

Lok'nStore Group 60p

In line results, trading at a 75% discount to NAV

10 November 2008

Share Price: 60p



12m High: 210.5p

12m Low: 60p

Market Cap: 15.8m

Shares in Issue: 26.4m fully diluted

NAV/Share: 244p with properties at valuation

Gearing: 53.6% with properties at valuation

Interest Cover: 0.5X

EPIC Code: LOK.L

Sector: Support Services

Market: London AIM

Broker: Investec

PR: Financial Dynamics

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Website: www.loknstore.co.uk

Description: Lok'nStore is the fourth largest self-storage group in the UK with a c. 5% market share. It owns 23 self-storage centres in the affluent South East of England, 20 of which are open. The freehold/leasehold split is 64/36. The household/business revenue split is 60/40.

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Full year results to end July 2008 were bang in line with our forecasts and showed impressive forward movement on a like-for-like basis despite current conditions in the housing market. However, occupancy will undoubtedly be harder to come by in the current year, and we are reducing our current year turnover estimate by 12% to reflect this.

Key points from the results statement are:

- Sales up 8.4% and Store EBITDA up 11.9%, both on a like-for-like basis underpinned by a 4.2% rise in prices to £18.01 per sq ft.
- Corporate revenues remained stable year-on-year whilst household revenues declined by a modest 1.3%.
- The end July 2008 external property valuation gave an adjusted NAV of 244p/share, a 9.6% decline on the July 2007 valuation of 270p/share. This is hardly surprising in light of the dire trading conditions in the commercial property market and the decline is certainly no worse than the average decline in NAV reported by most property-related stocks.
- Net debt has increased, from £10.46m to £22.8m following a heavy £14.3m capex programme. Even so, gearing with properties at valuation remains comfortable at 53.5%.
- The company currently has £14.6m of headroom on its existing banking facilities which run through to 2012. Interest on the facility is a competitive LIBOR + 1.25%.
- LTV and earnings covenants remain sound.

Management's focus in the current financial year will be on maximising the cash profits of the existing stores where the company has considerable scope to push through further price rises. This will put a temporary hold on forward capital commitments but a development pipeline of 228,000 sq ft places Lok'nStore in a good position for when the economic cycle turns, possibly in 2010.

In the context of these results, the 46% slump in the share price over the past two months looks overdone.

At the current 60p, the shares are trading at a 75% discount to NAV and an 84% discount to our embedded net asset value per share.

| Y/E | Group Sales | Group EBITDA | Declared Profit/(Loss) | Adjusted Profit/(Loss) | Adjusted EPS | Mkt Cap/EBITDA | Divi | Yield |
|-------|-------------|--------------|------------------------|------------------------|--------------|----------------|------|-------|
| July | £m | £m | £m | £m | P | X | p | % |
| 2007A | 10.67 | 2.90 | 0.95 | 0.37 | 1.2 | 5.5 | 0.67 | 1.1 |
| 2008A | 10.83 | 2.73 | (0.74) | (0.31) | (1.5) | 5.8 | 1.00 | 1.6 |
| 2009E | 10.24 | 1.97 | (1.19) | (1.19) | (4.5) | 8.0 | 1.00 | 1.6 |
| 2010E | 10.71 | 2.06 | (1.09) | (1.09) | (4.1) | 7.7 | 1.00 | 1.6 |

The Full Year Results

Much has been made about the correlation between the housing market and self-storage companies. Lok'nStore's full year results cover a period when housing market transactions fell to record lows, and were bang in line with our forecasts.

