MARTEN & CO

Update | REITs

16 May 2017

Drum Income Plus REIT

Delivering on promises

DRUM Income Plus REIT (DRIP), which focuses on acquiring properties overlooked by large institutional and overseas buyers (smaller lot sizes, multi-let), provided an NAV total return of 2.4% in Q1 2017 including a 0.8% capital return. Its most recent acquisitions (the latest, Kew Retail Park, was announced on 11 May) were made at particularly attractive net initial yields and the manager is engaged in a number of asset management initiatives that should further improve income from the portfolio. DRIP recently issued equity; it remains small, but still has a strong desire to grow, with the aims of increasing its cost efficiency and liquidity.

Secondary assets in good regional locations

DRIP invests in a portfolio of regional commercial property assets, principally in the office, retail and industrial sectors, with the aim of providing investors with an attractive level of income while also delivering annual capital growth. It is targeting lot sizes worth between £2m and £15m, and looks for secondary property assets in what the managers consider to be good, but not necessarily prime locations. The managers believe that such assets offer marked yield advantages over primary assets in prime locations, but still allow them to make acquisitions with the same level of covenant protection and sufficient liquidity, so that these assets will not be hard to sell. We think that this is a key differentiator for DRIP in comparison with its peers.

As discussed on page 18, DRIP is also focused on multi-let assets and the managers are seeking properties where they can add value through asset management initiatives. DRIP has a long-term gearing target of 40% of gross assets.

Year ended	Share price total return (%)	NAV total return (%)	S&P UK REIT Index total return (%)	IPD UK All Prop Index total return (%)
31/03/17	(6.7)	11.5	(0.2)	3.8

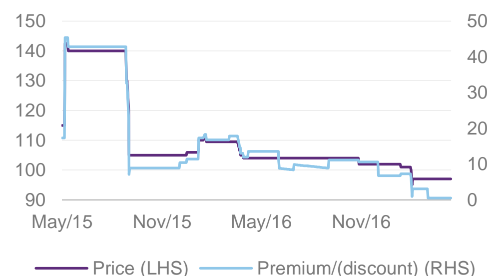
Source: Morningstar, Bloomberg, Marten & Co

Sector	UK Property
Ticker	DRIP LN
Base currency	GBP
Price	97.0p
NAV*	96.5p
Premium/(discount)	0.5%
Yield**	5.7%

Source: Morningstar, Bloomberg, Marten & Co *Note: NAV as at 31 March 2017. **Note: yield based on dividend target of 5.5p per share for the year ending 30 September 2017.

Share price & premium/(disc.)

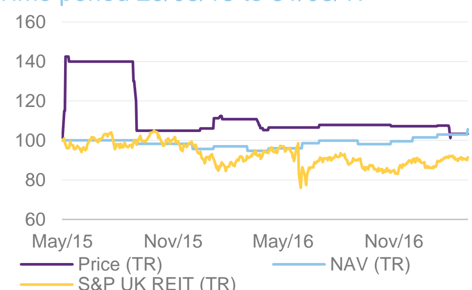
Time period 29/05/15 to 12/05/17



Source: Morningstar, Marten & Co

Performance since inception

Time period 29/05/15 to 31/03/17



Source: Morningstar, Bloomberg, Marten & Co

Domicile	United Kingdom
Inception date	29 May 2015
Manager	Bryan Sherriff
Market cap.	37.1m
Shares outstanding	38.2m
Daily vol. (1-yr. avg.)	332 shares
Net gearing*	32.2%

*Note: net gearing as at 31 March 2017 pre-Kew Retail Park.

Click here for our initiation note

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NAV growth over Q1 2017

Readers may also be interested in our initiation note of July 2016. Please click here to view.

DRIP' has recently announced that its NAV, as at 31 March 2017, was 96.5p per share. This is an increase of 1.0% over the quarter and, including dividends, DRIP has provided an NAV total return of 2.4% over the quarter. The portfolio valuation has seen a 0.8% increase to £49.2m (31 December 2016: £48.8m).

Further portfolio expansion

DRIP has acquired its first industrial property.

Since we published our initiation note in July 2016, DRIP has acquired three additional properties (an office property in Edinburgh, in July 2016, an industrial property in Aberdeen, in August 2016, and a retail park property in Southport, in May 2017) bringing the total number of properties in the portfolio to 10. These additions have further diversified the income sources within the portfolio.

The Edinburgh property was acquired using a mix of equity and debt funding; the Aberdeen property represents a first for DRIP as it was acquired using a stock swap as well as debt and existing cash resources; and the Southport property was acquired using DRIP's loan facility. Assuming that the Southport acquisition has no effect on NAV and there have been no other changes to valuations, net gearing may now be around 56%, equivalent to an LTV close to 40%, in-line with DRIP's long-term target.

Further information regarding the tax considerations for stock swaps is provided, in Appendix 2 on pages 31 and 32 of our July 2016 note.

3 Lochside Way, Edinburgh

Further information can be found at the building's website:

www.3lochsideway.com

3 Lochside Way, Edinburgh, is located in The Edinburgh Park (www.edinburghpark.com). The office building, which is pictured in Figures 1 to 3, was acquired in July 2016, from Aston Property Ventures, for £4.45m. This represented a net initial yield of 8.44% with a reversionary yield of 7.79%. The building offers three floors of 7,800 square feet, broken down into two wings of 3,900 square feet, with subdivisions from 1,600 square feet. DRIP's manager says that the building offers a very flexible space.

The 15-year-old property has recently undergone an extensive refurbishment.

The 23,400 square foot freehold property, which was built circa 2002, has recently undergone a refurbishment programme which included:

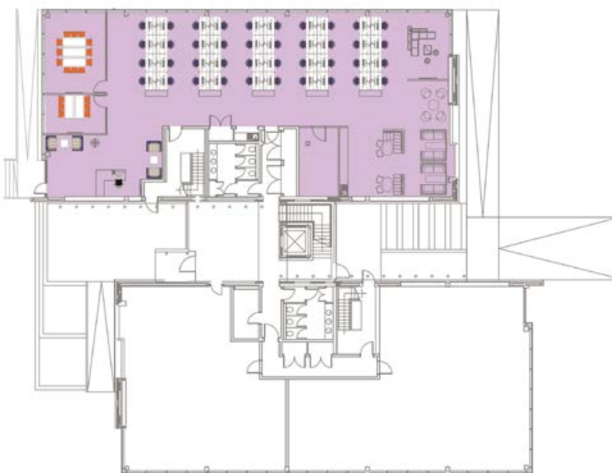
- A full refurbishment of the reception area including a soft seating area, planting, LED downlight fixtures and feature pendant lighting
- A raised access floor and refurbished suspended ceiling with recessed lighting
- New Mitsubishi air-conditioning with a heat recovery system
- New decoration throughout including LED downlight fixtures to all communal areas
- New carpet flooring throughout all office suites and common areas
- Refurbished dedicated male, female and disabled WCs
- Refurbished façade and parking facilities
- New audio-digital gate and door-access system

The property also has showers on every floor; an eight-person lift; full disabled access; separately metered spaces with tenants having direct access and cost control of their heating and cooling; a finished floor to ceiling height of 2.7m; and an EPC – C rating. The building is very close to Edinburgh Airport, has two railway stations nearby and is well served by Edinburgh's tram system (there are three stops on or adjacent to the Park). The building also benefits from 91 car parking spaces (1: per 257 square feet of lettable area).

