

UK REITs: Building back better

2 May 2024

Tickers mentioned

- AEWU
- LABS
- SREI
- SUPR

Sectors mentioned

- Property – UK Commercial

Opportunities to benefit from REIT rerating

UK commercial property has been a cornerstone asset for many income-seeking investors (both retail and institutional) in recent decades, particularly since the global financial crisis of 2007/8 and the resulting ultra-low interest rate environment. However, since rates began to rise in 2022 to tackle surging inflation, meaningful returns have once more become available on lower-risk assets such as cash and government bonds, which has led to a retrenchment from alternative income assets such as property. With the majority of funds using debt finance to fund property purchases, the rise in interest rates has also increased borrowing costs for many players. In the open-ended (PAIF) sector, the result has been restrictions on withdrawals, the closure of some funds, and questions over the suitability of a structure offering daily liquidity while holding illiquid assets. Meanwhile, in the closed-ended (REIT) sector, many funds that had previously traded on appreciable premiums to NAV because of their attractive yields have fallen to wide discounts.

In this note we argue that at current valuations, REITs may offer a significant opportunity for investors with a medium-term horizon. While government bond yields remain somewhat elevated, given fears that Bank of England base rate cuts may be off the table in the immediate future, many REITs offer a decent yield pick-up over the risk-free rate, both in terms of their portfolio income and their current dividend yields. Furthermore, dependent on the individual REIT's investment approach, there could be significant opportunities for capital growth, income growth or reliable, index-linked income over many years. Although there may be no obvious near-term catalyst for a rerating, there is also in many cases no compelling reason for share prices to be as depressed as they currently are.

The UK REIT sector offers an interesting selection of both generalist and specialist strategies, whether seeking to unlock under-appreciated value, deliver sustainable, future-proofed buildings, or serve the needs of specific types of occupier with strong long-term fundamentals. We have chosen a diverse group of four – AEW UK REIT, Schroder Real Estate, Life Science REIT and Supermarket Income REIT – to help illustrate why now might be a good time for investors to revisit this unloved sector.

We will be hosting all of these REITs at our latest Investment Trusts roundtable on 2 May at the Dome Room, 1 Cornhill, London EC3V 3ND. To attend this in-person seminar, which provides a great opportunity to meet the managers of these trusts at this very apposite juncture, please [contact us directly via this email link](#), [visit the conference page on our website](#), or speak to one of the team on 020 7082 5501. Speakers at the event will be: Henry Butt (AEWU), Simon Farnsworth (LABS), Nick Montgomery (SREI) and Rob Abraham (SUPR).

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Trust Name (Click to jump to)	Ticker	Sector	Price	NAV/ Share	(Discount)/ Premium	Yield
AEW UK REIT	AEWU	Property – UK Commercial	84.1	100.4	(16.2)%	9.5%
Life Science REIT	LABS	Property – UK Commercial	39.5	80.8	(51.1)%	5.1%
Schroder Real Estate	SREI	Property – UK Commercial	44.4	63.3	(29.8)%	7.3%
Supermarket Income REIT	SUPR	Property – UK Commercial	72.2	89.0	(18.9)%	8.4%

Market data snapshot is taken on 30 April 2024.

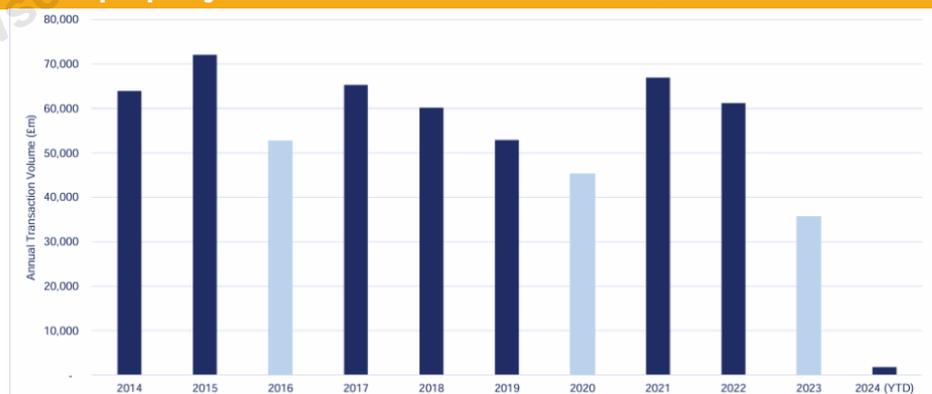
What are the opportunities?

UK commercial property values have fallen sharply in the period since Covid lockdowns, correcting more swiftly than other markets and seeing valuation declines of as much as 30% – two-thirds the level of the price falls seen in the global financial crisis (GFC), yet arguably in a period where fundamentals are nowhere near as bad. While interest rates are now at their highest level since the pre-GFC period, the financial crisis itself came on the back of a debt-fuelled and largely speculative building boom. Today – in spite of some changes in the occupational market as a result of more people working from home or only partly in an office – there has been far less building, occupancy levels are high and rents have remained resilient. Furthermore, property funds themselves are far less leveraged, with average loan-to-value ratios of c 30%, compared with c 60% going into the GFC. While the higher level of interest rates may present refinancing risk for some investors, many funds have locked in low-cost borrowing facilities that will not expire until rates are anticipated to have fallen.

Spreads returning to normal

While risk-free rates (based on long-dated government bond yields) spiked to the high single digits in the immediate aftermath of the Truss/Kwarteng mini-Budget in 2022, making alternative income assets less attractive, current assumptions – despite yields having risen again in recent weeks as a result of the uncertain environment – are for the 10-year gilt yield to be around 3.5% by the end of 2025 (falling from a level of c 4.4% at the end of April 2024). Rental yields on property are forecast to be around 5.5% by the same date, which is around the long-term average yield premium over the risk-free rate. With average discounts to NAV for UK property funds currently nearing 25%, and dividend yields on current share prices averaging 7.5%, there could be an argument made for investing while prices remain depressed, and collecting an attractive income while anticipating a return to a more normal level of spreads.

Could property transactions bounce back in 2024?



Source: AEW UK REIT/MSCI, January 2024.