| 12m to July (£m) | 2007 | 2008 | % Change |
|--------------------------------------|-------|--------|----------|
| Total group sales | 10.83 | 10.67 | 1.5% |
| Store EBITDA | 4.49 | 4.61 | 2.9% |
| Group EBITDA | 2.90 | 2.73 | -5.9% |
| Depreciation | 1.29 | 1.44 | 11.6% |
| EBIT | 1.31 | 0.66 | -49.4% |
| Net Interest | 0.97 | 1.28 | 32% |
| Interest Cover | 1.4x | 0.5x | - |
| Pre-tax Profit/(Loss), Declared | 0.95 | (0.74) | - |
| Pre-tax Profit/(Loss), Adjusted | 0.37 | (0.31) | - |
| Tax | 0.32 | 0.09 | - |
| Eps, diluted, p | 2.4p | (3.2)p | - |
| Dividend p | 0.67p | 1.00p | - |
| Net Debt | 10.3 | 22.8 | 121% |
| Gearing with properties at valuation | 20% | 53% | - |
| NAV/Share (IFRS), Adjusted | 270p | 244p | -9.6% |

Sales: At the headline level sales increased by 1.5% to £10.83m, marginally ahead of our forecast of £10.8m.

The 15 established stores over 5 years old reported sales growth of 2.2%. This was a better performance than we were expecting considering the group sold two mature freehold stores at the end of its last financial year. On a like-for-like basis, sales in this category were up 4.6%.

The four developing stores continue to grow rapidly (up 18.9% like-for-like) and accounted for 21% of group sales in the y/e July 2008, up from 11.9% the previous year. This category includes the significantly larger, purpose-build freehold units in Crayford and Farnborough, where sales per store and store EBITDA margins are already matching the average of the established stores over 5 years old.

Stripping out the Kingston and Woking stores, overall like-for-like sales increased by 8.4% supported by a 4.2% rise in self-storage unit prices to £18.01 per sq. It is worth noting that Lok'nStore's average price per sq ft is still some way below the industry average, despite the group's concentration on the South East of England.

Store EBITDA (Before Central Overheads): increased by 11.9% like-for-like to £4.61m. This is a key business metric since it measures the cash profits of the stores.

Store EBITDA margins rose from 41.8% to 42.9%. Interestingly, all of this increase was driven by the developing stores. Store margins in the established estate actually fell during the course of the year, from 43.8% to 43.5% although we acknowledge the Woking and Kingston stores were particularly profitable units generating EBITDA margins of c. 55%.

Group Operating Profit: There are three reasons for the 49% overall decline and 39% like-for-like decline in operating profit. Firstly, central costs increased by 4.6%, to £7.8m driven by an 18% increase in overheads which will not be repeated in the current financial year. Secondly, the annual depreciation charge increased by 32% to £1.28m but we were expecting this. In fact, the actual increase for the year was slightly lower than we were expecting because of the fall in the market value of the freehold properties this year. Thirdly, the 2008 accounts include a significant, albeit one-off goodwill write-down charge taken against the group's under-performing self-storage unit in Swindon. Stripping out this last item, the decline in EBIT was 25%.

“Sales per store and store EBITDA margins in the developing Farnborough and Crayford units are already matching the average of the established stores over 5 years old.”

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Net Interest Charge: Rose by 32% because net debt has risen and the all-in interest rate on the group's £40m banking facility increased to 7.3% from 6.85% in the prior year. Post the year end the all-in interest rate has eased back to 2007 levels, and could well fall further given recent declines in LIBOR.

As pointed out in our last research note, Lok'nStore conservatively expenses all interest costs associated with its development pipeline. However, a change in IFRS Accounting Standards will mean that from 1 August 2009 onwards all interest on the group's development pipeline will be capitalised. This will obviously not benefit the current y/e July 2009 p & I account but the implications for future years could be significant.

Pre-tax Loss: The declared pre-tax loss for the year of £0.74m was £0.02m better than our forecast. Adding back the goodwill write-off charge of £311k and transfer costs of £125k relating to the move from the old leasehold in Portsmouth to the new purpose built freehold unit, both items that most investment managers would view as one-off, the adjusted pre-tax loss for the year was £305k.

Tax Charge: The £98k tax charge in these latest accounts translates to an effective tax rate of 13.2% and reflects a movement in deferred tax. No corporation tax was actually paid during the year and because Lok'nStore has £5.7m of carried forward tax losses, no tax is likely to be payable for some time.