Figure 1: 3 Lochside Way, Edinburgh – exterior

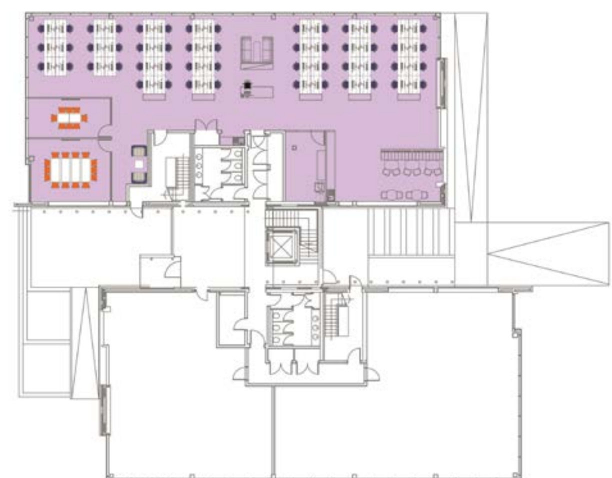
Source: Drum Income Plus REIT

Figure 2: 3 Lochside Way, Edinburgh – Ground floor, plan A



Source: Drum Income Plus REIT

Figure 3: 3 Lochside Way, Edinburgh – Ground floor, plan B



Source: Drum Income Plus REIT

The purchase was driven by valuation considerations.

DRIP's manager says that the decision to purchase was largely driven by what the manager considered to be a compelling valuation for a very lettable commodity. The building was acquired at a net initial yield of 8.44%, but previously changed hands, towards the top of the market, at a yield closer to 6.5%. At the end of September the building had a low weighted average unexpired lease term (WAULT) of 1.77 years, but the manager sees this as an opportunity as he expects to see rent increases from what he considers to be the current low base.

The manager considers that the building is highly lettable and benefits from a tight local market for rentals of this size.

The manager says that, while the area has experienced low rents historically, there is limited supply of vacant space and, with growing demand, the market for this type of accommodation in West Edinburgh is very tight. City-centre rents are currently in the region of £34 per square foot, having been on a rising trend. In the manager's view this suggests considerable demand to underpin the building's current rent rate, which is in the region of £17 per square foot, and sees good growth prospects. The manager also considers that the majority of lettings are in the 2,500 to 5,000 square foot range, which he believes puts 3 Lochside Way in a 'sweet spot'.

Data from Jones Lang Lasalle (JLL) confirms the manager's view. JLL's Quarterly Market Report for Edinburgh, for Q1 2017, says that, "The total supply of offices throughout Edinburgh has decreased, with the vacancy rate falling from 4.8%, recorded in Q4 2016, to 4.5% in Q1 2017. Supply is forecast to tighten over the long term". The report also says that, "49 occupier deals were transacted in Q1 2017 with an average deal size of 416 square metres (4,480 square feet)" and, "74% of all deals were sub 500 square metres (5,382 square feet)". In compiling this note, we spoke to Cameron Stott, Director – Office Agency, of JLL in Edinburgh. Cameron said that JLL is seeing very positive activity in the Edinburgh office market and he expects this trend to continue. He also advised that there is now very little accommodation in Edinburgh Park and that its vacancy rate has fallen dramatically, during the last 12 to 18 months, which he expects to support rental growth.

The building benefits from rent guarantees which expire in December. The manager is aiming to secure additional lettings this year.

The vendor has provided rental guarantees until December 2017. Including these guarantees, the building had 100% occupancy as at the end of September 2016. Of the 23,400 square feet available to let, 3,900 square feet is let to Lockheed Martin while another 2,100 feet is currently under offer. There are two floors of 3,900 square feet each to be let and the manager is aiming to have completed up to two additional lettings by the end of 2017.

Reflecting the extensive nature of the recent refurbishment (by the vendor), DRIP's manager says that there is little required in terms of capital investment in the near term.

Burnside Industrial Estate, Aberdeen

Burnside Industrial Estate, Aberdeen, is located within an industrial complex, near to Aberdeen Airport, which DRIP's manager says has traditionally benefitted from high occupancy levels (typically to oil and oil service related companies). The freehold complex, pictured in Figures 4 to 9, was acquired using a stock swap as well as debt and existing cash resources in a transaction that valued the property at £2.6m. This represented a net initial yield of 10.55% (the highest of all of the assets DRIP has acquired so far) and a reversionary yield of 8.47%.

Burnside is an older industrial property that comprises two terraces of workshop units with a central forecourt area for access and parking to the front of the units (see Figures 4 and 5). The acquisition also included an adjacent office building at the entrance to the estate. The industrial area extends to 22,204 square feet with a yard area of approximately 4000 square feet. The offices comprise 7,941 square feet over two storeys. The tenants include SKF (UK) Ltd, Aroplus and Precision Pumping and

Metering, while nearby occupiers within the estate include BP, Baker Hughes, Drill-Quip, Noble Drilling and Wood Group.

Burnside is a counter-cyclical play taking advantage of depressed property values in Aberdeen.

DRIP's manager sees the investment as being, in part, a counter cyclical play (larger investors have been avoiding the Aberdeen investment market due to the prevailing view on the oil price). The property was valued at a net initial yield in the region of 7% around 18 months ago but values for industrial property, in Aberdeen, have fallen markedly following the fall in the oil price, which, along with the small lot size, has allowed DRIP to acquire the property at such a high net initial yield.

The manager believes that the market is tighter than the net initial yield perhaps suggests and that the risk to rents is primarily to the upside.

However, new developments in Aberdeen have focused on office space, rather than industrial, and DRIP's manager believes that supply of industrial space is increasingly constrained - perhaps more so than the net initial yield on the property suggests. He believes that, in terms of rents, the risk is now primarily to the upside and says that, when one of the units became vacant, the vendor was able to re-let this within six weeks, at an improved rent, suggesting that there is support for the current pricing level.

Figure 4: Burnside Industrial Estate, Aberdeen - exterior

Source: Drum Income Plus REIT

Figure 5: Burnside Industrial Estate, Aberdeen - exterior

Source: Drum Income Plus REIT

Figure 6: Burnside Industrial Estate, Aberdeen - interior

Source: Drum Income Plus REIT

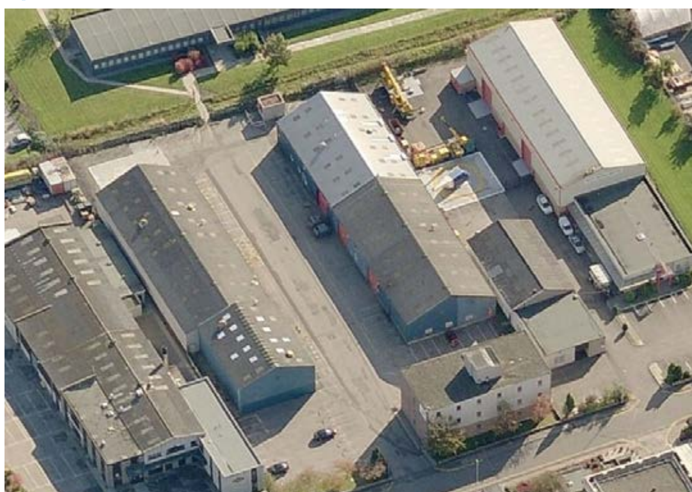
Figure 7: Burnside Industrial Estate, Aberdeen - exterior

Source: Drum Income Plus REIT

The near-term strategy is to focus on improving income. Measures include modest refurbishments and a programme of good estate management.

