle of Man (12%). CIPF benefits from the longer lease periods on the Channel Islands than in mainland UK and its revenue stream is secured for a couple of years in advance. As at end-June 2023, the WAULT of CIPF's portfolio stood at 11.2 years and the average period to earliest break clause stood at 7.2 years (as at end-March 2023).

The manager is future-proofing the portfolio

CIPF currently focuses on property management, which includes refurbishments in line with current tenant expectations, as well as an emphasis on ESG. In H123 it fitted out Investec's offices at Liberation House and refurbished the ground floor of Windward House for BDO, both of which included more 'non-office' space than before. D2RE is wary of climate-related criteria and expects that 'green premia' and 'brown discounts' will continue to increase, meaning it is taking steps to advance its sustainability programme as well as ESG transparency. Unlike the mainland UK, the Channel Islands has not imposed energy efficiency requirements as yet but is clearly moving in that direction. Landlords, such as CIPF, are already being driven by tenant requirements to implement ESG criteria and improve transparency. Jersey will shortly introduce its own version of the UK's Energy Performance Certificates (EPC) and CIPF expects them to come into force in 2025.

Increasing ESG transparency

CIPF plans to publish its first sustainability report before the end of calendar year in which it will outline its ESG agenda. The fund's portfolio has already been measured against the UK's EPC with an overall good scoring, according to CIPF. The fund seeks to ensure that sustainability considerations are integrated in investment decisions and the ongoing management of the portfolio. At the same time, D2RE aims to incorporate ESG in its day-to-day management of CIPF's portfolio (see examples in our previous note).

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