Potential for transactions to pick up

As shown in the chart above, transaction volumes in the UK (all property) market in 2023 were at their most subdued level in the past 10 years: worse even than in 2016 (Brexit) or 2020 (Covid). A lack of transactions can limit price discovery, leading to property valuers marking down capital values. While history does not always repeat itself, it is worth noting a strong rebound in the years following a trough, which could indicate a higher volume of transactions

to come in 2024, as market participants gain confidence in anticipation of lower interest rates.

Green agenda driving asset management opportunities

While both the Conservative and Labour parties may have rowed back on some of their commitments to tackling climate change, 'greener' buildings are popular with occupiers given their lower energy costs. Improving energy efficiency of buildings is essential for many property owners given the increase in minimum energy efficiency standard (MEES) requirements over the next five years, but by meeting or exceeding the standards now, premium rental values may be achieved.

As well as seeking energy efficiency, tenants may also be attracted by sustainable buildings that help them meet their own environmental, social and governance (ESG) agendas. Fitting solar panels and electric vehicle (EV) charging points may be 'easy wins' for landlords looking to provide compelling and future-proofed locations.

Why look at REITs?

The permanent capital structure of investment trusts, of which UK REITs are a subset, arguably makes them the ideal vehicle for holding assets such as physical property, where individual investment sizes are large compared with buying shares in a company, and purchase and sale transactions can be protracted. As has been seen in the open-ended property fund sector, holding illiquid assets in a vehicle designed to offer instant liquidity can be a recipe for investor consternation. While the property sector can be vulnerable to swings in sentiment, regardless of fundamentals, the investment trust model – where shares change hands at the prevailing market price, without needing to interfere with the underlying portfolio to meet redemption requests – gives the manager the ability to ride out such fluctuations.

REIT discounts have undoubtedly widened in the increasing interest rate environment of the past two years, as higher risk-free rates have made safer assets such as cash and government bonds an attractive home for investors' capital for the first time since the global financial crisis (GFC) of 2007/8. However, it is worth remembering that after the initial shock of the GFC, property funds enjoyed a long period of favour, with their attractive yields in many cases seeing them trade at sustained premiums to NAV. While we may never return to the super-accommodative monetary policy and minimal inflation of the 2010s and early 2020s, the next move in interest rates – whether it happens this year or early next – is almost certain to be downwards. Long-dated gilt yields have risen over recent weeks as hopes of an imminent cut to base rates have waned, yet the average REIT in the AIC Property – UK Commercial sector still offers a c 300bp dividend yield premium versus the 10-year gilt.

A spate of M&A approaches in the UK REIT sector in recent months suggests the acquirers see compelling value in the opportunity to pick up quality assets below their intrinsic value but above prevailing share prices. The resultant reduction in choice for investors could provide a tailwind for those remaining REITs with strong and differentiated investment propositions.

Our trust selection

In the following pages we consider each of our four chosen REITs on relevant measures such as strategy, portfolio, yield, debt profile, performance, discount/premium to NAV, and management.

We've also explained why we believe each strategy is primed for success for investors seeking exposure to UK commercial property.

All metrics and portfolio breakdowns presented in relation to the investment companies below are based on relevant stock market data at the time of going to press, or the latest company release, unless otherwise stated.

Trust Name (click to jump to)	Ticker	Total assets £m	1y price TR	1y NAV TR	Discount	OCF	Yield
AEW UK REIT	AEWU	218.6	-6.8	2.2	-16.2	1.4	9.5
Life Science REIT	LABS	282.7	-40.9	-7.7	-51.1	1.7	5.1
Schroder Real Estate	SREI	471.2	3.3	5.8	-29.8	2.3	7.3
Supermarket Income REIT	SUPR	1,487.0	-10.8	-1.0	-18.9	1.3	8.4
Front Page							
Market data snapshot is taken on 30 April 2024.							

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Overview

AIC Sector:
Property – UK
Commercial
Ticker: AEWU

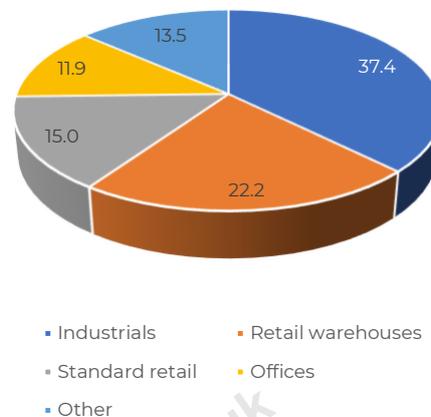
AEWU was launched in 2015 with the objective of delivering an attractive total return to shareholders by investing predominantly in a portfolio of smaller commercial properties in the UK. It follows a value investing approach, aiming to find properties that are attractively priced versus local comparators – usually with low capital values and low passing rents per square foot – and seeks to add value through asset management initiatives, boosting both rental income and the eventual sale price. AEWU's manager follows a sector-agnostic, opportunistic approach to both purchases and sales, which can lead to high levels of portfolio activity. There are currently 33 properties in the portfolio; since launch, 18 have been sold at an average premium of 38% to their purchase price. This underpins the total return performance of the company, with AEWU ranking first in its Association of Investment Companies (AIC) peer group for NAV total return performance over three and five years, and fourth and first respectively for share price total returns over the same periods.

Geographically, assets tend to be located away from major city centre 'prime' locations such as London, Manchester and Edinburgh, with a greater focus on smaller cities and towns where valuations tend to be lower.

Given the focus on unlocking value through active asset management, average lease lengths tend to be quite short (see Figure 2) – the weighted average unexpired lease term (WAULT) at 31 March 2024 was 4.3 years to break and 5.6 years to lease expiry. Properties with short unexpired lease terms may be attractively valued because they have not been subject to improvement for some time, and also because of the uncertainty of future income when the lease expires. AEWU's managers take advantage of this valuation discount, and look to improve properties to maximise returns before re-letting, or alternatively by selling with vacant possession either to owner-occupiers or for alternative use. "We like to get properly under the bonnet to assess all the options when a lease is approaching its end," says Butt. "Rather than doing a lease re-gear with 12-18 months to go – which is a more defensive approach as the lease event is further down the line – we are more likely to take the lease up to expiry. At that point, there are two potential outcomes: you could renew it and push the rent on so it does what you want in terms of the income profile, or you can renew it and see significant yield compression, so you might sell it on and crystallise the capital upside."

