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Lok'nStore

Stepping Up The Growth Rate

280p 4.6.2007

Share Price: 282p

12m High: 300p

12m Low: 150p

Market Cap: £73m

Shares in Issue: 26m fully diluted

NAV/Share: 209p (Jan 2007)

Gearing: 25% at July 2006 with properties at valuation.

Interest Cover: 2.0X at end-January 2007

EPIC Code: LOK

Sector: Support Services

Market: London AIM

PR: Financial Dynamics

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Website: www.loknstore.co.uk

Previous Research Note: 'Another New Site' 4 April 2007, 265p.

Analysts: Roger Hardman/Sonia Kaur

The rate of new openings of self storage premises is going to be increased from now on. In a way, this shouldn't be a surprise, because in February management announced new borrowing facilities in order to cope with just such an eventuality. The deals announced on June 4 – a move to a larger unit in Southampton and the sale of the small, unit in Woking, are part of this process.

Other key points are:

- We have upgraded our current year sales, profit and eps estimates. The new units being brought on stream, and the rebranding under a new common format, are proving more successful than we or management expected. The upgrade is in spite of FRS 20 costs, which we had not previously allowed for.
- The ramping up of the opening programme will probably lead to a lower profit than we previously expected for y/e July 2008 The sale of Kingston and to a lesser extent Woking will also have a significant short term impact.
- EPS will move forward strongly from 2009 onwards.

The business model takes standard industrial zoned land and can considerably increase its value when used for self storage. Ignore the profits (or losses). Don't look at short term earnings. Instead, Look at the underlying asset value being created, and the rapid growth rate of this new marketplace.

Y/E June	Sales £m	Declared Profit £m	Adjusted Profit £m	Adjusted Eps p.	P/e ratio	Divi p.	Yield %	NAV p.	Premium/ Discount
2005A	7.7	0.1	0.1	0.5	-	0	-	41	-
2006A	8.9	0	0	-0.5	-	0	-	200	41%
2007E	10.6	11.4	0.5	2.1	134	1.0	0.3	239	18%
2008E	11.1	0.3	0.3	1.3	217	1.25	0.4	239	18%

The Business Model

Lok'nStore and its competitors in the self storage market let out space in their warehouses for a weekly or monthly charge, for people and businesses to temporarily store possessions. This can range from furniture pending a house purchase completion through to archiving of files and documents. The industry is well established in the USA, but is a relatively new entrant on the British industrial scene. It is experiencing a rapid growth rate.

The business is capital intensive, with low marginal costs. New units typically operate at a loss for the first eighteen months, and take five years to reach full profitability. A self storage company with a large proportion of immature units therefore will operate with a low level of profits, or at a loss. This is not necessarily a bad thing, however, because once established a self storage unit has a predictable income flow that gives a high quality earnings stream stretching years into the future. The standard property valuation system for self storage units is in fact based on discounting future income flows. In the UK the respected chartered surveyors Cushman & Wakefield value the properties of all three of the leading companies. Their methodology is identical to that used in the USA, where it has been applied successfully for several decades.

Increasingly, management teams of all the leading companies are adopting pro-active policies in order to get units to operational breakeven more quickly. One of these is to offer low initial rates to attract volume, then to ratchet up rates once a certain capacity utilisation has been achieved (like the airline industry). Another is to fit out the building in stages – there is no point in spending money on fit-out for space that will only be filled a year or more ahead.

The Key Investment Point

The key point for investors – the economic driver behind this business – is that self storage space lets out for rather more than standard industrial warehouse space, yet is grouped with in under the same planning categories.

Lok'nStore's average price received is currently £16.70/sq.ft., compared to £16.40/sq.ft. previously.

It is obtaining this revenue on each floor of its property. Unlike conventional warehouses, self storage units are multi-storied (although they may not look like it from the outside). Lok'nStore usually operates with at least one mezzanine floor, usually two, and so do its main competitors.

