Investors' Chronicle | Alpha

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Alpha small company research

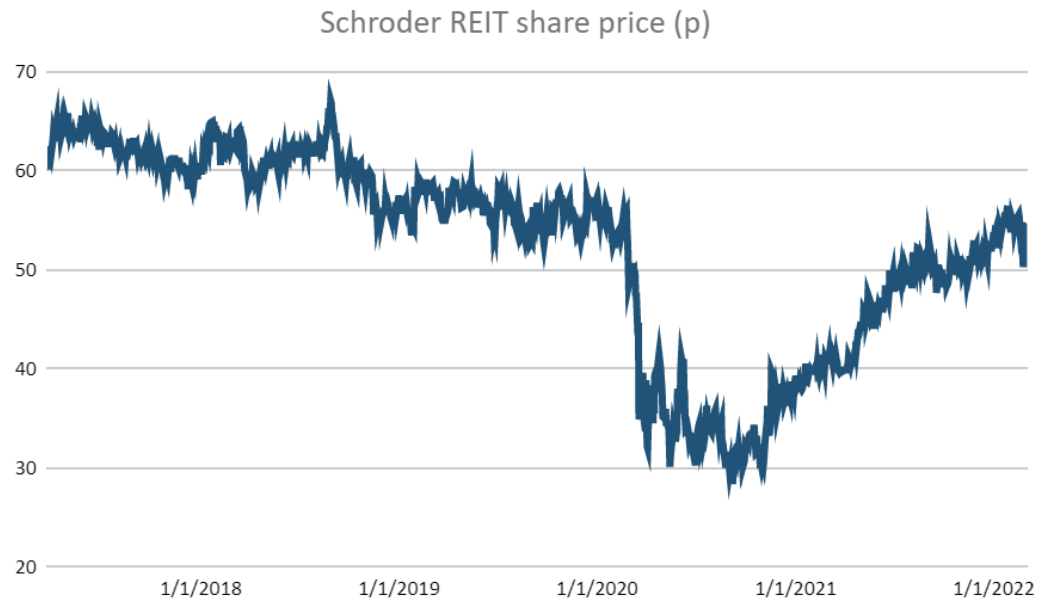
4 March 2022

Targeting high-yield property to out-run inflation

This well managed REIT has been delivering strong returns for shareholders and outperforming its benchmark since IPO.

Simon Thompson's view:

'Investors are not only facing heightened geopolitical risk, but also an inflationary backdrop that could hammer the real value of money. High-yielding property, in key market segments that are benefiting from strong fundamentals, offers a high degree of protection. This is especially true of industrial and retail warehousing assets, both of which are supported by structural growth drivers. Quarterly results from Schroder REIT not only highlight sectoral growth trends, but bring into sharp focus the investment opportunity with the shares trading on an unwarranted 24 per cent discount to NAV.'



Source: FactSet

Bull points

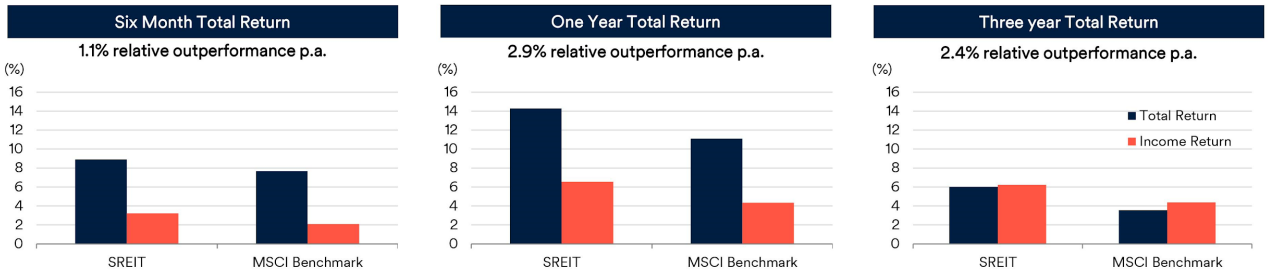
1. High weighting to industrial and retail warehouse property.
2. Latest asset sales above book value.
3. Capital being recycled into high-yielding industrial assets.
4. Yield compression and ongoing rental growth driving valuation uplifts.
5. Exposure to regional office market recovery.
6. Dividend now back to pre-Covid-19 levels.
7. Potential for further dividend increases given reversionary profile of portfolio.
8. High dividend yield and pay-out fully covered.
9. Diversified tenant mix.
10. Active management initiatives adding value.
11. Rating favourable to both sector peers and pure industrial property REITs.
12. Low gearing and low-interest borrowing facility support further acquisitions.

Bear points

1. Tenant default risk.
2. Any resurgence of Covid-19 pandemic could hit rent collections.
3. Short-weighted average unexpired lease terms.
4. Void rates of 5.7 per cent.

Portfolio performance to 30 September 2021

Delivering outperformance across a diversified portfolio using specialist capabilities



MSCI sector/total return	SREIT total return p.a. (%)			MSCI Index total return p.a. (%)			Relative p.a. (%)		
To 30 September 2021	Six months	One year	Three years	Six months	One year	Three years	Six months	One year	Three years
Industrial	15.7	29.4	15.3	15.4	28.9	13.5	0.3	0.3	1.5
Offices	2.6	4.6	4.8	3.1	3.0	2.7	-0.5	1.6	2.1
Retail	6.8	7.9	-3.3	5.8	4.4	-4.4	1.0	3.3	1.1
Other commercial	17.6	13.6	-0.9	4.4	5.6	3.3	12.7	7.6	-4.0
All	8.9	14.3	6.0	7.7	11.1	3.6	1.1	2.9	2.4

Source: Schroders

Schroder Real Estate Investment Trust (SREI) released an eye-catching portfolio update this week that suggests that the company's outperformance has some way to run.

In the three-months to 31 December 2021, Schroder REIT delivered a 5 per cent like-for-like valuation movement and a total return of 6.4 per cent, lifting the valuation of its 42 properties to £500mn. For calendar year 2021, the portfolio produced a total return of 19.2 per cent, a 2.6 percentage points outperformance of the MSCI Benchmark index.