The portfolio is broadly diversified by type of property (see chart above). In the past two years the sector weightings have changed markedly, with industrials exposure

Sector breakdown at 31 March
2024 %



Top 10 holdings at 31/3/24	Sector	% of portfolio
Central Six Retail Park, Coventry	Retail warehouses	10.7
Northgate House, Bath	Mixed use (retail and offices)	6.1
Gresford Industrial Estate, Wrexham	Industrial (single let)	6.0
Cambridge House, Bath	Mixed use (offices and retail)	5.2
40 Queen Square, Bristol	Offices	5.1
London East Leisure Park, Dagenham	Other (leisure)	4.9
Tanner Row, York	Other (multi-storey car park)	4.8
Arrow Point Retail Park, Shrewsbury	Retail warehouses	3.9
Apollo Business Park, Basildon	Industrial (multi-let)	3.4
Wyndeham	Industrial	3.0
Top 10 total		53.0

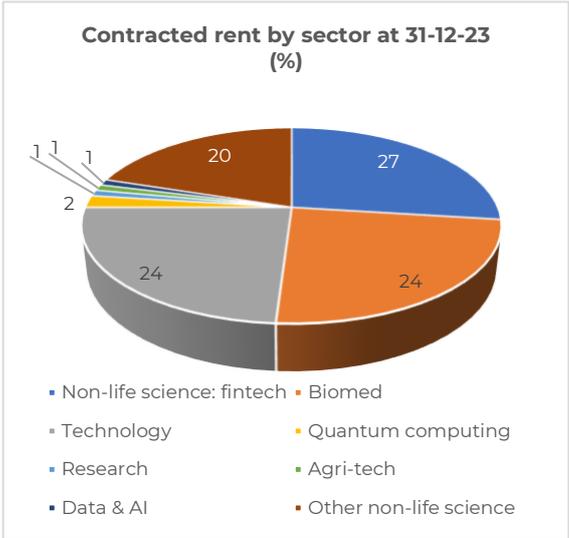
falling from over 50% to 37.4% and offices down from c 18% to 11.9%, while retail (high street and warehouse) has increased from c 25% to c 37%.

Why we like AEWU		As one of the smaller diversified funds in its peer group, AEWU is perhaps at risk of being overlooked by some larger fund buyers. However, its lower-than-average discount to NAV versus peers (particularly before the deep market malaise of the past six months) suggests its differentiated strategy and superior return profile have garnered something of a following. Its focus on both identifying and adding value – buying properties in good commercial locations at attractive prices and lower-than-average rents, usually with relatively low outstanding lease terms, and improving the return profile through active asset management – has led to both a high NIY of 8% and a history of profitable exits, with 18 properties sold to date at an average 38% premium to the purchase price. The 2p per quarter dividend has never been cut, and the recent fall in the share price has pushed the dividend yield to 9.6%, the second highest in the peer group. AEWU's refinancing risk is minimal in the near term, after a savvy move in early 2022 (close to the beginning of the BoE rate hiking cycle) to fix its debt at a rate of less than 3% until May 2027. We view the current c 16% discount to NAV (which compares with a long-term average in the low single digits) as a potentially attractive opportunity, and would note that even at par, the dividend yield would still be close to 8%.
Property yield	NIY 8.0%, reversionary yield 8.8%	AEWU's high net initial yield of 8.0% is underpinned by its value-focused strategy, seeking to acquire properties with net initial yields of 7-10%, low book values and low passing rents per square foot relative to the local area. With a WAULT of 4.3 years to break and 5.6 years to expiry, coupled with a focus on active asset management to improve or repurpose buildings and tackle rent reviews outstanding at acquisition, the reversionary yield of 8.8% is supplemented by capital growth potential through profitable exits.
Dividend yield	9.5% (at 30 April 2024)	Dividends have been maintained at a level of 2p per quarter (8p per year) since June 2016. In recent years they have tended to be somewhat uncovered by income (68.4% covered by EPRA EPS in FY23, 75.1% in FY22 and 90.1% in FY21), however there is a large distributable reserve that can be used to top up the quarterly income payments if necessary, and the capital and income-focused investment strategy means that while dividends have largely been funded by EPRA earnings, these can be supplemented when necessary by profit crystallised on the NAV-accretive sale of assets in prior quarters. The recent decline in the share price has pushed the dividend yield close to 10%.
Debt profile	Loan to GAV 26.2% (at 31 December)	AEWU has a £60m borrowing facility with AgFe. The five-year fixed-rate loan (with a total annual interest cost of 2.959%) was taken out in May 2022, replacing a previous floating-rate facility (1.4% above SONIA) with Royal Bank of Scotland International, which had been due to expire in October 2023. Locking in the financing at a low fixed rate near to the beginning of the current rate-hiking cycle, and well ahead of the previous facility's expiry, has averted a potentially steep rise in financing costs: while 1.4% above SONIA was equivalent to just 2.2% in March 2022, it would now be around 6.6%. The loan is fully drawn. The maximum permitted loan to gross asset value (GAV) is 35% at the time of drawdown and the target maximum loan to GAV is 25%; the marginally higher figures at 31 December 2023 are as a result of a decline in capital values since the loan was drawn.
Property total returns	10.0% (3y annualised to 31 December)	AEWU's property total return over one year to end-December 2023 was c 7%, outperforming the MSCI/AREF UK PFI Balanced Funds Quarterly Index benchmark, which saw a small decline. On an annualised basis, three- and five-year property total returns were c 10% and c 9%, in both cases also well ahead of the sub-5% annualised returns from the benchmark index. Performance has been aided by AEWU's total return focus, with a significant contribution to the returns coming from profitable disposals as well as from rental income.
Share price total returns	12.5% (3y to 30 April)	AEWU's share price total return has lagged its AIC sector peers over one year (at -6.8% versus an average of -4.1%), but is well ahead over three and five years, returning 12.5% and 37.6% respectively compared with sector average returns of -7.2% and -12.2%. NAV total returns have been even better, at 2.2%, 25.4% and 50.3% respectively over one, three and five years, substantially outperforming the peer group over all periods.
Premium/ (discount) to NAV	(16.2%) at 30 April	Until recently, AEWU had bucked the trend of widening discounts to NAV, averaging a low single-digit discount in all but the most abnormal market conditions. However, continued poor sentiment towards the property sector in a higher-for-longer interest rate environment has had an effect in 2024 to date. AEWU has the authority, renewed annually, to allot up to 10% and repurchase up to 14.99% of the issued share capital in order to manage a discount or a premium to NAV. No shares were allotted or bought back in FY23 or FY24 (ending 31 March).