Dividend: The final dividend has been maintained at 0.67p/share, giving a dividend for the year of 1p (we had looked for an increase to 1.1p/share). This is a prudent move in our view and underlines the Board's confidence in the long-term prospects of the business.

Net Debt: Lok'nStore finished the 2008 financial year with total borrowings of £25.3m and net debt of £22.8m following a heavy £14.3m store capex programme which included the acquisition of a record three new sites.

Despite the increase in net debt, gearing on an IFRS basis taking the freehold properties at valuation remains reasonable at 53.5%. Excluding the full deferred tax provision of £12.4m, £10m of which relates to the revaluation gains on freehold property and is therefore unlikely to ever be paid, balance sheet gearing falls to 38%.

As at 7 November 2008 the company had headroom on its banking facilities of £14.6m which run through to 2012. Loan to value and earnings covenants remain sound and we expect this situation to continue in the current financial year.

Net Asset Value Per Share: The 2008 year-end external property valuation conducted by industry valuers Cushman & Wakefield gave a value for the group's properties of £72.1m against a net book value for these sites of £35.4m. The 2008 figure represents a 4.1% decline on the July 2007 valuation although we note the latest valuation includes a significantly reduced 'hope' value for the residential planning permission at Reading for obvious reasons. Adding the value of the stores under development at cost, the total value of the group's property at end July 2008 was £86.4m.

Ignoring the deferred tax provision, adjusted net assets per share were 244p, a 9.6% decrease on the prior year.

We have been flagging the possibility of a decline in NAV for some time given the dire trading conditions in the commercial property market. Looking at the 15 trading properties that were also valued in 2007 the decline in value over the year was 3.26%. Of this, -3.56% related to market factors i.e. a decrease in capital growth. The balance of 0.3% was due to an increase in operational performance.

“From 1 August 2009 all interest on the group's development pipeline will be capitalised”

“Excluding the deferred tax provision, balance sheet gearing falls to 38%”

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Industry Outlook

The UK self-storage industry is likely to report its first major slowdown in over a decade in 2008. Prior to 2008, the industry was growing at a compound rate of 15-20%.

With the economy predicted to shrink by 1% this year and housing market transactions in excess of 50% below peak levels, occupancy rates are likely to come under increasing pressure over the next 12/18 months. To date all of the major self-storage operators have mitigated the impact of flat to slightly negative occupancy by raising prices. This mirrors trading patterns in the more established US market where anecdotal evidence suggests national occupancy has held firm through the economic downturn because customers are being tempted through the door by short-term deals and end up staying beyond the special offer period at higher average rates.

Despite these short-term pressures we continue to believe the long term fundamentals of the self-storage industry remain strong supported by several factors including an increasingly mobile population, rising consumer awareness, a rise in divorce rates, shortage of UK housing stock and the need to use property resources more effectively.

Resilience of the Lok'nStore Business Model

Lok'nStore does not have the same level of exposure to the housing market as its quoted peer group as 40% of its revenue is generated by business customers who tend to spend more and stay for longer. Also, it is probably the most price competitive of all the five major UK operators and therefore has considerable scope to push through above inflation prices over the coming years.

Underlining the resilience of its business model, Lok'nStore's household business fell by a modest 1.3% year-on-year. The group's higher value corporate business nudged up 0.3% and has continued to hold firm in the current financial year.

Moreover, the risk of bad debt provisioning is extremely low. All customers are required to pay a minimum of four week's rental in advance and Lok'nStore retains a lien over customers' goods in the event of non-payment. In the 2008 financial year the group's bad debt ratio was a negligible 0.4% of turnover.

Capital Spending

In view of the economic climate, forward capital commitments are to be curtailed. The current year capital spending programme is therefore unlikely to exceed the £2m cost of completing Harlow which is expected to open on 2 January 2009. This new 69,000 sq ft freehold unit will increase the group's total lettable space to 1.1m sq ft.