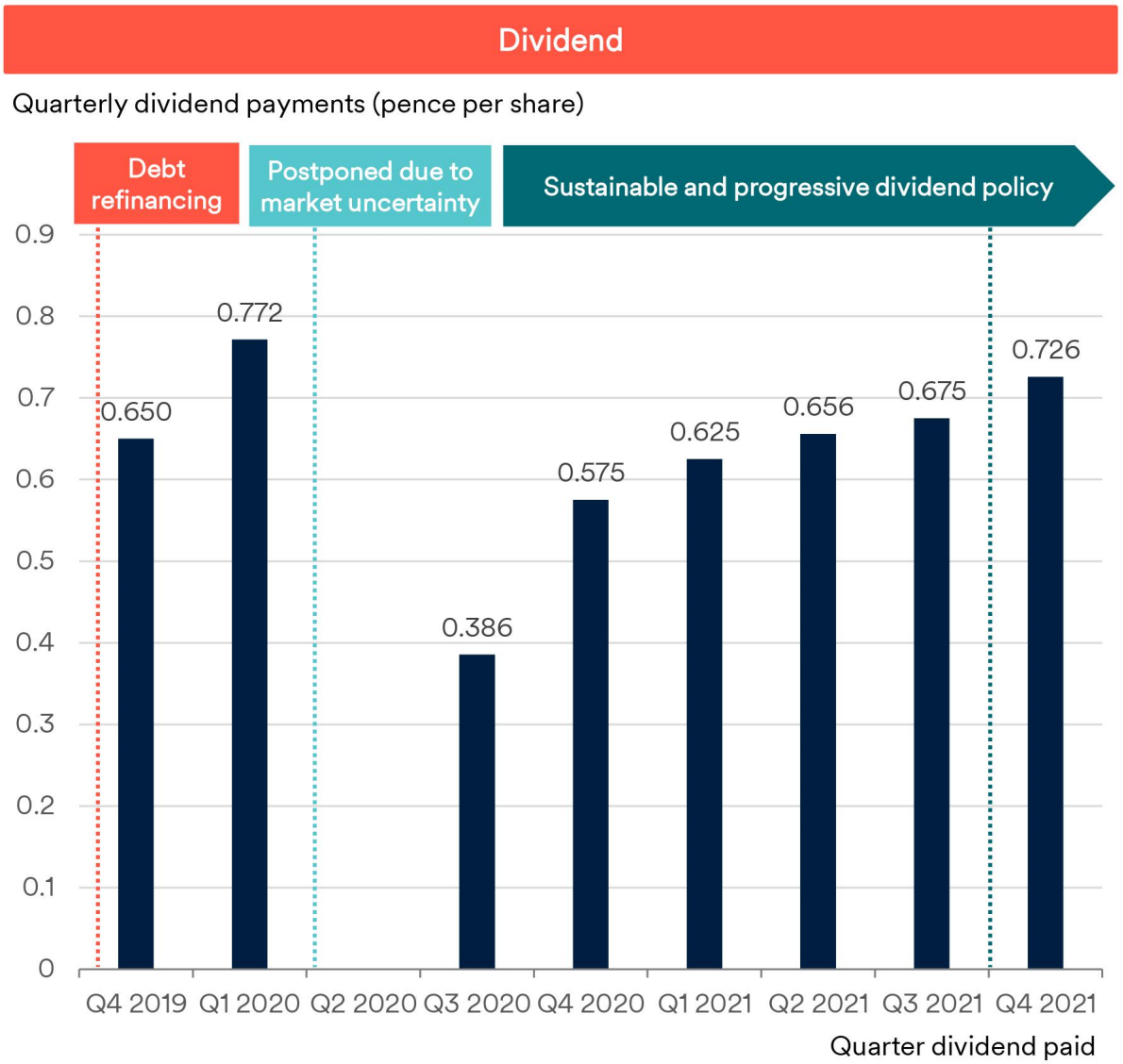
It's not a one-off either. When the company released half-year results in late November 2021, it delivered significant outperformance not only over that six-month trading period, but also over the previous one and three years. In fact, the company has outperformed its benchmark index by an average of 1.1 per cent per annum since IPO in 2004.

Key information

Schroder REIT (SREI)	
Ticker	SREI
Current price	53.55p
Bid-offer spread	53.4 to 53.7p
Target price	67p (plus 3.1p per share dividend)
Market cap	£263mn
52 week high	56.9p
52 week low	39.25p
Net debt	£149.8mn* (1 March 2022)
Loan-to-value ratio	30 per cent
Annualised 12-mth dividend	3.1 p per share
Dividend yield	5.7 per cent
Discount to NAV	24.3 per cent
Shares in issue	491.1mn
Financial year end	31 March
Next event	annual results May 2022
Website	schroders.com/uk/adviser/fund-centre

*Adjusted for sale receipts from The Arc, Nottingham

Despite the ongoing outperformance, Schroder REIT's share price is trading on a hefty 24.3 per cent discount to net asset value (NAV) of 70.4p at 31 December 2021, up from 65.8p a share at 30 September 2021 and 60.4p on 31 March 2021. In addition, the board has hiked the quarterly dividend per share by 6.3 per cent from 0.726p to 0.772p (ex: dividend: 10 March 2022), thus returning the pay-out to pre-pandemic levels.



Source: Schroders

This means that it's not only possible to lock into a healthy 5.7 per cent dividend yield, but there are sound reasons to believe that NAV per share will continue to rise, too. As more investors cotton onto this fact, it is reasonable to expect a narrowing of the unwarranted deep share price discount to NAV, thus turbo-charging returns.