Manager	AEW UK (Laura Elkin, Henry Butt)	AEWU is managed by Laura Elkin (lead portfolio manager) and Henry Butt (assistant portfolio manager) at the UK arm of Boston (US)-headquartered global real estate investment manager AEW. Elkin has worked on AEWU since launch and became lead manager in 2020. Butt was a director in AEW's asset management team before being named assistant portfolio manager of AEWU in 2022.
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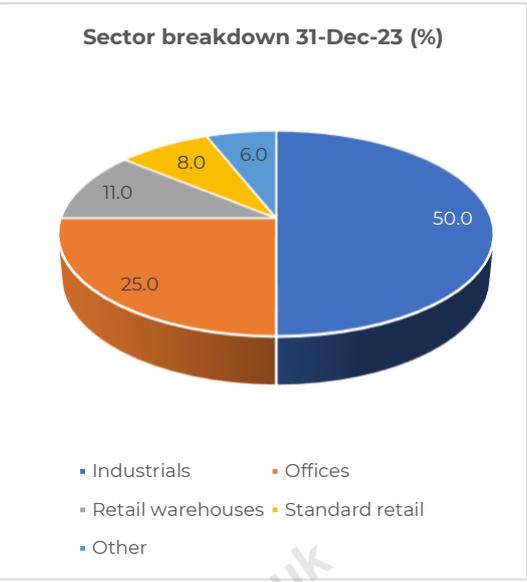
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Life Science REIT	Metric	Comment																
<p>Overview</p> <p>AIC Sector: Property – UK Commercial Ticker: LABS</p>		<p>Life Science REIT came to the market (initially on AIM) in November 2021, aiming to provide shareholders with an attractive level of total return (capital growth and a growing level of income) by investing primarily in a diversified portfolio of UK properties that are leased or intended to be leased to tenants operating in the life science sector.</p> <p>The company has executed its strategy through a combination of acquiring and repurposing office assets and building new laboratory and flexible 'tech box' space. Geographically, it focuses on the 'golden triangle' of Oxford, Cambridge and London, home to multiple research institutes, university spinouts and British and international specialists in life sciences and technology.</p> <p>LABS's managers argue that life science has become one of the most attractive areas in UK real estate, in recognition of how much space is needed by this fast-growing area of the economy. In Cambridge alone (where LABS owns over 230k sq ft of space at Cambourne Park, a former office park, and has committed to delivering 8,800 sq ft of fully fitted labs), there was only 89k sq ft of lab space available to rent at the end of 2023, compared with estimated demand for over 900k sq ft. At Cambourne Park, the cost of conversion to fully fitted laboratory space is £250-300 per sq ft, which includes some central plant work, but the repurposed space should achieve rents roughly double those for offices, and the space is expected to be valued on a tighter yield, driving a valuation increase, so the strategy should lead to both capital and income growth for the portfolio in the medium term.</p> <p>Although Cambourne Park and Rolling Stock Yard in London are fundamentally repurposing stories, with some spaces already completed and some in progress, while others continue to be occupied as offices until their current leases expire, the big development story is at Oxford Technology Park. The asset was acquired partly developed in May 2022, with the first two (of 12) buildings already complete, as well as a Premier Inn. Under LABS's ownership, buildings 3, 4A, 4B and 5 are now also complete, 6-9 are due to be complete in 2024 and 10 and 11 are in the planning stage and expected to be finished in 2025.</p> <p>Buildings 4A and 4B are known as the 'Innovation Quarter', offering smaller units for smaller companies. LABS has established a quantum computing hub in this area, with recent lets to Cold Quanta, Quantum Solutions and Oxford Ionics.</p> <p>The significant amount of development or repurposing going on in the portfolio has affected both occupancy (79% for investment property and 63.3% including</p> <table border="1" data-bbox="544 1491 1445 1686"> <thead> <tr> <th>Top holdings at 31/12/23</th> <th>% of portfolio</th> </tr> </thead> <tbody> <tr> <td>Rolling Stock Yard, London</td> <td>21.8</td> </tr> <tr> <td>Cambourne Park, Cambridge</td> <td>21.3</td> </tr> <tr> <td>Oxford Technology Park</td> <td>18.9</td> </tr> <tr> <td>Herbrand Street, London</td> <td>18.4</td> </tr> <tr> <td>OTP in development</td> <td>17.6</td> </tr> <tr> <td>The Merrifield Centre, Cambridge</td> <td>2.0</td> </tr> <tr> <td>Total</td> <td>100</td> </tr> </tbody> </table> <p>developments and land) and income (although the 100% rent collection figure is notable), which has been a headwind for the share price in an environment of generally negative sentiment towards the real estate sector. However, the sale of Lumen House in Oxford in 2023 at a 9% uplift on the acquisition price has helped to prove the value in the portfolio, and allows LABS additional flexibility in executing on its core strategy of meeting the increasing demand from the life sciences sector for fit-for-purpose space.</p>	Top holdings at 31/12/23	% of portfolio	Rolling Stock Yard, London	21.8	Cambourne Park, Cambridge	21.3	Oxford Technology Park	18.9	Herbrand Street, London	18.4	OTP in development	17.6	The Merrifield Centre, Cambridge	2.0	Total	100
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<p>Why we like LABS</p>		<p>The life sciences sector is a key growth area for the UK, underpinned by strong academic research from world-leading universities. LABS's focus on providing high-quality space for both new and existing businesses in the 'genius loci' of Oxford, Cambridge and London's Bloomsbury area should therefore be well supported as firms seek space that can support their needs. LABS's strategy of repurposing office space as well as building new life science capacity offers significant rental uplifts, with</p>																