Having said this, bearish conditions in the investment property marketplace are throwing up some potentially exciting acquisition opportunities for the group. The question is whether prices have further to fall – this is not a company that is prepared to overpay for sites.

Even if no new sites are acquired this year, a development pipeline of 228,000 sq ft means the company will be in a good position for when the economic cycle turns, possibly in 2010.

Current Year Forecast

We are pulling back our current year turnover forecast from £11.6m to £10.2m, a decrease of 12% because it is clear that fewer enquiries are currently being converted into sales. Some of the falls in occupancy will be offset by price rises but probably not all.

Our estimate model also assumes store EBITDA margins will reduce, from 42.9% to 40.3%.

Both the depreciation charge and the net interest charge will be lower than we were originally looking for in the current financial year and only slightly ahead of 2008 levels. We are scaling back our depreciation charge from £1.8m to £1.5m as the likelihood of new store

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openings beyond Harlow this year looks slim. The interest charge will be lower, even on increased net debt of £25m, because LIBOR rates are falling.

We expect a full year loss of £1.2m for the year and believe the full year dividend will be maintained at 1p.

Valuation

In the past we have suggested two possible ways of valuing Lok'nStore. These are:

1. Discount/Premium to NAV versus the quoted competition.
2. Embedded Value i.e. assuming the existing estate is mature and run for cash.

Lok'nStore v Big Yellow and Safestore

| | Lok'nStore | Safestore | Big Yellow |
|--|------------|-----------|------------|
| EPIC Code | LOK | SAFE | BYG |
| Financial Year End | Jul 08 | Oct 07 | Mar 08 |
| Total No. of Stores | 23 | 124 | 71 |
| Total Lettable Area Sq. ft. (Operating & Pipeline) m | 1.22 | 5.5 | 4.5 |
| Avg. Price per Sq. ft. (£) | 18.01 | 24.01 | 26.21 |
| Share Price p.** | 60p | 86p | 286.5p |
| % change in SP (3 months) | -53% | -41% | -18.5% |
| Mkt Cap £m | 15.8 | 160 | 335 |
| Net Debt £m | 23 | 225 | 282.3 |
| Gearing %, on Re-valued Properties | 53% | 92% | 48% |
| Enterprise Value, £m | 38.8 | 385 | 617.3 |
| Adjusted NAV per share p. | 244p | 214.6p* | 520.5p |
| Sales (£m) | 10.8 | 74 | 56.9 |
| EBITDA Before Exceptionals (£m) | 2.90 | 40.7 | 29.6 |
| Dividend p. | 0.67 | 4.5 | 9.5p |
| EBITDA Margin % | 27% | 55% | 52% |
| Adjusted EPS p. (2009E) | | N/A | 11.6 |
| P/E 2009 E (consensus forecast) | | N/A | 25 |
| Mkt Cap/EBITDA, X | 5.4X | 3.9X | 11.3X |
| EV per Store (Total) £m | 1.7 | 3.1 | 8.7 |
| EV per sq ft Op & Planned (£) | 31.8 | 70 | 137 |
| (Discount)/Premium to NAV | -75% | -60% | -45% |
| Average store size sq ft | 53,500 | 42,000 | 60,000 |
| Freehold/Leasehold split (operational and planned) | 64/36 | 55/45 | 86/14 |

Source: Hardman & Co, Fidessa

*All p & l figures for Safestore relate to the y/e October 2007, Figures on pricing, store numbers and Adjusted NAV are given as at 30 April 2008.

** Based on 7 November 2008 closing share prices.

As can be seen, shares in all three companies in the quoted self storage space have been hit hard by the recent crisis in financial markets. In the case of Lok'nStore, the share price has retreated to levels not seen since 2003.