Schroder REIT's third-quarter NAV performance

NAV as at 30 September 2021	£323.4mn	65.8p	Comments
Unrealised net increase in the valuations of the direct real estate portfolio and Joint Ventures	£25.6mn	5.2p	Portfolio like-for-like valuation movement, net of capital expenditure, of 5 per cent over the quarter to 31 December 2021.
Capital expenditure (direct portfolio and share of Joint Ventures)	-£1.7mn	-0.3p	Includes asset management activity across the multi-let industrial portfolio to capture rental growth (Stacey Bushes, Milton Keynes and Millshaw Industrial Estate, Leeds).
Acquisition costs	-£1.3mn	-0.3p	Transaction costs incurred relating to the £19.85mn industrial portfolio acquired in December 2021.
Net revenue	£3.3mn	0.7p	Quarterly EPRA earnings.
Dividend paid	-£3.6mn	-0.7p	Dividend for the quarter ended 30 September 2021 paid in December 2021 (at 0.726 pence per share). Fully covered over the quarter on a cash basis.
Others	£0.2mn	-	All other items.
NAV as at 31 December 2021	**£345.9mn**	**70.4p**	**Calculation based on 491.1mn shares.**

Source: Schroder REIT (1 March 2022)

Letting activity remains robust. Since the 31 March 2021 year-end, Schroder REIT has completed 71 new lettings, renewals and reviews across the entire portfolio. In aggregate, lettings have generated £3.5mn per annum of contracted rents in the past nine months, representing £1.3mn of additional rental income. Portfolio voids are 5.7 per cent after taking account of space under offer. Vacancy rates are close to historical lows and are consistent with an active management strategy of adding value to under-let properties through refurbishments ahead of re-letting at higher rents. Rent collection has stabilised at pre-pandemic levels and 96 per cent of rent due for the quarter ending 31 March 2022 has already been collected.

Schroder REIT portfolio summary (31 December 2021)

Portfolio valuation	£500mn
EPRA net initial yield	5.5%
Reversionary yield	6.7%
Annual rent	£29.5mn
Estimated rental value	£33.3mn
Number of properties	42
Average lot size	£11.9mn
Weighted average unexpired lease term (WAULT) to first break	5.4 years
Void rate (net of space under offer at 1 March 2022)	5.7%
Proforma net borrowings (adjusted for £13mn sale receipt from The Arc on 28 February 2022)	£149.8mn
Loan-to-value ratio net of cash on balance sheet	30.0%

Source: Schroder REIT quarterly update to 31 December 2021. Property valuation and annualised contracted rental income adjusted for subsequent sale of The Arc, Nottingham for £13mn on 28 February 2022.

To put the valuation into perspective, the current 24.3 per cent share price discount to NAV is six percentage points deeper than the average of Liberum Capital's UK commercial property peer group. That's despite the company being overweight industrial (46.5 per cent portfolio weighting) and retail warehousing (11.5 per cent). Both hot sub-sectors are beneficiaries of the online shopping boom as companies expand their distribution and warehouse facilities, a trend that started well before the Covid-19 pandemic.

Schroder REIT property portfolio by sub-sector

Sector weightings	**Weighting (%)**	
	Schroder REIT	**MSCI Benchmark Index**
Industrial	46.5	33.1
Offices	28.1	25.0
Retail warehouse	11.5	9.0
Retail	7.6	12.5
Retail ancillary to main use	*4.4*	
Retail single use	*3.2*	
Other	6.3	16.6
Unattributable	-	3.7

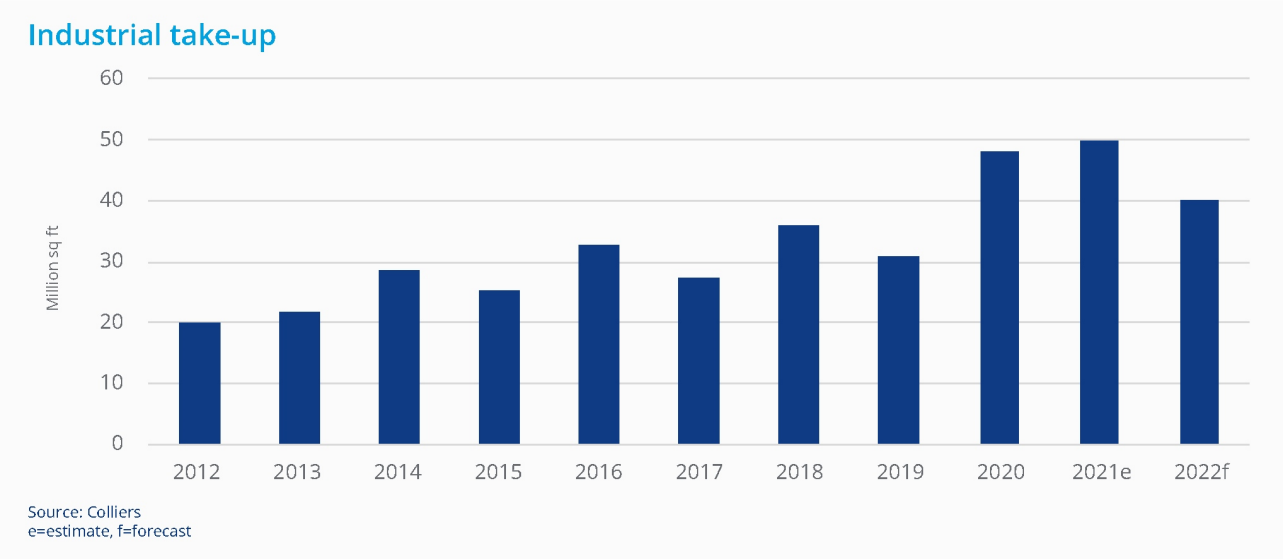
Source: Source: Schroder REIT (1 March 2022)

Strong tenant and investor demand for warehouse and logistic space

The increase in localised production due to supply chain disruption experienced during the Covid-19 pandemic, and spiralling shipping costs from manufacturing facilities in Asia, are other factors driving demand for UK industrial warehouse and distribution space. Offshoring is far less attractive than it once was, the consequence of which is higher domestic demand.

Property consultancy Colliers expects take-up of large distribution warehouses of 100,000 sq ft or more will exceed 40mn sq ft for the third year running in what remains an undersupplied market. That is not going to change anytime soon as there are material barriers preventing supply of industrial space coming onto the market such as restrictions in obtaining planning consent for new buildings, and sharp increases in the cost of construction materials.