		<p>estimated rental values of c £50-100+ per sq ft (depending on location) for fully fitted lab space, an average premium of 70% over office rents. The timing of the REIT's launch in late 2021 (just prior to the Bank of England rate hiking cycle that has seen the base rate move from 0.1% to 5.25%) has meant it has had to contend with difficult market conditions, as well as the board's recent decision to rebase the dividend from 4p to 2p per year, leading to a lower-than-average dividend yield of 5.1% at the current share price (2.5% at par). However, we believe LABS should be considered more in terms of its total return potential – as an example, we calculate that the completion of works at the Cambourne site in Cambridge (c 21% of LABS's portfolio) could drive a net gain of more than two-thirds above the acquisition cost. The current 51.1% discount to NAV is close to the widest it has been since IPO, reflecting the recent dividend cut as well as the general market malaise caused by higher risk-free rates and funding costs, and also perhaps a 'fear factor' given the higher perceived risks of investing in niche areas such as biotechnology. However, with the fruits of the development and repurposing strategy beginning to be seen in new lettings (which should be accompanied by capital uplifts as life science space is valued more highly than office space), we see a brighter future ahead for LABS.</p>
Property yield	NII 4.2%, reversionary yield 5.8%	<p>LABS's somewhat low net initial yield of 4.2% reflects the high level of development ongoing in the portfolio, with over 275k sq ft of space still in development or being repurposed from office to laboratory use. With investment property occupancy currently at 79.0% there is considerable potential for income to increase, with a reversionary yield of 5.8%. As lab space commands a premium valuation compared with offices, LABS's portfolio yield should be seen in the context of a strategy in which the potential for future profitable exits is significant.</p>
Dividend yield	5.1%	<p>The recent rebasing in LABS's dividend (from 4p to 2p a year) has reduced the dividend yield to just over 5% based on the current share price. This is the lowest yield in the AIC peer group. However it should be noted that the large exposure to development within the portfolio – where such assets do not currently produce any income – will reduce over time as buildings become operational. This should help the REIT move towards a fully covered dividend.</p>
Debt profile	LTV 24.7%	<p>LABS undertook two debt refinancings in 2023, first using an existing bank facility and cash resources to refinance the high-cost debt facility acquired with Oxford Technology Park, and then conducting a £150m refinancing on its HSBC bank facility, extending the term to June 2026 and fully hedging the debt at 4.5% interest payable until March 2025. The borrowing is structured as a term loan and revolving credit facility, with Bank of Ireland added to the syndicate alongside HSBC during 2023. The current loan-to-value of 24.7% is comfortably below the longer-term target range of 30-40%, and an interest rate of 4.5% is relatively attractive versus the current BoE base rate of 5.25%.</p>
Property total returns	5.2% (CAG estimate, 1y to 31 Dec)	<p>LABS's net rental income increased by 26.6% to £13.8m in FY23 (ended 31 December). However, a 7.1% like-for-like reduction in the value of investment properties pegged back the portfolio total return, which we estimate at 5.2% (based on rental income, changes in property valuation and net cash used in investment activities) for the year. Space defined as laboratories was more resilient, with a decline of 1.6% compared with -9.8% for space defined as offices. As more of the REIT's assets are repurposed for lab use, this could therefore underpin more robust valuations in the future.</p>
Share price total returns	-40.9% (1y to 30 April)	<p>As a relatively new entrant to the REIT space, LABS does not yet have a three-year track record. Its one-year share price total return of -40.9% puts it near the bottom of its peer group, where the average return was -4.1%; however, its NAV total return of -7.7% over the same period (to 30 April) is closer to the sector average of -1.4%.</p>
Premium/(discount) to NAV	(51.1%)	<p>LABS's discount to NAV widened substantially ahead of a rebasing of its dividend in March 2024 (see above), and is currently the second-widest in the AIC Property – UK Commercial sector. Further progress on life science assets in development, leading to new leases and additional income, as well as strong reversionary potential, could see the discount return to more normal levels over the medium term.</p>
Manager	Ironstone Asset Management (Simon Farnsworth)	<p>Simon Farnsworth, managing director of Ironstone Asset Management, has overseen the LABS portfolio since the REIT's launch in 2021. He is an experienced fund manager and chartered surveyor with over 30 years' UK real estate experience. He is supported by a team including research analysts, asset management specialists and other property professionals.</p>