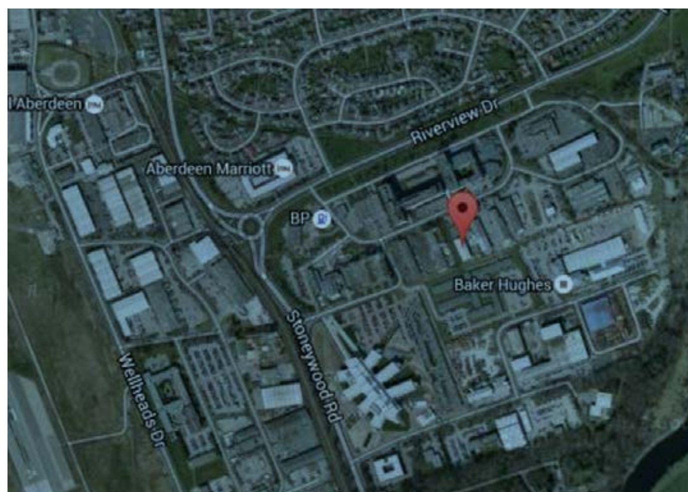
The near-term strategy for Burnside is to undertake initiatives to improve income from the property rather than those aimed at driving capital growth. The manager is looking to improve tenant retention, re-gear the tenant leases and carry out rent reviews. In this regard, the manager proposes to undertake modest refurbishments and has put in place a programme of good estate management (for example cutting the grass and trimming the trees regularly, repainting the units and repainting the car park lines) to make the environment more attractive for the tenants and encourage them to stay.

Figure 8: Burnside Industrial Estate, Aberdeen – close up aerial view



Source: Drum Income Plus REIT, Google Maps

Figure 9: Burnside Industrial Estate, Aberdeen – aerial view



Source: Drum Income Plus REIT

Longer term, the manager sees the potential for a change of use of the site to residential property, which could lead to a marked uplift in valuation. The manager notes that the property is located opposite BP's former HQ (see Figure 9), which has now been converted to residential (see Figure 4). DRIP's manager would not look to undertake such a development but, if the valuations warranted it, would look to obtain the necessary permissions and sell the property with the higher use value.

Kew Retail Park, Southport

Kew Retail Park, Southport, pictured in Figures 10 and 11 below, is located in an established out of town retail hub on the A570 Southport Road. The freehold complex was acquired in May 2017 from Aviva for a purchase price, excluding costs, of £8.65m (having been marketed for £9.75m), which represents a net initial yield of 8.78%. The purchase was funded using debt provided by DRIP's bank facility.

Kew Retail Park comprises a terrace of seven retail warehouses and a purpose-built car wash, totalling 53,858 square feet. The retail warehousing terrace is of steel portal frame construction, under pitched roofs, and there are approximately 161 car parking spaces, which reflects a ratio of 1:335 square feet. The site is approximately 3.71 acres (1.50 hectares) providing a low site coverage of 35.6%. The property is subject to eight full repairing and insuring (FRI) leases, with a total income of £810,237 pa, and the average weighted unexpired lease term is 8.5 years to expiry or 7.4 years to breaks.

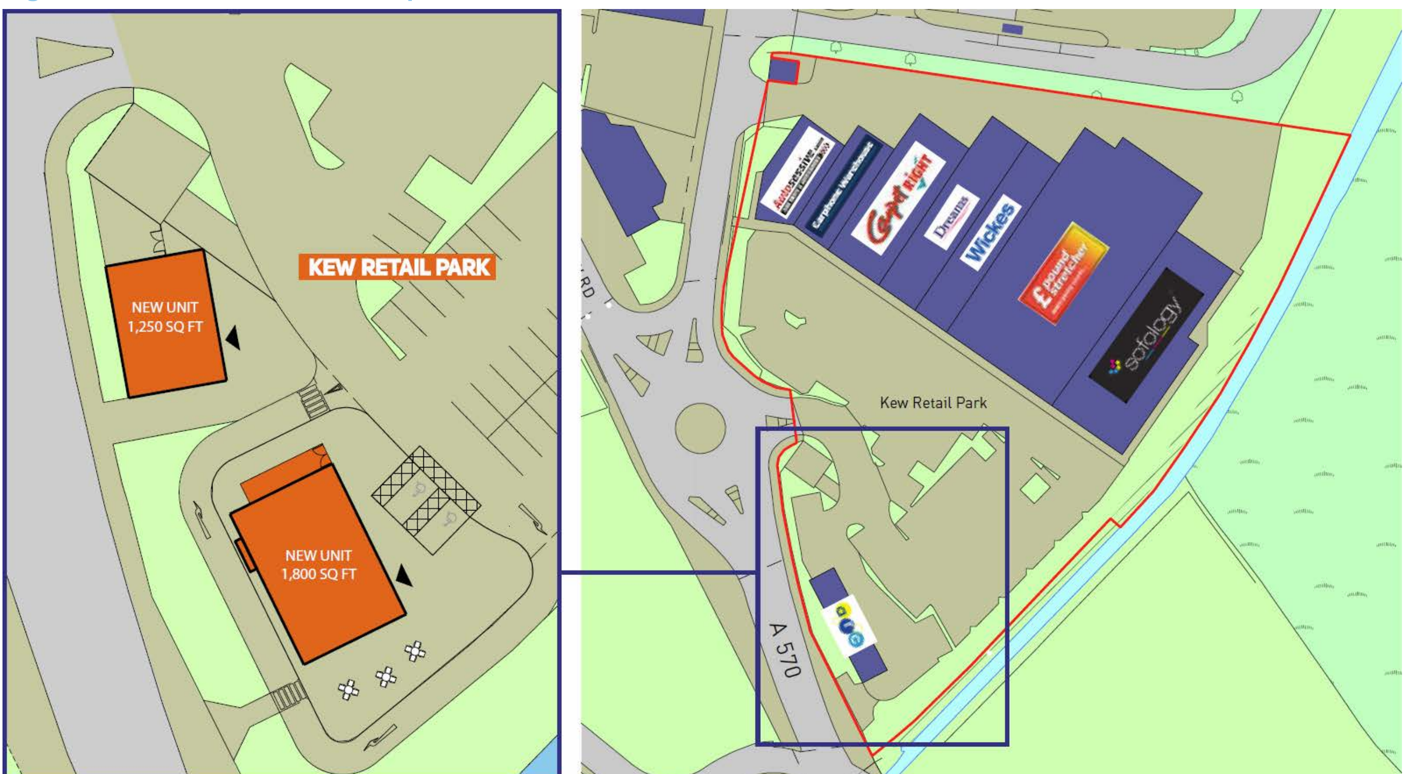
The property has wide bulky goods planning permission and a wide range of products can be sold from the units. One unit has permission for storage/distribution whilst another has permission to be used as a restaurant. Neighbouring properties include a B&Q, Meols Cop Retail Park (Homebase, Harveys, Currys/PC World, Home Bargains, Argos, Dreams, Halfords, Topps Tiles), Aldi and a Tesco Extra.

DRIP's manager considers that Kew is a high quality asset, which was available at an attractive valuation, and offered a number of positive attributes, making it suitable for DRIP's portfolio. The manager liked the high net initial yield, strong WAULT, low capital per square foot and felt that the low passing rents offered opportunity for growth. In addition, the manager says that Kew's income profile is highly complementary to DRIP's existing portfolio and that its addition improves DRIP's dividend cover and income security.