Given the backdrop of a landlord favourable supply/demand imbalance, increasing land values and inflationary pressures on construction costs, expect rents to continue to rise in an occupier market where developers are reluctant to agree a set rent in advance for pre-lets on purpose-built projects and speculative schemes.



The upshot is that the strong occupier market is likely to continue attracting investors and drive down yields in a market where property owners are dictating rental levels. The investment managers at Schroder REIT are well aware of these valuation drivers, having increased their exposure to the industrial property sector from 30 per cent to 44 per cent in the 12 months to 30 September 2021.

So far, this decision has paid off. In the six months to 30 September 2021, the company's industrial property portfolio surged by 13.3 per cent in value, the highest six-month increase ever recorded for the sector in the company's history. The six-month total return of 15.7 per

cent from the sector was supported by rental value growth of 4.2 per cent, higher income return of 2.8 per cent and yield compression. Growth from industrial and retail warehousing were the key drivers behind Schroder REIT's 9 per cent growth in NAV per share from 60.4p to 65.8p in the six months to 30 September 2021.

Portfolio overview

Top 10 Properties

#	Property	Sector	Value (£m)	% Portfolio
1	Milton Keynes, Stacey Bushes Industrial Estate	Industrial	50.5	10.4
2	Leeds, Millshaw Industrial Estate	Industrial	47.7	9.9
3	Manchester, City Tower (25% share)	Mixed use office	40.3	8.3
4	London, The University of Law (50% share)	Office	39.4	8.1
5	Bedford, St John's Retail Park	Retail warehouse	29.5	6.1
6	Leeds, Headingley Central	Mixed use retail	23.9	4.9
7	Chippenham, Langley Park Industrial Estate	Industrial	22.8	4.7
8	Norwich, Union Park Industrial	Industrial	22.5	4.6
9	Cheadle, Stanley Green Trading Estate	Industrial	20.3	4.2
10	Uxbridge, 106 Oxford Road	Office	15.4	3.2

Source: Schroders, November 2021 post period end industrial portfolio acquisition.

Since the half-year-end, Schroder REIT's investment manager has made a further £19.85mn of industrial property purchases (Birkenhead, Sandbach and Haydock) to increase the industrial sub-sector weighting from 44 per cent to 46.5 per cent. The acquisitions were well-timed and should offer decent reversionary value, as they were purchased on a modest capital value of £53 per sq ft. A net initial yield of 6.9 per cent compares favourably with an 8.2 per cent Estimated Rental Value (ERV) on the properties purchased.

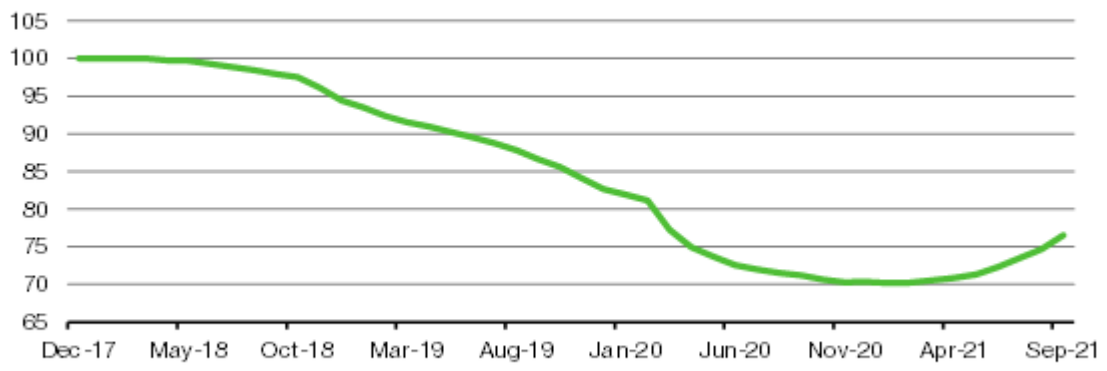
The investment manager's strategy is to recycle cash into larger, more resilient assets in higher growth sectors, which offer a high standard of operational and sustainability performance and should deliver more sustainable income and total returns over the long term.

For instance, the £11.4mn purchase of the Valley Road Industrial Estate in Birkenhead was acquired on a low average capital value of £60 per sq ft. Located close to the M53, the 10-acre site produces rental income of £0.83mn (£4.36 per sq ft) and has an ERV of £0.95mn (£4.99 per sq ft) when fully let. There is good tenant interest in the newly refurbished vacant space, which accounts for 10 per cent of the 190,000 sq ft industrial estate. The weighted average unexpired lease term (WAULT) is only four years, thus offering scope to push through material rent rises on lease renewals.

Similar dynamics are at work in the retail warehousing sector where improved investor sentiment helped drive up Schroder REIT's average capital values for the segment by 7.5 per cent in the six months to 30 September 2021. The retail warehouse sector is complementing multi-channel retail strategies such as click-and-collect and home delivery, while at the same time benefiting from higher demand from home and food occupiers.

The positive leasing activity is highlighted by the company's largest retail asset, St John's Retail Park in Bedford. The 130,000 sq ft retail warehouse scheme has a roll call of blue-chip tenants including discount retailers Lidl, Home Bargains and TK Maxx. All units are either let or under offer with the net initial yield of 6 per cent supporting a £29.5mn valuation of the asset.