Schroder Real Estate	Metric	Comment																																				
<p>Overview</p> <p>AIC Sector: Property – UK Commercial Ticker: SREI</p>		<p>Schroder Real Estate (SREI) is one of the longer-established UK commercial property REITs, having initially been launched in 2004, with Schroders appointed manager in 2012. In 2023 the company announced a strategic pivot to put sustainability at the heart of its investment proposition, building sustainability objectives and KPIs into its investment policy and introducing a proprietary ESG scorecard. Manager Nick Montgomery says delivering sustainability is key to driving higher income growth. "Tenants are willing to pay a green premium, so all our asset management strategies are clear on net zero, which is ambitious. We are doing it not just because it is right to do, but because it drives earnings and tenant demand."</p> <p>The portfolio is well diversified regionally, with a strong focus on multi-let industrials (around half the portfolio), as well as office exposure concentrated in strong regional cities such as Edinburgh and Manchester. Traditional London office exposure is minimal: the largest asset classed as an office is actually the premises of the University of Law in Bloomsbury, whose fundamentals are completely different from a standard office tenant. A recent lease extension has helped drive the performance of this asset.</p> <p>While SREI has a strong income profile, with a net initial yield of 6.0% compared with 5.2% for its MSCI benchmark, capital performance is also an important contributor, particularly in the industrials space. Montgomery gives the example of the Stanley Green Trading Estate in Cheadle (the third-largest asset by value), which has produced a total return of 36% over one year compared with 3% for the benchmark. "It is multi-let and we bought it with an adjacent plot of land, on which we have developed an additional 80,000 sq ft," he says. Over the course of 2023, all areas of the portfolio outperformed the benchmark in capital terms, with a portfolio-level capital return of -3.3% versus -6.3% for the benchmark. The property total return was +2.8% versus -2.0% for the index.</p> <p>Looking ahead, Montgomery sees the biggest opportunity in the chance to crystallise some of the c £10m of reversionary potential in the portfolio. "Our current contracted rent is c £30m and the estimated rental value is c £40m, so we have got one-third or £10m of reversionary potential," he says. With a relatively short WAULT of around five years (to break or expiry), there is a reasonable likelihood of an appreciable boost to portfolio income in the medium term.</p> <table border="1" data-bbox="531 1518 1460 1809"> <thead> <tr> <th>Top 10 holdings at 31/12/23</th> <th>Sector</th> <th>% of portfolio</th> </tr> </thead> <tbody> <tr> <td>Stacey Bushes Ind Est, Milton Keynes</td> <td>Industrial</td> <td>11.2</td> </tr> <tr> <td>Milshaw Park Ind Est, Leeds</td> <td>Industrial</td> <td>9.8</td> </tr> <tr> <td>Stanley Green Trading Est, Cheadle</td> <td>Industrial</td> <td>8.7</td> </tr> <tr> <td>University of Law, London (50% share)</td> <td>Offices/university</td> <td>8.4</td> </tr> <tr> <td>City Tower, Manchester (25% share)</td> <td>Office/hotel/retail</td> <td>6.6</td> </tr> <tr> <td>St John's Retail Park, Bedford</td> <td>Retail warehouses</td> <td>6.4</td> </tr> <tr> <td>Langley Park Ind Est, Chippenham</td> <td>Industrial</td> <td>5.6</td> </tr> <tr> <td>Union Park Ind Est, Norwich</td> <td>Industrial</td> <td>4.8</td> </tr> <tr> <td>Headingley Central, Leeds</td> <td>Hotel/retail</td> <td>4.5</td> </tr> <tr> <td>Valley Park Ind Est, Birkenhead</td> <td>Industrial</td> <td>2.7</td> </tr> <tr> <td>Top 10 total</td> <td></td> <td>68.7</td> </tr> </tbody> </table>	Top 10 holdings at 31/12/23	Sector	% of portfolio	Stacey Bushes Ind Est, Milton Keynes	Industrial	11.2	Milshaw Park Ind Est, Leeds	Industrial	9.8	Stanley Green Trading Est, Cheadle	Industrial	8.7	University of Law, London (50% share)	Offices/university	8.4	City Tower, Manchester (25% share)	Office/hotel/retail	6.6	St John's Retail Park, Bedford	Retail warehouses	6.4	Langley Park Ind Est, Chippenham	Industrial	5.6	Union Park Ind Est, Norwich	Industrial	4.8	Headingley Central, Leeds	Hotel/retail	4.5	Valley Park Ind Est, Birkenhead	Industrial	2.7	Top 10 total		68.7
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<p>Why we like SREI</p>		<p>SREI does things differently from many of the generalists in its sector. Its focus on improving sustainability and environmental performance at its assets is not only in line with a policy agenda enforcing improvements to energy efficiency in the coming years, but also helps to reduce running costs for tenants – an important differentiator in a time of higher inflation and energy costs. With the whole UK REIT sector arguably having been marked down because of the higher interest rate environment, raising risk-free rates and increasing fears over refinancing risk, we believe that SREI's 6.0% NIY, considerable reversionary potential and long-term, low-cost fixed rate debt profile mean it deserves greater investor attention than its current 30%+ discount to NAV implies. While a significant rerating would act to reduce the current 7.5%</p>																																				