Figure 10: Kew Retail Park, Southport – exterior view

Source: Jones Lang LaSalle

Figure 11: Kew Retail Park, Southport – aerial illustration



Source: Jones Lang LaSalle

Kew was marketed with two key asset management opportunities: 1) negotiating a surrender of the car wash lease and redeveloping this area to create two A3 pod units with potential for drive-through, subject to planning (see Figure 11 for illustration), and 2) Re-gearing and extending the leases of Carpetright and Travis Perkins. DRIP's manager says that he will give some consideration to these in due course.

Other portfolio developments

Arthur House, Manchester

Further information on Arthur House is available on pages 12 and 13, and 27 to 29, of our July 2016 initiation note.

Arthur House is a 25,500 square foot, freehold office property in Manchester city centre that was purchased in February 2016, having been marketed as "refurbishment/repositioning opportunity". As part of the strategy for acquiring the property, DRIP's manager had identified a number of asset management initiatives to improve net rental income from the property. These, as well as the attributes that make the property desirable, are detailed within a case study on Arthur House on pages 12 and 13 of our July 2016 note. However, key elements of the programme are to:

- Conduct essential repair works to common parts to reduce ongoing landlord irrecoverables
- Carry out refurbishment of common parts to create a "sense of arrival"
- Carry out refurbishment works to the building to create a modern feel

The manager has been making progress on these initiatives, particularly with regard to creating a welcoming environment both to the exterior of the building and the reception area.

Figure 12: Arthur House reception – new interior

Source: Drum Income Plus REIT

Figure 13: Arthur House reception – previous interior

Source: Drum Income Plus REIT

Planning permission has now been granted for the proposed refurbishments to the reception area (see Figures 12 and 13 for 'before and after shots' of reception interior and Figures 14 and 15 for 'before and after shots' of reception exterior) as well as to replace all of the windows on floors 1 to 6. As part of the refurbishment, the window space for the reception area is also to be increased. This will allow more light in and make the environment more welcoming. Practical completion, for the works to the reception area, is expected to occur during May 2017.

The manager has also instructed both the fourth floor refurbishments and replacement of the windows on floors four to six. Practical completion for these is expected to occur during July 2017.

In addition to refurbishing the lifts and stairwells, the manager has signed a new 10-year lease, over 4,000 square feet on the fourth floor, with building consultancy, Tony Gee. Tony Gee previously occupied 2,900 square feet on the sixth floor but, under the terms of the new lease, is moving to a modestly refurbished space on the fourth floor and is taking an additional 400 square feet of space, and are paying a higher rate per square foot (from £13.50 to £17.50). The manager says that this has led to a significant uplift in rent and value of the building. This also leaves the sixth floor clear for the manager to undertake refurbishment works. Once these are complete, the manager expects to be able to re-let the space with the expectation of another uplift in income. Midas Investment Management, which occupies 2,632 square feet (1,155 on the first floor and 877 feet on the second floor), has signed a new five-year lease with a break at year three. This has seen an increase in rent of 7.1% to £15 per square foot.

Figure 14: Arthur House reception – new exterior

Source: Drum Income Plus REIT

Figure 15: Arthur House reception – previous exterior

Source: Drum Income Plus REIT

Gosforth Shopping Centre, High Street, Newcastle upon Tyne

Gosforth Shopping Centre remains DRIP's largest asset. It was purchased in October 2015 at a cost of £12.25m (a net initial yield of 7.3%) and is anchored by Sainsbury's, which occupies 33,000 of the shopping centre's 73,000 square foot of rentable space. Sainsbury's lease expires in 2032, has no break clauses and has a guaranteed rental uplift of 2% per annum compound, every five years. Sainsbury's lease has just been re-geared, creating a rental uplift of 11.041%. Sainsbury's provides around 40% of DRIP's income from the centre and remains DRIP's largest overall tenant

When we last wrote in July 2016 (see page 23 of that note for details of the rationale and strategy for Gosforth) the manager was looking to focus on increasing 'dwell time' in the centre (initiatives to achieve this could include the provision of free wi-fi and Amazon lockers), and developing a tenant and shopper engagement strategy (a new website for the centre had already been put in place). Since this time, the wi-fi installation and Amazon lockers have been completed. Further engagement initiatives include installing children's play rides, operating a 'Santa's Grotto' for two weeks in the run up to Christmas and running a programme of activities over Good Friday and Saturday (Easter egg hunt, egg decorating and craft activities). In addition to the new lettings to Card Factory and Naked Deli, discussed in our last note, a new lease has

been signed with Costa Coffee. There is currently one vacant unit, which was paying rent of circa half the market rate, and so the manager expects to see an increase in income when this unit is re-let.

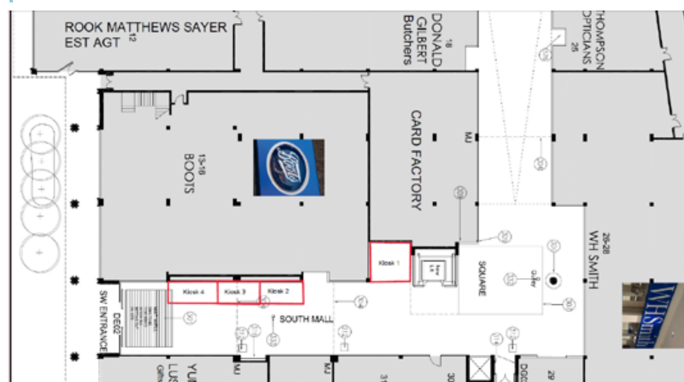
A new key initiative is to create four kiosks using space within the centre that has been previously unlet (an illustration is provided in Figures 16 and 17). Three of the kiosks have now been completed and manager expects the remaining kiosk to be completed during 2017. The total cost for constructing the four kiosks is in the region of £35k but the manager expects to be able to let each for an annual rent of circa £9,000 (£36k in total), which suggests a very quick payback on the investment and the manager expects this to result in an uplift in the valuation for the centre of c £300k.

When we last wrote, in our July 2016 initiation note, a new 10-year lease had been put in place with Boots and negotiations with WH Smith (Units 26 to 28), which had a lease expiration approaching, had commenced. WH Smith has since signed a new five-year lease, with no rent-free period for £69,500 per annum (a decrease of 11.6%) for the 5,070 square feet it occupies. Donald Gilberts, a butcher's shop that occupies Unit 18 (944 square feet) has signed a new 10-year lease for £21,500 per annum (an increase of 1.1%).

Figure 16: Gosforth Shopping Centre – Kiosk exterior illustration

Source: Drum Income Plus REIT

Figure 17: Gosforth Shopping Centre – Kiosk location plan



Source: Drum Income Plus REIT

Montieth House, 11 George Square, Glasgow

Montieth House continues to be DRIP's second-largest asset, by market value. It was purchased in November 2015 at a cost of £5.75m (a net initial yield of 7.6%). The manager advises that, reflecting tightening demand and supply conditions locally, the estimated rental value (ERV) of the property has been increasing. As detailed in our July 2016 note, LS Buchanan's leases (fifth and sixth floors) had a break option in January 2017 and expire in January 2018. The January 2017 break option was not exercised but, with the January 2018 expiration looming and the recent tightening in the local rental market, DRIP's manager is expecting to be able to negotiate a rental uplift. The remaining leases for the property expire in 2021.

Lakeside 5500, Cheadle Royal Business Park, Manchester

Lakeside 5500 is a three-storey modern office that was acquired, fully let, from Quorum Properties in December 2015 for £5.475m (a net initial yield of 7.82%). Micron Europe occupies 8,800 square feet on the ground floor with the lease for half of this space expiring at the end of March 2017. The manager has since signed a five-year lease with the tenant, with a break at year three, that saw a 15.5% increase the rent rate.