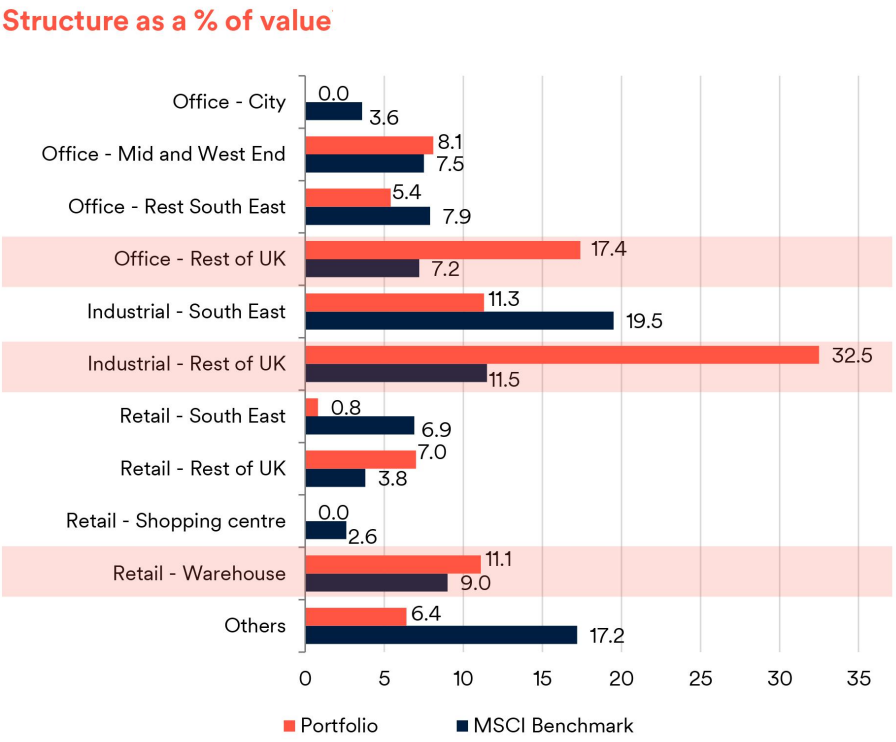
MSCI IPD UK retail warehouse capital value index (rebased)



Source: Liberum, MSCI IPD

Analysts at Colliers expect that retail warehousing will continue its 'bull' run in 2022 with depth of investor demand maintained across prime and secondary level assets, albeit yields are unlikely to see the dramatic sharpening as they did in 2021. Capital growth is forecast nonetheless and points to further capital valuation uplifts to Schroder REIT's own retail warehousing portfolio.

Admittedly, the company also has 7.6 per cent of the portfolio invested in retail, but this is well below the average 12.5 per cent weighting in the MSCI Benchmark index. Furthermore, Schroder REIT has no exposure to shopping centres, a segment that has been dragging down capital value growth across the retail sector.



Source: Schroder REIT

Office portfolio (28.1 per cent weighting at 31 December 2021)

Colliers predicts that leasing demand for quality, future-proofed and sustainable offices will continue to increase through 2022 with both London and regional central business districts seeing stiff competition from occupiers for new Grade A space. This will lead to further pressure on development pipelines and rents for both sub-premium and premium space. Analysts at the consultancy firm add that refurbishment activity will increase as developers seek to promote sustainable credentials and aim for Net Zero carbon overhauls, noting that UK REITS are ahead of this curve. Schroder REIT has been focusing on environmental, social and governance (ESG) considerations throughout the real estate lifecycle and is second in the GRESB Benchmark rankings amongst its UK diversified commercial property listed peers.

The company is also adapting space to meet changes in occupier behaviour. A good example are recent office lettings at City Tower, Manchester, in which Schroder REIT has a 25 per cent share in the 610,000 sq ft mixed-use scheme. The first phase of City Tower's Elevate flexible working concept has completed with around 90 per cent of the company's 12,321 sq ft share of space let out. New five-year leases have been signed with two tenants, which will produce net office rents of £27.73 per sq ft and £25.17, respectively. These represent net uplifts of 23 per cent and 17 per cent.

The Elevate 28th floor tenant lounge at City Tower, Manchester

Around 70 per cent of Schroder REIT's office portfolio is located in the regions and the company has no exposure to the City of London office market.

Prospects for the regional office property market

The Covid-19 pandemic and the UK government's working from home guidance has influenced office occupation and made fundamental changes to the way companies operate longer term. However, trends towards flexible and home working were already under way pre Covid-19, and the enforced move to remote working has simply accelerated the momentum.

The shift in working patterns is benefiting the regions as companies reflect on the requirement for expensive Central London offices. That said, the debate around the demise of the office looks premature and recent lettings activity shows that employers remain convinced of the role of the workplace. Furthermore, previous forecasts of the demise of the office – in the early 1980s with the advancement of computer technology and again in the early 2000s during the dotcom era – proved unfounded. Over two-thirds of respondents to a British Council for Offices survey stated that the office is important for developing networks, forming connections with other employees and their own career developments, thus highlighting that the office culture is far from dead.

Regional office yields – November 2021

Region	Prime	Secondary *	Spread
Aberdeen	6.75%	8.50%	175 bps
Birmingham	5.00%	6.75%	175 bps
Bristol	5.00%	6.75%	175 bps
Cardiff	5.50%	8.00%	250 bps
Edinburgh	4.50%	6.25%	175 bps
Glasgow	5.00%	7.00%	200 bps
Leeds	5.00%	7.50%	250 bps
Manchester	4.75%	6.50%	175 bps
M25	5.50%	8.50%	300 bps

Source: Savills Research Note: *Secondary yields refer to buildings in core locations of both a lower quality and rental price point.

Property consultancy Savills estimates that since 2015, excluding London, more than 30mn sq ft of office space has been converted to residential under Permitted Development Rights in England. Availability of Grade B and C space across the regional markets in England has fallen by more than 40 per cent since 2015. At the same time, there has been limited speculative regional office development, a key reason why the available office supply in the UK regional office markets has declined by more than a sixth since 2019. The UK government's multi-billion pound Levelling-Up Fund is another positive for economic activity in the regions, and take-up of high quality vacant office space.

In terms of the investment market, demand is polarised with prime opportunities being actively targeted if they ESG criteria and provide medium-to-long term income. This has resulted in prime regional office yields hardening and returning to the pre-Covid-19 level of 4.75 per cent at the end of 2021. The fact that Schroder REIT's regional office portfolio accounts for around 17 per cent of the portfolio, or more than double the 7.2 per cent weighting in the MSCI Benchmark, means that it is far better placed to benefit from a recovery in regional office markets as the UK emerges from the Covid-19 pandemic.

Realising value from assets and recycling cash into acquisitions

The portfolio manager is proving adept at realising value from assets, too, having recently announced the £13mn sale of The Arc, a 44,602 sq ft office block in Nottingham with a short WAULT of 1.7 years. The disposal price represents a 39 per cent premium to the 31 December 2021 independent valuation of £9.35mn and reflects a net initial yield of 4.5 per cent.