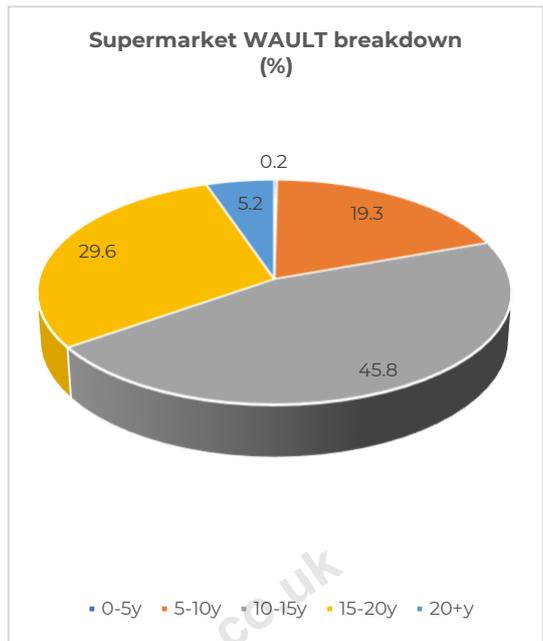


		dividend yield (at par it would be 5.3%), we would note that the dividend is both fully covered and progressive, and therefore has good prospects for increasing further as the risk-free rate falls.
Property yield	NIY 6.0%, reversionary yield 8.4%	SREI's focus on sustainable buildings, strong locations and diverse occupiers (for example, its one central London 'office' is actually a university building) helps to drive a net initial yield of 6.0%. With a WAULT of 5.3 years (to break or expiry) versus 11.2 years for the benchmark index (which includes long income funds), there is c £10m of reversionary potential in the portfolio.
Dividend yield	7.3%	Dividends are paid quarterly, and SREI has a policy of pursuing a progressive and sustainable payout. In spite of a dip in payments in respect of Q2 2020 (the initial Covid lockdown period), dividends have grown at a compound annual rate of 5.6% over the past five years, and the current quarterly dividend payment of 0.84p per share is more than 8% higher than in the immediate pre-Covid period. The dividend was fully covered in both FY23 and H124, and the significant reversionary potential in the portfolio could help to support further dividend growth in the future. The current dividend yield of 7.3% (at 30 April) is broadly in line with the average for the AIC peer group.
Debt profile	Net LTV 36.6%	SREI has available debt of £204.6m (£175.6m of which is currently drawn), made up of a £75m revolving credit facility with Royal Bank of Scotland International and a £129.6m term loan with Canada Life, 50% of which matures in 2032, with the balance in 2039 (average maturity of 12.3 years). The average interest rate on the drawn debt is 3.5% but the Canada Life loan terms are particularly favourable, with an average fixed interest cost of 2.5%. At 31 December 2023 the loan to value, net of cash, was 36.6%, which is slightly above the long-term strategic LTV range of 25-35%, as SREI has been drawing down funds for development.
Property total returns	6.0% (3y annualised)	SREI's property total return over one year to end-December 2023 was 2.8%, outperforming the MSCI UK Balanced Monthly and Quarterly Funds Quarterly Property Index (Unfrozen) benchmark, which saw a 2.0% decline. On an annualised basis, three- and five-year property total returns were 6.0% and 4.5%, in both cases also well ahead of the 1.3% and 0.9% annualised returns from the benchmark index. Outperformance of the benchmark has been aided by a higher income stream and asset management initiatives.
Share price total returns	21.5% (3y)	SREI has one of the better performance records in its sector, ranking third over one year to 30 April with a share price total return of 3.3%, first over three years (+21.5%) and second over five years (+3.9%). In terms of NAV total return it ranks second (+5.8%), second (+19.7%) and fourth (+13.4%) respectively over the same periods. In all cases performance has been well ahead of the peer group average.
Premium/ (discount) to NAV	(29.8)%	Having widened substantially during the initial Covid lockdown period (when the dividend was briefly cut) and again following the Truss/Kwarteng mini-budget in autumn 2022, SREI's discount to NAV currently sits a little wider than the AIC Property – UK Commercial sector average of c 25%. SREI has the authority, renewed annually, to allot up to 10% and repurchase up to 14.99% of the issued share capital in order to manage a discount or a premium to NAV. The company repurchased c 2m shares in FY23 (ended 31 March) but did not undertake any buybacks in FY24.
Manager	Schroders Capital (Nick Montgomery, Bradley Biggins)	SREI is managed by Nick Montgomery (head of UK real estate investment at Schroders Capital) and Bradley Biggins. Montgomery, a member of the Royal Institution of Chartered Surveyors, has 22 years' real estate experience, and has been with Schroders since 2012. Biggins is a chartered accountant by training and joined Schroders in 2014, initially in the Schroders Group M&A team before moving to the real estate team at Schroders Capital.

Overview

AIC Sector:
Property – UK
Commercial
Ticker: SUPR

Supermarket Income REIT (SUPR) was launched in 2017 with the aim of providing its shareholders with an attractive level of income together with the potential for capital growth by investing in a diversified portfolio of supermarket real estate assets in the UK. In late April 2024 it announced its first expansion into Europe through the €75m acquisition of a portfolio of Carrefour stores, mainly in Northern France. Like the majority of the UK assets in SUPR's portfolio, the new acquisitions are 'omnichannel' stores, which means they offer in-person shopping, click & collect and online delivery from a single site. SUPR's managers see the omnichannel model as offering future-proofing to the portfolio, as it is insulated from any changes in shopping habits.



Top tenants by value at 31/12/23	% of portfolio
Tesco	49
Sainsbury's	31
Morrisons	5
Waitrose	5
Asda	2
Aldi	1
M&S	1
Iceland	1
Top 8 total	95

The average plot size for such stores is 9-13 acres, including plenty of car parking (increasingly with electric vehicle charging available), multiple delivery vans, and staff who can be flexibly deployed either serving customers or picking online orders. Operator revenues from these stores can be anything from £50m-100m per year, and rents average around 4% of store turnover. Many of these locations have been trading as supermarkets for over 30 years and, with planning priorities having changed and large sites much harder to come by, "if you want the confidence that your tenants will stay in place at the end of the lease, the fact they have nowhere to build is definitely a factor," says SUPR fund manager Rob Abraham. This feeds into rental growth, with lease re-gears (renegotiations ahead of expiry) coming in comfortably ahead of open market values per square foot.

SUPR targets the top quarter of trading locations and has a heavy bias towards Tesco and Sainsbury's stores (80% of the portfolio prior to the Carrefour acquisition). Some 75% of the portfolio has a weighted average unexpired lease term (WAULT) in excess of 10 years (portfolio average of 13 years), and with 78% of leases being linked to inflation (with caps and collars ensuring that rents never fall but increases are not overly onerous), SUPR enjoys good visibility over its cashflows, which has helped it to pay a progressive dividend since inception.

While the public perception may be that the UK grocery market is increasingly skewed towards discounters such as Aldi and Lidl, Abraham points out that the growth in new discounter store openings has slowed dramatically, from an average of around 90 net new stores in the six years from 2017 to 2022 to just 43 in 2023. These store openings (568 in total) have been a significant contributing factor in the £16bn of sales growth the discounters have achieved since 2017. However, it is worth noting that this is less than the £18bn of growth achieved by omnichannel stores, which added just one net new store in the same time period.

Although retail has not been immune from the general decline in UK property values in recent years, SUPR is encouraged by an uptick in investment activity in its particular niche. Chairman Nick Hewson noted in the recent H124 results that a record £2.1bn was invested into UK supermarket property in 2023, "highlighting the strong appeal of the asset class and the attractiveness of current asset values". SUPR's own investment activity, which has seen strong locations added to the portfolio at well above the average NIY, should support both income and capital growth into the future.