Mayflower House, Fifth Avenue Business Park, Gateshead

Mayflower House is multi-let office property that was purchased in October 2015 for £2.67m, reflecting a net initial yield of 9.25%. Addison Motors, which occupies 3,500 of the building's 28,200 square feet did not exercise its break and so the property's WAULT has increased.

108 Eastern Avenue Retail Park, Gloucester

108 Eastern Avenue Retail Park, Gloucester (Eastern Avenue) was purchased from CBRE Investors, in February 2016 for £5.3m, which reflected a net initial yield of 8.4%. The property, which is a three-unit scheme of 32,000 square feet with a wide bulky goods consent, was acquired fully let to Staples, Maplin Electronic and Farmfoods. Staples, which occupies circa 20,000 square feet, experienced some widely reported financial difficulties and the business was eventually sold to Hilco in November 2016 for £1. DRIP's manager says that there were no rent arrears but, given the challenges the company was experiencing, this potentially creates an asset management opportunity, such as a decline in rent for longer term certainty.

The UK property market

Readers interested in further information on the UK property market, and the manager's view should see pages 7 to 11 of our July 2016 initiation note.

DRIP's manager advises that, in terms of his long-term view, little has changed since we published our initiation note in July 2016. Further information is provided on pages 7 to 11 of that note but, in summary, DRIP is focused on properties valued between £2m and £15m as there is less competition for properties in this segment (it falls below the radar of most institutional investors, but is generally too large for individual private investors) leading to superior yields.

The manager believes that lack of new supply, in the £2m to £15m segment, has translated into low vacancy rates with the prospect of rent increases.

The manager believes that the combination of a lack of new supply of properties in the markets that DRIP targets, persistently low interest rates, relatively low unemployment, low inflation, real wage growth, and improving business and consumer confidence are all supportive of positive returns from property of the types and in the locations favoured by DREIM for DRIP's portfolio. Of these influences, the manager thinks that the lack of new supply (very little commercial property has been built in regional locations since 2008) may be the most significant as it is translating into low vacancy rates and the prospect of rent increases.

UK interest-rate rises, while a potential headwind, look to be a distant prospect. The manager believes that rate rises would not have a significant impact on the valuation of DRIP's portfolio.

DRIP's focus away from London and the South East is benefitting from a broadening of the UK economic recovery and, whilst the possibility of higher interest rates in the UK was previously a concern, UK rate rises look like a relatively distant prospect. The manager thinks that, in any case, there is a sufficient yield gap between yields on UK gilts and property yields, especially yields on properties favoured by DRIP, with the result that modest rate rises would not have a significant impact on the valuation of DRIP's portfolio.

Persistent low interest rates and a growing economy have attracted overseas buyers for UK property and have helped increase allocations to the asset class from domestic investors. This has put pressure on prime yields, but these have expanded again following the EU referendum and so tight yields are much less of a concern. The effect of yield compression was most pronounced in London although the managers had observed that the phenomenon was impacting on some regional markets as UK institutions went in search of higher yields (NB they are still focusing on larger lot sizes).

It would therefore seem reasonable that the prospect of capital loss and yield expansion is likely to be less in the regions.

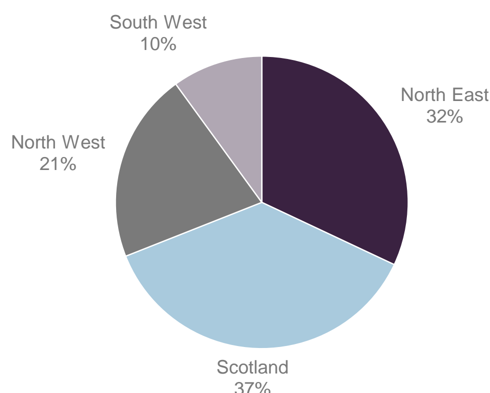
DRIP's manager believes that high single digit returns can be achieved for DRIP's portfolio over the next 12 months.

At the beginning of 2016 many commentators and investors were saying that they expected the pace of yield compression to ease off or stop altogether, but they thought future returns would be derived from income and we could see rent increases. A year on the picture remains broadly the same. Despite the current economic and political challenges, the managers agree with this assessment and believe high single digit returns can be achieved for DRIP's portfolio over the next 12 months.

Asset allocation

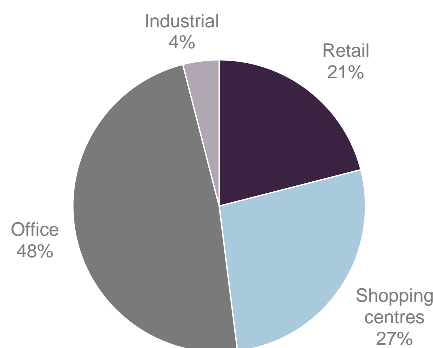
Following the acquisitions of 3 Lochside Way in Edinburgh and Burnside Industrial estate in Aberdeen, DRIP owns a portfolio of nine properties spread across the UK with a bias away from London and the South East. The properties were acquired on yields between 7.3% and 10.6%, and each of the property values falls within DRIP's target £2m to £15m range.

Figure 18: Portfolio allocation by geographic location as at 31 March 2017



Source: Drum Income Plus REIT

Figure 19: Portfolio allocation by property type as at 31 March 2017



Source: Drum Income Plus REIT

As at 31 March 2017, the portfolio had 82 tenants (an average of 9.1 per asset, down from 10.9 prior to the two most recent purchases); a WAULT to expiry of 5.83 years; a WAULT to break of 4.44 years; a portfolio yield of 8.7%; 91.4% occupancy by square foot excluding rental guarantees; and 90.8% occupancy by ERV excluding rental guarantees (occupancy has fallen from 96% since we last wrote but largely reflects the refurbishment programme at Arthur House, although including rental guarantees, occupancy remains at circa 96%. The manager says that from an income perspective, the reduction in occupancy from the Arthur House refurbishments has been more than offset by other improvements made within the portfolio.

The loan-to-value ratio, as at 31 March 2017, was 29.4% (a modest increase from the 27.3% when we last wrote). However, the completion of the acquisition of Kew Retail Park will take DRIP close to its 40% target level. However, the managers reiterate that they have an attractive pipeline of opportunities, which will lead to the company being fully invested in due course. As illustrated in Figure 19, which shows the portfolio split according to property type, DRIP has a 21% allocation to retail properties (down from 45% as at the end of March 2016), 27% allocation to shopping centres (down from 31%), 48% allocation to office properties (up from 24%) and a 4% allocation to industrial properties (up from a zero allocation). With 82 tenants across its nine properties, DRIP has considerable diversification within its tenant base.

Figure 20: Portfolio, values as at 31 March 2017

	Location	Type	Actual rent £'000	Estimated rent £'000	Acquisition yield %	Market value £m
Gosforth Shopping Centre	Newcastle	Shopping centre	886	1,029	7.3	13.1
Monteith House	Glasgow	Offices	465	473	7.6	6.1
Lakeside 5500	Manchester	Offices	362	470	7.8	5.6
Eastern Avenue	Gloucester	Retail	472	389	8.4	5.3
Duloch Park	Dunfermline	Retail	357	397	7.4	4.8
3 Lochside Way	Edinburgh	Offices	407	402	8.5	4.6
Arthur House	Manchester	Offices	158	465	8.9	4.5
Mayflower House	Gateshead	Offices	257	259	9.3	2.6
Burnside Industrial Estate	Aberdeen	Industrial	333	289	10.5	2.6

Source: Drum Income Plus REIT

As DRIP grows, the concentration in its rent roll should reduce. Further details on all portfolio properties, including some commentary of the rationale behind their purchases is included in Appendix 1 on pages 23 to 30 of our July 2016 initiation note.