Situated on the edge of Nottingham city centre, Schroder REIT acquired The Arc in August 2018 and has generated an ungeared total return of 12.1 per cent per annum on the asset since purchase. The return compares favourably with the MSCI All Offices index return of 3.5 per cent per annum for the same period.

The transaction completed on 28 February 2022 and will add 0.74p a share to NAV in the current quarter, implying a live NAV of 71.45p which widens the share price discount to 25 per cent, one of the deepest in the sector. The disposal means that the £500mn portfolio now has net debt of £149.8mn and a relatively low 30 per cent loan-to-value ratio, thus offering ample firepower for the investment manager to recycle the cash into new investment opportunities in the pipeline.

Schroder REIT has total low-cost debt facilities of £180mn, so has potentially £30mn headroom to make further acquisitions. The loan-to-value covenant of 65 per cent on its debt facilities is more than double current levels of leverage.

Tenants

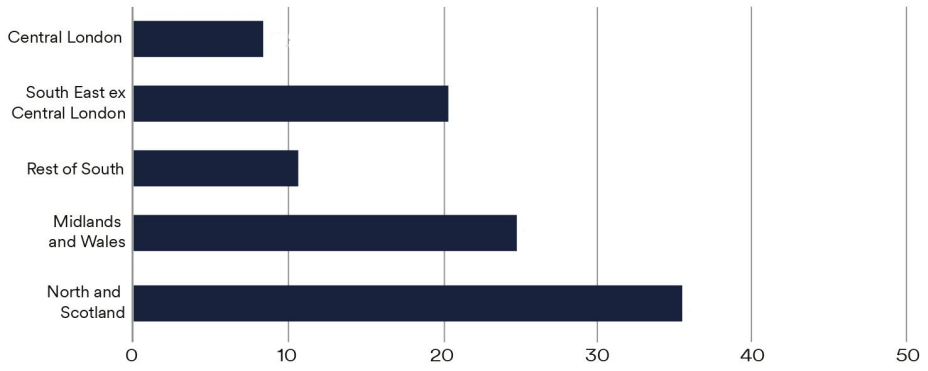
The company's income is diverse and comes from more than 300 tenants across its 42 properties. The top 20 tenants represent 26.8 per cent of the portfolio as a percentage of annual rental income of £29.5mn. The largest tenant, London University of Law, produces rental income of £2mn (6.8 per cent of the total) and accounts for 8 per cent of the £500mn portfolio valuation.

The diverse and granular underlying rental income, and a high level of occupier engagement, has supported improving rent collection rates. Around 98 per cent of contracted rents had been collected for the final quarter of 2021 when the company released interim results in late November 2021. The breakdown between sectors is 99 per cent of office rent collected, 97 per cent of industrial rent collected and 95 per cent of retail, leisure and other rent collected. Management remains in active dialogue with its tenants for historic arrears of £2.3mn at 30 September 2021. Of this sum, £850,000 is categorised as bad debt, a modest amount in relation to an annual rent roll of £29.5mn.

Tenants		Rent p.a (£m)	%*
1	University of Law Limited	2.00	6.8%
2	Buckinghamshire New University	1.15	3.9%
3	Siemens Mobility	0.97	3.3%
4	The Secretary of State	0.88	3.0%
5	Matalan Retail Limited	0.57	1.9%
6	Express Bi Folding Doors Limited	0.54	1.8%
7	TJX UK Limited T/A Homesense	0.51	1.7%
8	Jupiter Hotels Limited T/A Mercure	0.46	1.6%
9	Premier Inn Hotels	0.42	1.4%
10	Lidl	0.42	1.4%
Sub total		7.91	26.8%

Source: Schroders. *Percentage of total portfolio rent.

The portfolio is also geographically well diversified across the UK. More than 60 per cent of the estate's value is held in property assets in the Midlands, North England, Wales and Scotland, so Schroder REIT is not overexposed to any one region. That's sensible risk management.



Source: Schroders. Percentage of total real estate portfolio value.

Board of directors

The board of directors is chaired by **Lorraine Baldry**. A former chief executive of Chesterton International and a past President of the British Property Federation, Baldry has previously been chair of London Thames Gateway Development Corporation, Central London Partnership, and DTZ Holdings, so has extensive industry experience. Baldry retires in July and will be replaced by the board's senior independent director, **Alastair Hughes**, who is also a non-executive director of **British Land (BLND)** and **Tritax Big Box (BOOX)**. Hughes has over 25 years of experience in real estate markets, and was previously Managing Director of Jones Lang LaSalle in the UK before becoming the chief executive for Europe, Middle East and Africa. The company is in the process of recruiting a senior independent director as Hughes' replacement for that position.

Schroder REIT has two non-executive directors, **Graham Basham** and **Stephen Bligh**. Basham is a director of several fund and fiduciary companies in Guernsey, and has over 40 years' experience in fund and fiduciary work. He is a partner of the Aspida Group, a firm of regulatory consultants, specialising in corporate governance, compliance and risk.

Bligh was previously with KPMG for 34 years, specialising in the audit of FTSE 350 companies in property and construction. He is a fellow of the Institute of Chartered Accountants and previously a non-executive Board Member of the Department of Business, Innovation & Skills.

Investment manager

Schroder REIT's investment team is led by **Nick Montgomery**. He joined Schroders from Invista Real Estate Investment Management where he was Head of UK Commercial Funds. Previously, Montgomery worked at Gatehouse Investment Management, having started his investment management career in 1999 at LaSalle Investment Management managing institutional pension fund property portfolios. He holds a BSc (Hons) in Estate Surveying from Nottingham Trent University and is a member of the Royal Institution of Chartered Surveyors.

In July 2020, **Duncan Owen** decided to step down from his role as joint fund manager of the company and Global Head of Real Estate. Owen had run Schroder REIT since its launch in 2004. He remains a special adviser to the board.

