James Carthew: DIGS' London moat had direct impact on returns

James Carthew   29 May, 2018

GCP Student Living (DIGS) is five years old and it has been a great success. An investor who subscribed £1 for a share in the real estate investment trust's initial public offering on 20 May 2013 has received 26.07p in dividends with another 1.48p on the way and, after a recent rally, has a share worth £1.46.

This works out as a return of 11.7% per annum, well ahead of the company's 8%-10% annualised total return target. At the same time, the trust's managers have seen a fund worth £70 million grow to one with a £759 million property portfolio and a market value of £562 million.

DIGS has traded at a healthy premium to net asset value (NAV) for much of its life but its share price was dragged down by the profit warning that emerged from **Empiric Student Property** (ESP) in

September 2017. Having traded at a discount approching 6%, it has just moved back to trading at asset value once again.

Empiric's share price started falling in the first week of September, ahead of the publication of its interim results on 12 September. The tone of the statement was upbeat but it warned that 'certain one-off items... have adversely impacted the result for the half year... the dividend for the full year is now not expected to be substantially covered by adjusted EPRA earnings per share'.

A negative research note from Numis Securities and a business review published in November highlighted the real problem; the company's operating margins were just too low and cost cutting was needed.

I bought some Empiric shortly afterwards and I'm sitting on a modest profit on my investment as the company gets stuck into a £10 million cost-reduction programme.

It probably isn't surprising that some investors saw the problems at Empiric and assumed that DIGS was similarly affected. However, despite their focus on the student accommodation market, the two investment trusts are quite different.

First, DIGS is focused mainly on London. It is a challenging market for planning applications, land is expensive and local authorities are trying to prioritise house building over the provision of student accommodation. These challenges represent a real barrier to entry to this market. This helps maintain the considerable shortfall in the supply of student accommodation (GCP reckons there are around 300,000 more students than available spaces, even factoring in unbuilt developments). In turn, this helps underpin rents, up 4.1% in 2017/18 over the previous year, and a 100% occupancy level versus 92% for Empiric's portfolio.

Second, DIGS has just 10 properties in its portfolio (two of with are under construction), with an average of 356 beds per property, all of which are managed in-house. By contrast, Empiric has 9,158 beds spread across 94 assets and, although it is tackling this, a large number of managing agents. DIGS benefits from economies of scale that aren't available to Empiric. Its lower overheads feed through into higher margins.

It is true that DIGS' dividend is not covered by earnings at the moment. There is a good reason for this, however. DIGS is seeking to drive its asset value higher by investing in some assets that aren't yet operational. In April 2017 it acquired a 455-bed building in Woburn Place in Bloomsbury. This is currently being refurbished to provide 420 beds under the Scape brand. The plan is to have at least some of this available for rent for the 2018/19 academic year. DIGS may also be able to let the refurbished property to non-students outside term time. This could prove quite lucrative.

It also raised £70 million in July 2017 to help forward fund the development of Circus Street in Brighton, a 450-bed scheme with 30,000 square feet of office space. Once complete (the target date is ahead of the 2019/20 academic year), the student accommodation will be let on a 21-year lease with rents that rise by more than inflation (RPI +0.5% a year). While it is in the development phase DIGS gets a 5.5% coupon.

DIGS has more investment opportunities up its sleeve, including a 400-bed building adjacent to its existing Scape East asset, serving Queen Mary University. At the end of March 2018 the portfolio was valued on a blended net initial yield of 5%.

Recent transactions in the sector might support higher valuations, however. For example, in December 2017, iQ Student

Accommodation paid £870 million to buy the 3,644 room Pure Student Living portfolio. The price equated to a yield just over 4%. There is talk that Goldman Sachs and the Wellcome Trust, owners of iQ, are considering a flotation some time this year. It will be interesting to see how things develop.

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