As illustrated in Figure 20, which shows the 10 largest tenants as at 31 March 2017, in terms of annual contracted rent, there is a degree of concentration, with the top four tenants accounting for 30.5% of the current rent roll. However, reflecting the manager's diversification strategy, this has reduced markedly since we last wrote (the most recent data then available showed that the top four tenants accounted for 36.7%). The top 10 tenants account for 50.2% of the current rent roll, with the remaining 72 tenants accounting for the balance of 49.8%. However, assuming that DRIP continues on its path of expansion, as it intends, whilst continuing to target smaller lot sizes in the same range, the concentration in rent roll should reduce. Within the current list of major tenants are many well-known companies (including Sainsbury's, Worldpay, Maplin Electronics and WH Smith) and two government agencies – the Scottish Network 1 & Tourist Board (Visit Scotland) and The Skills Development Scotland Company (Skills Development Scotland). Further details on each of the properties in Figure 20 can be found at the beginning of this note and in Appendix 1, on pages 23 to 30, of our July 2016 initiation note. DRIP's portfolio is valued by an independent third party on a quarterly basis.

Figure 21: Top 10 tenants as at 31 March 2017

Tenant	Property	Contracted gross annual rent £'000	% of portfolio contracted gross annual rent	Next lease break/ expiry
Sainsbury's	Gosforth SC	386	9.5	10/04/32
Staples UK	Eastern Avenue	315	7.8	24/03/24
Agilent Technologies LDA UK	Lakeside 5500	299	7.4	24/03/22
Scottish Network & Tourist Board	Monteith House	235	5.8	26/01/21
Micron Europe	Lakeside 5500	177	4.4	24/03/20
Worldpay	Mayflower House	158	3.9	11/03/20
SF (UK)	Burnside	144	3.6	01/09/18
The Skills Development Scotland Co	Monteith House	126	3.1	23/07/18
LS Buchanan	Monteith House	104	2.6	19/01/18
Maplin Electronics	Eastern Avenue	87	2.1	27/03/21
Top 10 total		**1,942**	**50.2**	
Remaining portfolio		**2,016**	**49.8**	

Source: Drum Income Plus REIT

In terms of portfolio development, the managers say that, geographically, they continue to believe that the portfolio would benefit from the addition of an asset in the Midlands and they are investigating a number of potential candidates. DRIP has now purchased its first industrial property (Burnside Industrial Estate), but the industrial exposure is still a small component of the overall portfolio mix and the manager is keen to add more properties to increase the diversification. The manager reiterates that the underweight exposure to industrial property may persist in the near term, as this is not where he is

currently seeing the strongest opportunities, but that he will continue to take an entrepreneurial approach, investing where he sees the most attractive valuations.

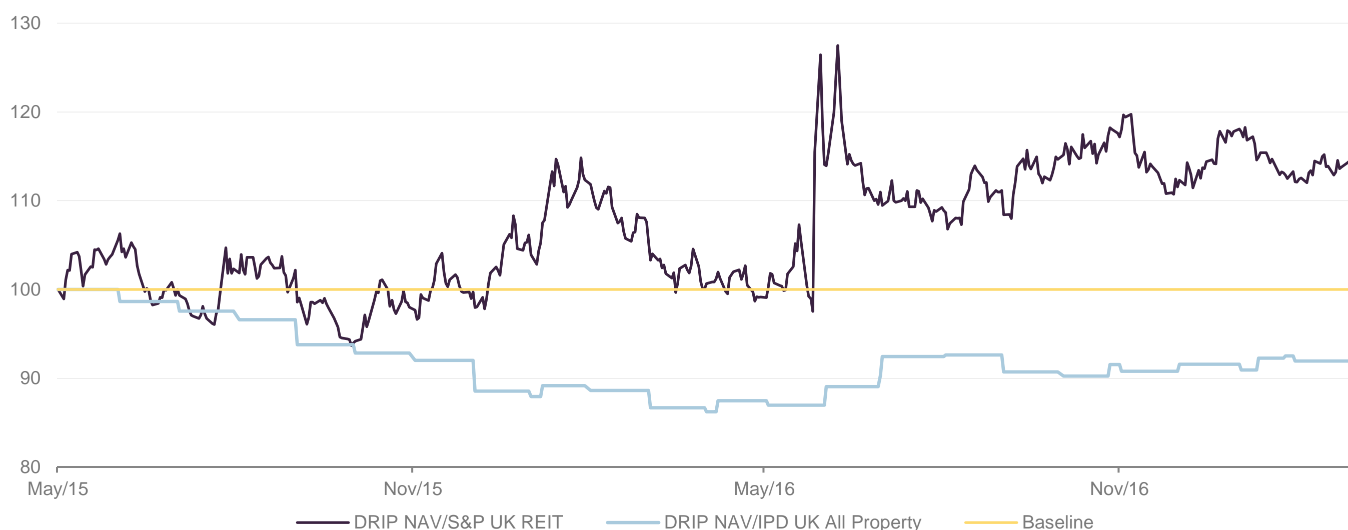
Performance

DRIP has been listed on the main market of the LSE for almost two years. In our view, DRIP's NAV performance during the last 12 months is broadly representative of what investors should expect going forward although, assuming it is able to issue further equity and continue to expand, we envisage that income generation should be able to expand as 1) costs are spread over a larger asset base and 2) DRIP moves closer to its target loan to value ratio of 40%.

We reiterate our view that, after almost two years of trading history, DRIP's first year of trading is not representative of the sort of NAV development that DRIP should experience in the future, and so care should be exercised when analysing DRIP's performance since launch. As discussed on page 5 of our initiation note, the initial costs of bringing DRIP to market saw it open with an NAV of 97.7p (a 2.3% reduction over its issue price) and the issue proceeds took time to invest. During this period, DRIP earned interest on its uninvested cash, but this is lower than the returns we would expect it to earn on its property investments (the portfolio is currently yielding 8.7%). There were also the one-off transactional costs associated with purchasing the portfolio of properties (mostly stamp duty), which cost 6.8p per share (6.8% of the issue price) and, while this is likely to remain a feature, as DRIP grows in size, it will not apply over the entire portfolio as it did in this first year and so its impact should be less marked.

As explained on page 2, DRIP's NAV increased by 1.0% over Q1 2017. Including dividends, DRIP provided an NAV total return of 2.4% over the quarter.

Figure 22: DRIP NAV/S&P UK REIT and DRIP NAV/IPD UK All property – rebased to 100 since 29 May 2015



Source: Morningstar, Marten & Co. *Note: DRIP was listed on 29 May 2015.

Figure 23: Cumulative total return performance to 31 March 2017

Heading	3 months (%)	6 months (%)	1 year (%)	Since launch*
DRIP NAV	2.4	7.7	11.5	5.7
DRIP share price	(3.6)	(4.2)	(6.7)	3.3
S&P UK REIT	1.2	1.1	(0.2)	(8.5)
IPD UK All Property	2.3	4.9	3.8	13.5

Source: Morningstar, Bloomberg, Marten & Co. *Note: DRIP was launched on 29 May 2015.