The most striking figures in the table, however, are the ones relating to discount to NAV. Historically, the major self-storage companies have always traded at a discount to NAV and

“The Lok'nStore share price has retreated to levels not seen since 2003”

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the same is true for most property-related stocks. But over the past two months this gap has widened significantly with discounts to NAV currently ranging between 45% - 75% against a range of 18-36% in May 2008 (the last time we happened to produce this table).

Lok'nStore shares continue to trade at the biggest discount to NAV, at 75%. The company also remains the cheapest of the three companies in terms of EV per store and EV per sq ft (both planned and operational). Even allowing for the fact that Big Yellow & Safestore achieve higher average rental prices per sq ft, Lok'nStore's discount to its peer is difficult to explain. In particular, Lok'nStore's discount to Safestore looks out of line considering Lok'nStore has the least gearing of the two, a higher average size store and higher freehold/leasehold mix.

Embedded Value

Our simplified model of the embedded value of the Lok'nStore estate is based on the following conservative assumptions:

- All 20 stores with a total maximum lettable area of 1,067,000 sq ft are fully established.
- No new sites are acquired and none are sold.
- All sites achieve occupancy of 75% at maturity. This compares favourably to the 79% occupancy rate at maturity used in the Cushman & Wakefield Model, and the 67% occupancy rate currently being achieved at the stores over 5 years old which are still growing.
- All stores achieve an average price of £18 per sq ft (2008 actual). Given that the industry average rate is c. £20 per sq ft and all the major self storage operators, including Lok'nStore are committed to pushing up average rents, this is likely to underestimate the actual price per sq ft achieved at maturity.
- Operating costs before depreciation are £8m (2008 actual: £7.8m).
- The yield on self-storage is 8.5%, 100bps higher than the historic yield on prime secondary properties.
- Stores in development are worth £14.4m at cost.

The above assumptions suggest total sales at maturity for the existing operating stores of £14.4m and a group EBITDA of £6.6m, a 33% and 59% increase on current levels respectively. Applying an 8.5% yield on self-storage would suggest a value for the current portfolio of £77.6m, or 310p/share ascribing zero value to the pipeline stores. Adding the stores in development at cost suggests a total value for the portfolio of 368p/share.

These estimates concur with Cushman & Wakefield's embedded net asset value for the group of 343p/share.

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| Management | Major Shareholders |
|--|---|
| <p>Chairman: Simon Thomas</p> <p>Chief Executive Officer: Andrew Jacobs</p> <p>Finance Director & Company Secretary: Ray Davies</p> <p>Acquisitions Director: Colin Jacobs</p> <p>Non-Executive Director: Richard Holmes</p> <p>Non-Executive Director: Robert Jackson</p> <p>Non-Executive Director: Edward Luker</p> <p>Non-Executive Director: Charles Peal</p> | <p>Andrew Jacobs: 20.74%</p> <p>Audley Capital: 16.64%</p> <p>Simon Thomas: 8.54%</p> <p>Town Centre Securities 5.19%</p> <p>Charles Stanley 5.14%</p> <p>Montanaro Investment Managers: 4.89%</p> <p>Close Investments: 3.46%</p> <p>BlackRock Investment Managers 3.35%</p> |
| Key Dates | Key Milestones |
| <p>Annual General Meeting: December 2008</p> <p>Interim Results Announcement: April 2009</p> <p>Full Year Results Announcement: November 2009</p> | <p>April 1997: Floated on OFEX raising £1.1m at 38p</p> <p>March 2008: Second fundraising raised £1.15m at 60p/share</p> <p>November 1999: Takeover approach from ACCESS rejected. ACCESS takes 29% stake in co for £4.8m</p> <p>June 2000: Lok'nStore moved to AIM</p> <p>July 2002: Share placing at 155p per share raises £10m</p> <p>January 2004: Second cash bid at 115p/share rejected</p> <p>February 2007: First purpose-build freehold store opened in Farnborough.</p> <p>March 2007: Kingston unit sold to a residential developer for £10m (NBV: £0.98m)</p> <p>January 2008: Residential planning permission granted for existing Reading store.</p> |

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