Owners of conventional warehouse storage space in the home counties are lucky if they can obtain £7/sq.ft. That figure is for total footprint – it equiates to £2.50 - £3.50/sq. ft. operationally for a self storage operator, which will add a mezzanine floor to the property and make that ground floor footprint sweat two or three times its normal value. Moreover, Lok'nStore has the ability to significantly increase this yield (by obtaining fuller capacity utilisation, and by price increases) that are not available to an ordinary property landlord.

The argument is not entirely one way, because no self storage company ever gets 100% occupancy, and a self storage business incurs operational costs that a conventional property rental company does not. Overall, however, we believe the advantage lies with self storage.

A Purchase And A Sale

On Monday June 4 Lok'nStore announced two changes to its portfolio of stores.

Southampton

A new freehold site has been secured in Southampton, and a 100,000 sq. ft. unit is to be built on the site. This is less than a mile from the existing Southampton freehold store, which is to be sold and all storage customers moved to the new facility when it opens in approximately twelve months' time.

The issue with Southampton is not so much capacity – the 'old' Southampton store at 84,000 sq. ft. was already larger than usual for Lok'nStore – but its location. The new site is in a much better position, and is on a 2.16 acre plot fronting the main access road to the Southampton City Centre. Southampton is a rapidly growing City Lok'nStore has found that new build high visibility stores with good main road frontage fill up more quickly than those in less visible locations. The existing Southampton store still has a little spare space so the move is a case of planning for the future. It also locks out competitors from the site; Lok'nStore's business could have suffered if a rival had put down a large self storage facility in front of its old back street unit.

The investment in the new store will be high at 'up to £8m', but will be partly financed by the sale of the old site. Lok'nStore will want to sell this for standard industrial use rather than as self storage, and we would expect the old site to raise at least £2m, leaving a net financial commitment at Southampton of possibly £6m.

Woking

The Woking store .has been sold for £2.4m, its valuation level. However, its book value is only £0.6m, so it will result in a profit of £1.8m being booked in the financial year to July 2007. This will be in addition to the £9m. exceptional profit to be booked on the sale of Kingston.

The Woking site was one of the smallest in the Lok'nStore portfolio, at 19,000 sq. ft. There was no possibility of expanding the unit, and apparently none of buying any adjoining property.

Lok'nStore has sold the unit to an investor, who will continue to operate it as a self storage unit, with Lok'nStore managing the facility under contract. We have increased our rental income forecast for y/e July 2008 to reflect this transaction.

The Woking deal is yet another indication that Lok'nStore is focusing on prospects two to three years ahead rather than maximising short term profits.

The Interim Results

6m to January	**2007**	**2006**
Turnover	£5.30m	£4.28m
Store EBITDA	£2.18m	£1.52m
Store EBITDA Margin	41.3%	35.6%
Head Office Costs	£0.74m	£0.69m
Group EBITDA	£1.44mn	£0.83m
Operating Profit	£0.90m	£0.43m
Operating Margin	17.0%	10.1%
Interest	£0.45m	£0.36m
EPS Fully Diluted	1.79p	0.29p

The interim results showed an acceleration of the growth rate from 15.1% at the end of the last full financial year to 23.8%. Store EBITDA – the key financial measure of progress – was up from 35.6% to 41.3%.

Head Office costs were kept under firm control, so the group benefited from economies of scale as the business grew. Group EBITDA was up by 73% and the Operating Profit was more than doubled, giving a very healthy operating margin of 17.1%.

For the first time in its history, Lok'nStore showed an Earnings Per Share figure that is of some relevance to the investment community. We were not expecting this, but are pleased by it.

Key Performance Indicators

Over the past four years Lok'nStore has been expanding at a measured pace, and its portfolio is starting to exhibit the signs of maturity that should be associated with a move into profitability. 14 of its 19 stores – 74% of them – are over 250 weeks old. As the rate of new store openings is increased, profits will be affected short term because new units take well over a year to reach break-even.

EBITDA is healthy because the two latest stores, which opened in 2006, are freehold and therefore do not bear rental payments. Any measure of performance by EBITDA is therefore inflated, because the property cost of these stores is in the interest charge (which obviously is post EBITDA) rather than as a rental payment.