Peer-group comparison

Up-to-date information on the UK property sector is available on the QuotedData website

Within the UK REITs sector, there is a diverse range of vehicles offering a multitude of strategies. Some focus on single asset classes (such as social housing, student property, 'big box' distribution centres or retail property); or perhaps different geographies (London and the southeast or more regional locations); or different asset qualities (prime versus secondary properties). As a consequence, while the UK listed REITs space is large, many REITs are of limited value when attempting to make peer-group comparisons for DRIP. In Figures 24, 25 and 26, a comparison is provided against AEW UK REIT, Custodian REIT, Ediston Property Investment Company and Regional REIT. These all make direct property investments in the UK, across a range of asset types and invest in more secondary locations.

Figure 24: Peer group cumulative NAV total return performance to 30 April 2017

Heading	3 months (%)	6 months (%)	1 year (%)	Since launch*
Drum Income Plus REIT	3.0	6.7	10.5	5.7
AEW UK REIT	0.0	2.3	2.8	7.8
Custodian REIT	0.9	2.7	6.2	13.0
Ediston Property	1.2	3.7	6.3	14.8
Regional REIT	0.2	1.1	3.7	

Source: Morningstar, Bloomberg, Marten & Co. *Note: DRIP was launched on 29 May 2015.

As discussed on page 14, we believe that the returns earned during the first year of DRIP's life are not representative of the returns investors should expect going forward but that the returns during the last 12 months should be. As illustrated in Figures 24 and 25, DRIP has underperformed its peers in terms of both price and NAV since its launch but, during the last 12 months has provided the strongest NAV growth. This NAV growth has not been reflected in DRIP's share-price performance, which arguably reflects the limited liquidity in DRIP's shares.

Figure 25: Peer group cumulative share price total return performance to 30 April 2017

Heading	3 months (%)	6 months (%)	1 year (%)	Since launch*
Drum Income Plus REIT	(3.6)	(4.2)	(1.8)	3.3
AEW UK REIT	8.7	5.7	8.6	10.1
Custodian REIT	2.3	8.3	11.4	15.6
Ediston Property	1.1	(0.5)	5.0	4.5
Regional REIT	4.5	5.2	11.1	

Source: Morningstar, Bloomberg, Marten & Co. *Note: DRIP was launched on 29 May 2015.

As illustrated in Figure 26, DRIP's market capitalisation is the smallest of its peers and, arguably reflecting its lower liquidity it has the highest share price standard deviation in the group. This smaller size is also arguably reflected in its ongoing charges ratio

although this should fall if DRIP is successful in expanding meaningfully. In the meantime, DRIP's manager has agreed to reduce its fees to the extent necessary so that the company's costs do not exceed 2% of net assets. Further information is provided on page 21 of our July 2016 initiation note.

Figure 26: Peer group comparison – size, fees, discount, yield and gearing as at 11 May 2017

	Market cap (£m)	St. dev. of price returns since DRIP's launch	Ongoing charges (%)	Perf. fee	Premium/ (discount) (%)	Dividend yield (%)	Net gearing
Drum Income Plus REIT	37.1	26.0	2.00*	No	(0.1)	5.7	155**
AEW UK REIT	126.1	6.9	1.14	No	4.7	7.8	112
Custodian REIT	379.9	15.7	1.71	No	9.7	5.7	119
Ediston Property	141.6	24.1	1.50	No	(0.6	5.0	137
Regional REIT	320.2	20.5		No	(0.6(	7.2	

Source: Morningstar, Marten & Co. *Note: capped at 2.0% ** Marten & Co estimate adjusting 31 March gearing for Southport acquisition and assuming no change to NAV sine 31 March 2017

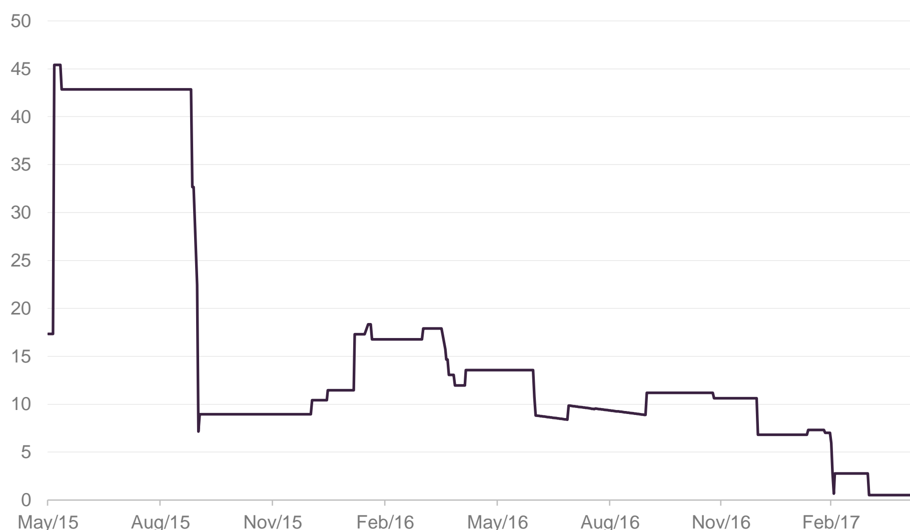
DRIP's net gearing is the highest of this peer group but is in-line with its long-term target and not unduly high for a property company. DRIP's yield, at 5.5%, is below that of most of its peers (Ediston has the lower yield).

Premium/discount

DRIP has consistently traded at a premium since launch. We believe this reflects DRIP's attractive yield, its smooth regular dividend payments and assets that should offer a strong degree of inflation protection.

As illustrated in Figure 27, DRIP has consistently traded at a premium since its launch in May 2015 although the broad trend during the last year has been one of premium narrowing, so that DRIP is now trading modestly above asset value (a premium of 1.6% to the 31 December NAV as at 19 April 2017). As discussed in our July 2016 initiation note, we believe that DRIP's premium rating, in part, reflects the fact that it has a number of features that make it attractive to investors seeking income, particularly in the current low interest-rate environment. Most notably DRIP offers an attractive yield, with smooth regular payments, which is backed by assets that should offer a strong degree of inflation protection as well as a smooth and predictable underlying income stream.

Figure 27: Premium/(discount) since launch (%)



Source: Morningstar, Marten & Co

DRIP's premium has been subject to sharp movements. We believe that asset growing the company will improve liquidity and lead to a smoother evolution over time.

We have previously commented that DRIP's premium has been subject to sharp movements. This continues to be the case, but the moves appear to be becoming less sharp. We believe that these movements reflect the current limited liquidity in DRIP's ordinary shares but expect that, if DRIP's board and manager are successful in their attempts to grow the company (a challenge that the board and managers are firmly committed to overcoming) that this should improve liquidity and lead to a smoother evolution of the premium/discount over time.

Further growth should make DRIP more attractive to investors.

Moreover, we firmly believe that further growth should provide a number of benefits to shareholders and make it more attractive to investors, which will likely stimulate further demand for DRIP's shares making it easier for the company to issue further stock and help the company to moderate the premium.

DRIP's highly-diversified tenant base mitigates the risks of a significant void.

In terms of downside risks, we believe that an event that had a significant negative impact on DRIP's ability to meet its dividend expectations, such as a significant void in its portfolio, could potentially undermine confidence and reduce its attractiveness. However, DRIP has a highly diversified tenant base, which helps to mitigate this risk.

Interest-rate normalisation would be negative for equities in general. We believe DRIP would be less affected than many other equities.

It would also seem reasonable that moves towards interest-rate normalisation could see a reduction in demand for DRIP shares and equities in general (rising interest rates traditionally being negative for equities as fixed income becomes more attractive). However, despite improvements in outlook for the broader global economy, significant interest-rate rises would not appear to be a likely prospect in the near term and, given that such an interest-rate rise would likely be a response to improving economic activity and rising inflation, we maintain our view that DRIP would likely be less affected than many other equities. This is because its leases have upward only rental reviews, with an increasing proportion being indexed against RPI, and improving economic activity would likely bode well for both rising capital values in its portfolio as well as improved prospects to increase rents at the margin.