Why we like SUPR		When SUPR launched in 2017, it quickly found favour with investors thanks to its clear niche strategy, leading it to trade at a sometimes substantial premium to NAV during the pre-Covid period. While appetite for its long-duration, largely index-linked income may have waned in an environment of higher risk-free rates, we see considerable potential for an improvement in sentiment as the interest rate cycle turns. Its managers are experts in their area, and have a keen understanding of the factors that make a particular store a success. The recent move into Europe with the acquisition of a portfolio of Carrefour stores (large, omnichannel assets with similar fundamentals to SUPR's core UK portfolio) is an interesting development, with a net initial yield (6.3%) in excess of the portfolio average of 5.8%. The current c 19% discount to NAV means new investors can enjoy a dividend yield in excess of 8%, backed up by an essentially fully covered and progressive dividend.
Property yield	NIY 5.8%	While SUPR's net initial yield of 5.8% looks fairly modest compared with some peers, it reflects a relatively low-risk approach, with a focus on strong omnichannel trading locations, more than three-quarters of rents on index-linked uplifts, a WAULT of 13 years and a focus on larger Tesco and Sainsbury's stores, which are able to offer more to their customers than lower-cost alternatives and are also less affected by rising input costs. The attraction of these assets is reflected in Sainsbury's decision in 2023 to buy back 21 of its stores that were held in a joint venture with SUPR.
Dividend yield	8.4%	SUPR pays dividends quarterly, with a progressive policy that has seen payouts rise in each year since IPO in 2017, growing at an annualised 1.8% over the past five years. The dividend target is set at the previous year's annual results, with a target for FY24 (ending 30 June) of 6.06p per share, 1% above the level paid in FY23. There is a focus on keeping the dividend sustainable, so it tends to be broadly fully covered by earnings (0.97x in FY23 and 1.08x in FY22). Adjusted EPRA EPS was 2.9p in H124 and, with the benefit of contractual reviews and acquisitions, the company expects the dividend to be fully covered for the full year to 30 June 2024. While SUPR's portfolio NIY is currently 5.8%, the fall in the share price over recent months has pushed the dividend yield to 8.4%, comfortably above the AIC peer group average of 7.5%.
Debt profile	Net LTV 37%	At the date of SUPR's H124 results statement in March, its borrowing facilities totalled £690m across eight lenders (60% unsecured/40% secured) with 4.1 years' average maturity and £177m of undrawn capacity (including a £75m accordion), leading to a loan-to-value ratio of 33%. The company subsequently announced a £37.5m increase in its unsecured facility with SMBC Bank, with the increased portion of that facility priced at a margin of 1.55% above SONIA. To fund the €75.3m (excluding purchase costs) Carrefour acquisition, the company has drawn €81.7m from its existing HSBC revolving credit facility, which was itself increased in size from £50m to £75m. The cost of the euro-denominated borrowing is 1.7% above Euribor (currently c 3.8%) and the net LTV is now 37%, which is equal to the level at the end of FY23 and well within the 60% covenant. SUPR targets an average LTV of 30-40% across a market cycle. The average cost of debt before the Carrefour transaction was 3.1%, which is comfortably below prevailing market rates.
Portfolio valuation	£1,675m (31 December 2023)	SUPR's net rental income increased by 32.1% to £95.2m in FY23 (ended 30 June) and by a further 10.5% (on an annualised basis) in H124 (ended 31 December 2023). In H124, the company received the final tranche of proceeds following the repurchase by Sainsbury's of 21 stores held in a joint venture, using some of this cash to purchase higher-yielding new assets (the remainder was used to pay down debt). The past 18 months have been difficult for the supermarket sector as well as the wider property market: in FY23 SUPR's portfolio saw a like-for-like valuation decline of 13.3% (compared with -19.0% for the MSCI All Property Capital Index), with a further like-for-like decline of 3.2% in H124 (-4.0% for the index). However, given limited supply of omnichannel supermarkets and with interest rates likely to fall over the medium term, SUPR remains positive on the outlook for valuations during 2024.
Share price total returns	-23.3% (3y)	Share price returns of -10.8%, -23.3% and -5.5% over one, three and five years to 30 April 2024 have lagged the NAV total return by 9.8pp, 21.3pp and 33.7pp respectively, underperforming the AIC peer group average over one and three years and outperforming over five years. Poorer performance has been concentrated in the period since summer 2022, when inflation was nearing its peak. With the Consumer Price Index now closer to its long-term average and with scope for interest rates to fall from their current 16-year high, downward pressure on SUPR's share price may ease going forwards.
Premium/ (discount) to NAV	(18.9%)	SUPR had traded at a sustained premium to NAV from its launch until mid-2022, but de-rated substantially during 2023, reaching a near-25% discount by the end of October. Following a c 25% share price rally in the last two months of the year (almost entirely eliminating the discount), it has since fallen back again, and the current c 19% discount is substantially wider than the long-term average, albeit still narrower than

		the AIC peer group average of 23.8%. SUPR has the authority, renewed annually, to allot up to 10% and repurchase up to 14.99% of the issued share capital in order to manage a discount or a premium to NAV. The company did not undertake any buybacks in FY23 or H124.
Manager	Atrato Capital (Rob Abraham, Ben Green, Steve Windsor, Steven Noble,)	The team at Atrato Capital who manage SUPR have significant experience in the finance and real estate sectors. Rob Abraham, fund manager, joined the firm in 2019 and has transacted over £1.5bn of supermarket acquisitions in that time, playing a key role in the growth of the fund. Ben Green has over 20 years' experience structuring and executing real estate transactions, including £4bn of supermarket sale and leasebacks. Steve Windsor was previously a partner at Goldman Sachs and specialises in finance and risk management. Steven Noble is a commercial real estate specialist who has negotiated and executed over £700m of supermarket property transactions.

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Conclusion

The current level of discounts to NAV for many REITs (averaging 23.8% for the AIC Property – UK Commercial sector, in a range from -14.7% to -63.6%) suggests a striking lack of investor confidence in an area of the market that has historically delivered consistent returns for income-orientated investors. Granted, property prices can be cyclical, and a hostile environment in the past two years has seen many capital values marked down, leading to negative NAV returns as well as falling share prices. However, this is not a rerun of the global financial crisis: demand for property remains quite strong, supply is more limited than it was in the post-building-boom GFC years, leverage is not generally at problematic levels and many REITs still have access to low-rate borrowing with little imminent refinancing risk. While there may not be an immediate catalyst for a broad-based REIT rerating, there is also no fundamental reason to assume that things will get much worse before they improve.

Indeed, with discounts having drifted wider over the past year, we believe there may be compelling opportunities for investors in REITs to strike *before* the iron is hot. The combination of high income, strong occupancy and lower leverage may not yet have convinced a broader market worried about interest rates, recession and political uncertainty, but with M&A activity often indicating the beginning of an upswing in sentiment, it may not be long before a rerating occurs.

We have arranged the opportunity for professional investors to meet with AEW UK REIT, Life Science REIT, Schroder Real Estate and Supermarket Income REIT, live at our May 2024 REITs roundtable. This will be held on 2 May at the Dome Room, 1 Cornhill, London EC3V 3ND. To book a place, please [contact us directly via this email link](#), [visit the conference page on our website](#), or speak to one of the team on 020 7082 5501.

For retail investors as well as those unable to attend, Schroders Real Estate/Nick Montgomery will also be presenting a webinar that will be hosted on the Capital Access Group website and the Research Tree platform.

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