Age of Stores

Over 250 Weeks	14
100 – 250 Weeks	3
Under 100 Weeks	2
Total	19

Excludes the Kingston and Woking stores, which are being sold.

Store Ownership

Freehold	10
Leasehold	9
Total	19

Includes Portsmouth as freehold, excludes Kingston and Woking

Expansion Programme

Over the last five years, Lok'nStore has been adding new units at the rate of one a year. This is likely to be increased to at least two a year.

Two other factors need to be taken into account here. First, the future additions to the portfolio will tend to be freehold stores, whereas in the past Lok'nStore's units have been split equally between freeholds and leaseholds. Secondly, the stores are getting larger. Lok'nStore has adopted 64,000 – 70,000 sq. ft. as its new standard unit size; this compares to stores over five years old which average 42,700 sq.ft. and stores between two and five years old which average 40,000 sq.ft.

The new Harlow store, announced in April 2007 and due to open in Spring 2008, will have 69,000 sq. ft. of storage space and will cost £5m when fully constructed and fitted out. We can expect the company's capital spend programme, therefore, to run at £10m a year, with additional revenue costs in terms of initial losses being made on the start-up units.

The impact on the p & l account of this faster expansion programme will initially be adverse, but it is necessary if the company is to expand to its full potential. The proportion of immature square footage to the total is likely to increase over the next two years.

Funding

In February 2007, Lok'nStore arranged a doubling of its bank facilities, from £20m to £40m. At end-January 2007 borrowings were up to £16.8m. The new borrowing level has clearly been fixed with an eye to what the company needs immediately, and on our calculations even expanding the store opening programme to 3 full sized freehold units a year the new borrowing limit will not be reached until just before the 2008 year end.

It is abundantly clear to us that a further tranche of borrowing facilities will be available when Lok'nStore needs them. At end-January 2007, treating the proceeds of the Kingston site sale as 'near cash' and taking all other properties at market value, gearing was only 10%. If the Reading planning application is approved, gearing may disappear altogether for a short time. Other property based businesses of this nature can run 150% - 200%.

FRS 20

From these interim results onwards, Lok'nStore has adopted FRS20 accounting for share based remuneration for directors and management – i.e. these costs are now being expensed to the p & l account for the first time.

For the current financial year, this charge is heavy. £270,000, split equally between first and second halves. We expect the charge to be lower in future.

The reason for the higher charge in the current year is the exercise of options over Founders Shares, going back to the original founding of the business. These gave CEO Andrew Jacobs, chairman Simon Thomas and executive director Colin Jacobs rights to buy shares at 37p, the price at which the company originally came onto OFEX. All Founders Share options have now been exercised.

IFRS Accounting

IFRS Accounting is due to be adopted for the July 2008 accounts.

Lok'nStore is to revalue its properties annually from now on. Under IFRS accounting, these gains will be passed through the p & l account. We shall strip them out again for our 'Adjusted' figures, as we already do with other companies such as Primary Health Properties and R.E.A. Holdings.

Goodwill will no longer be amortised; this has been negligible for Lok'nStore and while we strip out this amortisation charge in our estimates, it is for all practical purposes irrelevant.

Other than this, we expect the implementation of IFRS to have minimal impact on Lok'nStore.

To REIT Or Not To REIT?

To date only one of the three major self storage companies has opted for REIT status, and that is Big Yellow. The advantages for any property based business of sidestepping tax are obvious, and now that Big Yellow has done all the hard work in convincing the Inland Revenue that self storage companies qualify, it would be very easy for Lok'nStore to follow.

For the time being, Lok'nStore is likely to maintain its current status, however. The last Lok'nStore Annual Acounts showed carried forward tax losses of £3.4m, and we understand is currently £5.5m as more capital allowances have been accumulated and because of the tax effects of FRS20 accounting. This gives a very useful cushion .

There are two other factors that management believes weigh heavily against a move to REIT status.

The first is that Lok'nStore appears to qualify for rollover relief on property sales, so physical payment of capital gains tax will not be an issue.