DRIP's occupancy has been increasing at the margin.

A further consideration is DRIP's occupancy level (91.4% as at 31 March 2017, although with rental guarantees it is closer to 96%). This has dropped in the near term while the manager undertakes refurbishments at Arthur House, but should revert in due course. All things being equal, an increase in occupancy should increase DRIP's income, making it more attractive to investors and stimulate demand for DRIP's shares. NAV would be relatively insensitive to such changes and so the discount would likely narrow or a premium could increase. On the downside, the reverse also applies and so a deterioration in occupancy could lead to a discount widening or a premium reduction. That said, DRIP's most recent acquisitions have been made at relatively high net initial yields and it had already been generating higher levels of income than had been anticipated at launch. This has provided capacity to reduce occupancy, to allow for refurbishment, while still generating sufficient income to meet its dividend targets (see below).

Key risk considerations

Figure 28: Risk matrix

Risk	Discussion
Ordinary share liquidity	DRIP has a low market capitalisation, compared to its peers, and its shares are very tightly held. This results in very low liquidity in its ordinary shares and a relatively wide spread. Investors run the risk of moving the market against them when transacting in size although, for purchasing shares, DRIP can undertake tap issuance which should provide some mitigation. DRIP's board and manager are highly committed to growing DRIP. If successful, this should improve liquidity and reduce its associated risk over time.
Interest rates/inflation	DRIP has a £25m three-year loan facility with the Royal Bank of Scotland. The facility incurs interest at a rate of Libor + 1.75% and expires on 6 January 2020. DRIP will be exposed to additional costs in the event that the Libor rate rises. Current levels of economic activity and uncertainty suggest significant near-term interest-rate rises are unlikely although these could occur in response to rising inflation. However, many of DRIP's leases are indexed against inflation and the manager is working to move the remaining leases to a similar basis over time.
UK and regional economic activity	DRIP holds a portfolio of UK commercial properties and so is indirectly exposed to the broader UK economic cycle as well as shifts in economic activity within the regions where it is invested. These have the potential to impact on rents, the capital value of assets and the premium/discount to NAV at which DRIP's shares trade.
Individual asset risk	DRIP maintains a relatively concentrated portfolio of assets and so could suffer should an event occur that rendered an asset unusable. This risk should continue to reduce if the board and manager are successful in their plans to grow DRIP and add further properties. There are also insurance policies in place to provide cover for such events.
Tenant risk	DRIP is exposed to the risk that individual tenants may fail to meet their obligations under their leases. An obvious example is where a tenant gets into financial difficulties as was recently the case with Staples. Figure 21, on page 13 of this note, provides an illustration of the largest tenants. DRIP's multi-let strategy provides significant tenant diversification and helps to mitigate this risk.

Source: Marten & Co

Fund profile

Smaller, multi-let assets with the potential for asset management initiatives

More information can be found at the trust's website: www.dripreit.co.uk

Readers may also be interested in our initiation note of July 2016. Please click here to view.

DRIP is focused on: smaller lot sizes than those that suit the portfolios of institutional and overseas investors; secondary assets in good locations; and multi-let assets, as these are often overlooked by other property investors. All things being equal, these should provide the company with greater diversification within its income stream.

In addition, the managers look for properties that offer the potential to add value by implementing asset management initiatives. Such initiatives come in a variety of forms. For example, lease expirations, in the current market environment, frequently offer the opportunity to renegotiate better terms, as the market is tighter than when many leases were originally signed; modest refurbishment of communal areas and amenities can facilitate rental increases and yield improvements; and reconfiguring spaces to increase the rentable area and make them more desirable for current usage can also lead to yield improvements.

It should be noted that, whilst the managers are looking, over time, to build a portfolio that is diversified by sector, geography and tenant mix, portfolio evolution is driven primarily by where the managers see the strongest opportunities at any given time as they work to expand the portfolio.

Dividend policy, revenue generation and dividend targets

DRIP pays quarterly dividends in equal instalments.

DRIP's dividend policy is to pay quarterly dividends, in equal instalments, in February, May, August and November of each year. To meet the obligations required to maintain its REIT status, DRIP is required to pay out at least 90% of its tax-exempt profit, from property rental, to shareholders each year. Since its launch, all of DRIP's dividends have been fully covered.

DRIP is targeting fully covered total dividends of at least 5.5 pence per share for the year ending 30 September 2017 and at least 6.0 pence for the following year.

Now that it is fully invested, it is expected that the overwhelming majority of DRIP's income will be derived from property rentals. DRIP's board says that it is targeting fully covered aggregate quarterly dividends of at least 5.5 pence per share in respect of the year ending 30 September 2017 and at least 6.0 pence per share in respect of the year ending 30 September 2018.

Further information regarding aspects of DRIP's dividends are provided on pages 16 to 19 of our July 2016 initiation note.

A strong desire to grow

DRIP's board and managers are firmly committed to growing the company, with the aims of improving liquidity, lowering average costs and further diversifying the portfolio and share register.

DRIP's board and manager are firmly committed to growing the company, with the aims of diluting the founder shareholders, improving the liquidity in its shares, reducing its average costs (by spreading DRIP's fixed costs over a larger asset base) and further diversifying its portfolio and income stream. We believe that all of these goals would be to the benefit of its shareholders and that increases in its size and liquidity should make DRIP more attractive to investors.

The managers have indicated, and we would agree with them, that DRIP's gross assets could be a substantial multiple of its current size without negatively affecting their ability to follow its strategy. DRIP's manager believes that they can comfortably deploy £10m of new funding per month (a mix of both debt and equity). This is discussed in more detail on page 12 of our July 2016 note.

Potential to grow from stock or asset swap

One way by which DRIP could continue to grow is by exchanging shares in DRIP in return for either acquiring a property, or for acquiring shares in a company that owns a property. This was the method by which the company acquired Burnside Industrial Estate in August 2016.

The managers say that any properties acquired in this way still need to meet their investment criteria and pricing continues to be key. In this regard, it is interesting that Burnside Industrial Estate is the property with the highest net initial yield to date (10.55%). Further information is provided, in Appendix 2 on pages 31 and 32 of our July 2016 note.

The DREIM team

DRIP's Alternative Investment Fund Manager (AIFM) is R&H Fund Services (Jersey) Limited. It has delegated the day-to-day management of the portfolio to Drum Real Estate Investment Management (DREIM).

Bryan Sherriff is the investment director for DREIM. He has over 25 years of experience in commercial property, across all sectors, and has acted for a range of institutional investors. The majority of DRIEM's efforts are dedicated to managing DRIP's portfolio.

Capping management fees

The asset manager has agreed to reduce its fees to the extent necessary so that the company's costs do not exceed 2% of net assets. Our analysis suggests that DRIP needs to grow its net assets by approximately 21% for the asset manager to receive its management fee in full, uncapped. Further discussion is provided on page 16 of our July 2016 initiation note.

Previous research publications

More information can be found at the Trust's website: at www.dripreit.co.uk

Readers interested in further information about DRIP such as investment process, fees, capital structure, trust life and the board, may wish to read our initiation note, *Good things in small packages*, published on 11 July 2016. The contents pages have been reproduced below. You can read the note by clicking on the contents pages or by visiting our website, www.martenandco.com.

Good things in small packages – 11 July 2016

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