In January 2021, Sophie van Oosterom was appointed **Global Head of Real Estate**. Van Oosterom was previously chief executive and chief investment officer of EMEA for CBRE Global Investors. Before joining CBRE Van Oosterom was a managing director and European Head of Asset Management of the Lehman Brothers Real Estate Partners private equity funds (now Silverpeak Real Estate Partners), which held around $20bn of assets under management at its peak.

The investment manager has agreed to reduce its annual management fee from 1.1 per cent of NAV to 0.9 per cent up to £500mn of NAV, to 0.8 per cent for NAV between £500mn to £1bn and to 0.7 per cent for NAV over £1bn. The termination notice period has been extended from nine to 12 months, with effect from 1 July 2021. The management charge is reasonable and doesn't impact the ability of the board to pay out a healthy dividend.

Dividend cover

After deducting £2.6mn of ongoing charges and finance charges of £2mn from first half rental income of £12.9mn, European Public Real Estate Association (EPRA) earnings of £8.3mn (excluding £24.7mn of valuation gains) produced earnings per share (EPS) of 1.7p which easily covered the 1.4p a share cash dividend payments made. The additional income from three industrial assets acquired in November 2021 adds £1.42mn to the annual rent roll and more than replaces the £622,000 rental income lost from the recently sold office property in Nottingham.

Statement of comprehensive income

	Six months ended 30 September 2021 £m	Six months ended 30 September 2020 £m	Year ended 31 March 2021 £m
Rental income – direct portfolio	11.8	10.3	21.4
Income from joint ventures	1.6	1.3	2.5
Other income	0.3	0.1	0.2
Property operating expenses	(0.8)	(1.7)	(3.0)
Net rental and related income	**12.9**	**10.0**	**21.1**
Profit on disposal of investment property	-	-	0.1
Net valuation gain/(loss) on investment property	24.7	(13.5)	(8.3)
Fund and other expenses	(2.6)	(2.6)	(5.3)
Finance costs – net interest payments	(2.0)	(2.3)	(4.2)
Share of joint venture valuation gains/(losses)	0.2	(0.4)	1.1
Profit/(loss)	**33.2**	**(8.8)**	**4.5**
Ongoing charges – fund only expenses	1.3%	1.3%	1.4%
Ongoing charges – fund and property expenses	2.3%	2.5%	2.5%

Source: Schroder REIT

Although there are no analyst estimates in the market, it's reasonable to expect the board to continue increasing the quarterly dividend – 0.772p a share declared for the current quarter – given the highly reversionary nature of the portfolio and the ongoing recycling of capital from asset sales into higher-yielding assets.

Shareholders

Several leading managers have backed the investment manager, including funds controlled by Investec, BlackRock, Witan and Premier Miton.

In aggregate the seven largest shareholders control 59 per cent of the 491.1mn shares in issue. Liquidity is good with the shares trading on a tight 0.4p a share bid-offer spread and bargains of 50,000 shares or more going through the market.

Schroder REIT major shareholders

Name	Percentage
Investec Wealth & Investment	16.0%
Schroders	15.2%
Witan Investment Trust	7.9%
Embarkment Investment Services	7.0%
Premier Miton	5.3%
BlackRock	4.5%
Hargreaves Lansdown Asset Management	3.2%
Total	**59.1%**

Source: Schroder REIT 2021 annual Report, London Stock Exchange regulatory announcements since 31 March 2021.

Peer group comparison and target price

Schroder REIT's share price has edged up to 53.55p since the third-quarter trading update even though equity markets have been under pressure. The company's share price discount of 24.3 per cent widens to 25 per cent after taking account of the 0.75p a share uplift from the disposal of the Arc, Nottingham. The discount is more than six percentage points higher than peers listed in Liberum Capital's UK Commercial space and the company's 5.7 per cent dividend yield is well above the 4.9 per cent average for its peers.

Moreover, with shorter than average lease lengths (5.4 years to expiry), Schroder REIT has greater opportunity to drive rents from a relatively low base as well as adding value from new lettings and renewals. The 71 lettings this year have increased the rent roll by £1.3mn.

The company also has a 46.5 per cent portfolio weighting in industrial property and 11.5 per cent weighting in the appreciating retail warehousing sub-sector, so has a more favourable portfolio mix than peers to support rental growth and valuation gains. Given the portfolio weighting, a more relevant comparison is with the UK industrial and logistic peers which trade on average 15.2 per cent share price premium to NAV and offer a much lower dividend yield of 3.6 per cent.

LIBERUM

ALTERNATIVE FUNDS VALUATION SHEET

Priced at close of business: 16/11/2021

Fund	Mkt Cap	Price CCY	Price Last	NAV Latest	NAV Date	Premium/ Discount	Div Yield	Basis	% NAV Total Return YTD	1y	3y	5y
UK Commercial												
AEW UK REIT PLC	£180m	GBP	113.4p	113.5p	31/12/2021	-0.1%	7.1%	12m Hist	1.2%	30.3%	47.3%	81.6%
Conygar Investment Co PLC	£97m	GBP	162.0p	217.4p	30/09/2021	-25.5%	0.0%	12m Hist	n/a	n/a	n/a	n/a
Custodian REIT	£443m	GBP	100.6p	113.7p	31/12/2021	-11.5%	5.5%	12m Hist	0.8%	23.2%	23.4%	48.0%
Ediston Property Investment Co	£164m	GBP	77.4p	90.6p	31/12/2021	-14.6%	6.5%	12m Hist	0.9%	14.1%	-6.7%	9.1%
BMO Commercial Property	£805m	GBP	108.4p	135.1p	31/12/2021	-19.8%	4.2%	12m Hist	0.5%	15.5%	0.5%	13.1%
BMO Real Estate Investment	£206m	GBP	85.6p	121.6p	31/12/2021	-29.6%	4.7%	12m Hist	0.5%	28.5%	29.1%	55.2%
Picton Property Income Ltd	£530m	GBP	96.8p	112.8p	31/12/2021	-14.2%	3.6%	12m Hist	n/a	21.9%	34.7%	67.5%
Regional REIT Ltd	£449m	GBP	87.0p	99.1p	30/06/2021	-12.2%	7.5%	Target	1.1%	6.8%	5.2%	32.0%
Schroder Real Estate Investment Trust	£256m	GBP	52.1p	70.4p	31/12/2021	-26.0%	5.9%	Target	0.5%	25.7%	14.2%	41.0%
Standard Life Investment Property Inc	£310m	GBP	78.2p	100.6p	31/12/2021	-22.2%	5.1%	12m Hist	0.6%	30.9%	28.4%	61.5%
UK Commercial Property Trust	£989m	GBP	76.1p	102.4p	31/12/2021	-25.7%	3.9%	Target	0.4%	22.1%	21.2%	41.9%
Subtotal/Average	**£4,428m**					**-18.3%**	**4.9%**		**0.7%**	**21.9%**	**19.7%**	**45.1%**
UK Industrial / Logistics												
Industrials REIT	£547m	GBP	189.8p	158.0p	30/09/2021	20.1%	3.6%	12m Hist	n/a	n/a	n/a	n/a
Tritax Big Box REIT	£4,356m	GBP	233.2p	185.5p	30/06/2021	25.7%	2.8%	12m Hist	n/a	15.7%	37.5%	79.3%
Urban Logistics REIT	£871m	GBP	184.5p	164.2p	30/09/2021	12.4%	4.1%	12m Hist	0.9%	21.7%	51.8%	87.8%
Warehouse REIT	£663m	GBP	156.0p	151.9p	30/09/2021	2.7%	4.0%	12m Hist	0.7%	38.0%	71.3%	n/a
Subtotal/Average	**£6,436m**					**15.2%**	**3.6%**		**0.8%**	**25.2%**	**53.6%**	**83.5%**