The second is that Lok'nStore is listed on AIM, and would have to move to the main London Stock Exchange in order to qualify as a REIT. This would cut private investors out of taper relief and also lose them their Inheritance Tax exemption.

Overall, the board of certainly has no need to need to make an immediate decision.

Leasehold to Freehold

Lok'nStore is able to add value to its portfolio by

- Buying the freehold of sites that it is leasing where this is possible.
- Extending and improving the terms of leases.

It has done both these successfully in the past, and we expect more developments of this nature. All but one of Lok'nStore's leases falls within the Landlord & Tenant Act, therefore any added value that the company creates by using conventional industrial estate land for self storage cannot be reflected in higher rent levels in the future. For the landlord, indeed, a sale to Lok'nStore as the sitting tenant is a natural development that benefits both parties. The Landord obtains a small but useful premium on the price that would be obtained from any other buyer, and Lok'nStore gains the freedom to amend and extend the store in a manner that is not possible with a leasehold site.

Sales For Development

When the Kingston freehold site was finally sold for property development earlier this year, the sale price, £10m, was a little higher than we expected (see our research note dated 4 April 2007). Its valuation as a residential development prior to the sale by Cushman & Wakefield was £9.1m, and the purchase cost was £0.98m.

There is a surplus site at Reading, currently slowly progressing through the planning process, that could provide a smaller capital gain. If this gains planning permission for residential development and is sold, the income could leave the group effectively ungeared.

Conclusion

The main issue for Lok'nStore at present is to find enough new sites to maintain its growth rate. The customers clearly want more self-storage, and fortunately the planning authorities generally appear to have become slightly relaxed about the concept of self storage recently.

The second half of the current year will be a good one for Lok'nStore, but profits may dip in y/e July 2008 as the new openings programme speeds up. We are totally happy with that scenario, because it signifies the potential for very much greater profits three years hence.

The growth of the net asset value per share is also a very important point. At 209p/share at end-January 2007 this strongly underpins the current share price, and reflects no 'lotting premium' for the operation of the fourth largest portfolio of self storage units in the country.

On most measures, Lok'nStore is looking cheap compared to its two quoted competitors. Both Big Yellow and Safestore are trading at a larger premium to NAV than Lok'nStore, and Lok'nStore also has by far the lowest Enterprise Value per sq. ft. of storage space. Also, underlying market conditions continue to be strong.

We are very happy with progress at this company.

Lok'nStore

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UK GAAP Accounting. Pre-IFRS

July **£'000**	**2004A**	**2005A**	**2006A**	**2007E**	**2008E**
Sales					
Self Storage Income, Stores > 250 wks	3105	4813	7243	8511	8511
Self Storage Income, Stores 100-250 wks	3159	2401	1443	1226	2208
Self Storage Income Stores < 100 wks	270	437	202	807	274
Rental income	77	123	58	58	116
Total Sales	**6611**	**7774**	**8946**	**10602**	**11108**
Sales Change (%)					
Self Storage Income, Stores > 250 wks	47%	55%	51%	18%	0%
Self Storage Income, Stores 100-250 wks	-3%	-24%	-40%	-15%	80%
Self Storage Income Stores < 100 wks	48%	62%	-54%	300%	-66%
Rental Income	40%	11%	-53%	0%	100%
Total Sales	18%	18%	15%	18.51%	5%
Operating Profit (EBITDA) Margins					
Self Storage Margin, Stores > 250 wks	48%	48%	40%	45%	48%
Self Storage Margin, Stores 100-250 wks	17%	15%	19%	20%	22%
Self Storage Margin, Stores < 100 wks	-100%	-41%	-39%	50%	25%
Rental Income	100%	100%	100%	100%	100%
Store Operating Profit (EBITDA) Margin	26.9%	32.4%	34.6%	42.1%	42.2%
Operating Profit (EBITDA) £'000					
Self Storage EBITDA, Stores > 250 wks	1490	2307	2885	3787	4085
Self Storage EBITDA, Stores 100-250 wks	537	349	269	245	486
Self Storage EBITDA Stores < 100 wks	-270	-179	-78	403	69
Trading Stores Operating Profit (EBITDA)	1757	2477	3076	4436	4639
Rental Income EBITDA	77	123	58	58	118
Head Office and Central Costs	1024	1240	1384	1500	1600
FRS 20 charge	0	0	165	270	180
EBITDA	810	1360	1585	2724	2977
Depreciation	664	729	875	1200	1400
Goodwill Amortisation	24	24	24	24	24
Group Operating Profit/Loss (EBIT)	**122**	**607**	**686**	**1500**	**1553**
Exceptionals	-126	0	0	10900	0
Net Interest Charge	163	493	727	990	1250
Interest Cover X	1	1.2	0.9	1.5	1.2
Declared Pre-tax Profit	-167	114	-41	11410	303
Adjusted Pre-Tax Profit	**-41**	**138**	**-17**	**534**	**327**
Tax (%)	0%	0%	0%	0%	0%
Tax Charge	0	0	100	0	0
After Tax Profit (Reported)	-167	114	-141	11410	303
After Tax Profit (Adjusted)	-41	138	-117	534	327
Dividend Payments	0	0	0	260	325
Retained Earnings	-167	114	-141	11150	-21
Average Number of Shares, Fully Diluted (m)	27436	25847	25979	25979	25980
Adjusted Profit Per Share p. (Fully Diluted)	**-0.1**	**0.5**	**-0.5**	**2.1**	**1.3**
Dividend Per Share p.	0.0	0.0	0.0	1.0	1.3