Source: Liberum

The solid income and capital growth potential offered by the company are likely to become increasingly attractive to investors. UK inflation is well above the Bank of England's target and is likely to remain so in 2022, persuading more investors to target sectors that produce positive inflation adjusted returns and offer a reliable income stream. Schroder REIT fits the bill.

In the circumstances, I can see ample scope for the 25 per cent share price discount to live NAV of 71.45p to narrow markedly as investors cotton onto the attractive combination of ongoing NAV growth, and a disciplined approach to capital allocation through a disposal strategy and reinvestment into better relative value opportunities.

From a technical perspective, a chart break-out above this year's high of 56.9p would add substance to the rally continuing towards the 2018 all-time high of 67p. On a 12-month basis, my target price is 67p which combined with 3.1p a share of future dividends would deliver a 29.5 per cent total return. **Buy.**

Risk assessment

There are several risk factors that should be considered when assessing any investment in the company:

1. Commercial property investment market. Any recession or future deterioration in the property market could cause the company to realise its investments at lower valuations and delay future realisations. In addition, property-related assets can be illiquid which makes them

more difficult to value and realise value from. There may be an adverse effect on profitability and NAV if properties are sold at valuations below their carrying values.

Mitigation: The company uses an independent external valuer (Knight Frank LLP) for the directly owned properties, and BNP Paribas Real Estate UK for the two joint ventures to value the properties at fair value in accordance with accepted RICS appraisal and valuation standards. Schroder REIT has investment restrictions in place to invest and manage its assets with the objective of spreading and mitigating risk.

2. Tenant default. Failure by tenants to fulfil their rental obligations could affect the income that the properties earn and the ability of the directors to declare and pay dividends to shareholders.

Mitigation: Comprehensive due diligence is undertaken on all new tenants, and covenant checks are carried out where a default would have a significant impact. The asset management team conducts ongoing monitoring and liaises with tenants to manage potential bad debt risk.

3. Asset management initiatives. Asset management initiatives, such as refurbishment works, may prove to be more extensive, expensive and take longer than anticipated. Cost overruns may have a material adverse effect on the company's profitability, NAV and the share price.

Mitigation: Costs incurred are monitored against budget and reviewed with the investment manager.

4. Fall in rental rates. The level of rents may be adversely affected by general UK economic conditions and other factors such as increased competition, and a property's location. Any decline in rents may have a material adverse effect on profitability and the company's ability to meet interest and capital repayments on debt facilities.

Mitigation: Schroder REIT has a diversified property and tenant base, and closely monitors concentration to individual occupiers (top ten tenants) and sectors (geographical and sector exposure). The largest tenant accounts for £2mn of the £29.5mn annual rent roll, but is a blue-chip organisation, London University of Law. The top 10 tenants account for 26.8 per cent of the rent roll and are all high quality. The remaining rent roll is derived from over 300 tenants, which highlights sensible concentration of risk.

5. Interest rate risk. Schroder REIT has two loan facilities, a £129.6mn term loan with Canada Life and a £52.5mn revolving credit facility with Royal Bank of Scotland, of which £45.7mn was drawn following the £19.85mn acquisition of the industrial property portfolio in late November 2021. These facilities provide a low all-in average cost of debt of 2.3 per cent and a blend of maturities in 2023, 2032 and 2039, reducing refinancing risk. The lengthy average loan duration of 11 years means that financing risk is not an issue.

The loan-to-value ratio of 30 per cent is well within the 65 per cent covenant and £39.4mn of the portfolio was unencumbered property when the company reported its half-year results. In addition, cash of £12.5mn at 31 December 2021 has been swelled by the £13mn cash proceeds from the sale of The Arc, Nottingham.

Mitigation: Schroder REIT's policy is to minimise interest rate risk, either by ensuring that borrowings are on a fixed rate basis, or through interest rate swaps/derivatives used solely for hedging purposes.

6. Breach of borrowing covenants. Adverse changes in valuations and net income may lead to breaches in the loan-to-value and interest cover ratio covenants on credit facilities.

Mitigation: The company targets long-term gearing of 25 to 35 per cent loan to NAV, well below the 65 per cent limit on its credit facilities. The board estimated that the company could withstand a 42 per cent valuation decline in the underlying portfolio before breaching covenants in its last annual accounts after factoring in cash and unsecured properties.

7. Ability to meet objectives. Poor relative total return performance may lead to an adverse reputational impact that affects the company's ability to raise new capital.

Mitigation. Schroder REIT has an investment policy to achieve a balanced portfolio with a diversified asset and tenant base.

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