Lok'nStore

4.6.2007

UK GAAP Accounting. Pre-IFRS

Summary Cash Flow Statement

July **£'000**	**2004A**	**2005A**	**2006A**	**2007E**	**2008E**
Group Operating Profit / (Loss)	122	607	686	1500	1553
Exceptionals	-126	0	0	10900	0
Group Operating Profit / (Loss) After Exceptionals	-4	607	686	12400	1553
Depreciation	664	729	875	1200	1400
Goodwill Amortisation	24	24	24	24	24
Decrease / (Increase) in Stocks	2	15	10	-15	-25
(Increase) / Decrease in Debtors	421	263	-330	-300	-450
Increase/(Decrease) in creditors	675	345	171	400	475
Operating Cash Flow	936	1983	1436	13709	2977
Capital Expenditure	1100	2294	6273	7200	15000
Net Interest	122	501	770	990	1250
Tax	0	0	52	0	0
Free Cashflow	-286	-812	-5659	5519	-13273
Cash Impact of Exceptionals	0	0	0	0	0
Acquisitions/Disposals	4329	0	0	0	0
Issue of Shares / (Buybacks)	3428	31	15	600	0
Dividends	0	0	0	-260	-325
Accruals & adjustments	0	0	0	0	0
Change in Net Debt (- = worsens, + = improves)	-8043	-843	-5674	4659	-13597

Lok'nStore

4.6.2007

UK GAAP Accounting. Pre-IFRS

Key Balance Sheet Items

July **£'000**	**2004A**	**2005A**	**2006A**	**2007E**	**2008E**
Intangible Assets	383	359	335	311	287
Tangible Assets*	18163	20033	66600	72600	86200
Stock	104	89	78	93	93
Trade Debtors	642	600	800	1050	1350
Other Debtors	1307	1085	1223	1350	1500
Net Cash / (Debt)	654	425	922	1000	1000
Trade Creditors	1010	1236	1400	1500	1700
Other Creditors	2085	2500	2478	3000	3400
Net current assets / (liabilities)	-388	-1537	-855	-1007	-1157
LT Debt	7600	8150	14067	9408	23005
Net Debt/(Cash)	6946	7725	13145	8408	22005
Provisions	0	0	100	0	0
Shareholders' Funds	**10558**	**10705**	**51913**	**62185**	**62038**
Gearing % / (Net Cash)	66%	72%	25%	14%	35%
Shares In Issue, No. 000	27436	25847	25979	25979	25980
NAV/Share p.	38.5	41.4	199.8	239.4	238.8

* Group's 21 trading centres were independently valued at £66.6m in JULY 2007, against a net book value of £25.2m.