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Results analysis Schroder Real Estate

SREI delivers a positive total return as property values begin to stabilise...

Update
13 June 2024

- **Schroder Real Estate's (SREI) final results to 31/03/2024 saw a positive NAV total return of 1.1%. The components of this positive total return were an increased 3.34pps dividend (+4%) and NAV decline of 2.7p (-4.4%) to 58.8p. SREI has outperformed the benchmark on a rolling three-year basis with a 5.5% per annum total return compared to the benchmark's 0.8% per annum.**

- **SREI's net asset value decline was largely accounted for by a fall in the valuations of the property portfolio, which fell by 2.8% over the year compared to the benchmark's decline of 5.7%. However in the most recent quarter of the financial year, SREI's portfolio valuation was flat, compared to a decline in the benchmark of 0.6%.**

- **The increased dividend was fully covered by EPRA earnings, with like for like rental growth of 4.6% compared to the MSCI benchmark rental growth of 3.3%. SREI's portfolio has an attractive yield profile, with a net initial yield of 6.1%, compared to the benchmark's 5.1%, while the reversionary yield of 8.4% compares to the benchmark's 6.1%. SREI collected 99% of rents due for the year.**

- **Over the year 108 new lettings, rent reviews and renewals were completed, totalling £10.4m of rental income, at an average of 7% above the estimated rental value at the start of the financial year, 31/03/2023.**

- **In December 2023, shareholders approved a change in strategy, with SREI adopting specific ESG-related objectives within its investment mandate. This will enable it to capture the 'green premium' for rents within the trusts' core sectors of industrial and retail warehouses, as well as in offices, that can be generated on assets with strong environmental and social credentials. The manager is supported by an in-house team of specialists together with a proprietary ESG scoring system developed by Schroders Capital, using external third parties to test and validate the system. This evolution in strategy will include SREI undertaking carefully assessed sustainability-led capital expenditure programmes across the existing portfolio to increase rental income. Examples of improvements include installation of solar PV panels, improvements to energy efficiency and the provision of facilities such as EV charging points.**

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- **SREI's net gearing was 37.1% on an LTV basis (2023: 36.0%), or 59% of net asset value basis . Two assets were disposed of during the year for £7.8m, at a 3.3% premium to carrying value at the start of the financial year, as part of a programme to reduce debt, and a programme of further disposals is underway which will bring LTV to within the target range of 25-35%. The majority of SREI's drawn debt (£129.6m or 73% of the total drawn) is fixed rate long dated debt, maturing in 2032 and 2039 with an average rate of c. 2.5%. There is £47m drawn on the revolving credit facility of which £30.5m is subject to an interest rate collar with the outstanding drawn balance of £16.5m currently at an interest rate of c. 7% and further disposals to repay this are likely to be earnings accretive.**

- **The trust increased its allocation to sectors the manager sees as higher growth, namely industrials, with multi-let estates and value retail warehousing now comprising 61.5% of the portfolio by value (2023: 58.6%).**

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- **Alastair Hughes, chair, said "Despite the challenging macroenvironment for UK real estate, with higher for longer interest rates, the occupational markets remain relatively resilient. During the year, asset management-led rental growth delivered a further increase in the fully covered dividend, supported by the Company's leading low-cost, long-term debt profile and increased allocation to higher growth sectors. As occupiers and investors increasingly value the benefits of sustainability, integrating these considerations into the core of investment decision-making will clearly differentiate the Company and its strategy from peers, improving the defensive qualities of the portfolio and driving risk-adjusted returns for shareholders."**

Kepler View

Schroder Real Estate (SREI) and its closest peers continue to trade on wide discounts to NAV, in SREI's case c. 26%, which may be a signal that investors are happy to sit on the fence until a rate cut actually comes, unsure of whether property assets really are at attractive valuations. Two things strike us, the first is that SREI's net initial yield is about 200bp higher than 10-year gilts, and the estimated rental value (ERV), 8.4%, is clearly much higher than that. The spread between property yields and the 10-year gilt is an age-old rule of thumb for property investors, with 200bps often seen as the 'right' number. Earlier on in the interest rate cycle, **our analysis** suggested that UK REITs share prices were actually at about the right level, as opposed to being undervalued, compared to gilts at the time, but this calculation has shifted now, with SREI's yield at NAV now being at the 'right' level, and therefore one can suggest, based on long-established convention, that the share price, a discount of 26% to the NAV, and the dividend yield of over 8%, undervalues the portfolio. The second thing that strikes us is that SREI's portfolio valuation levelled off in the final quarter of the year, and while one must of course treat this as just one small datapoint, it's interesting that it occurred just as the net initial yield reached our so-called 'right' level.

SREI's adoption of specific sustainability criteria, overwhelmingly approved by shareholders in December 2023, is based on a pragmatic assessment that buildings that can demonstrate higher sustainability performance are very likely to generate higher rent, and thus higher returns for shareholders. The team has already completed a number of asset management initiatives where capital expenditure on upgrades has been exceeded by increases in rental income, and by adopting a strategy of improving existing assets rather than simply purchasing a portfolio of sustainable buildings, the trust's entry price is likely to be much lower. While ESG mandates more widely, for example ESG equity funds, remain somewhat polarizing, within real estate the focus on the sustainability performance of buildings is far more mainstream even among investors that haven't adopted formal targets such as SREI, so in our view the adoption of the formal policy should widen the appeal of SREI rather than restrict it to investors with their own specific ESG goals.

SREI's net gearing, 37% LTV, is higher than average within its peer group and one can of course empathise with investors' worries about gearing generally over the last two years. But SREI is largely geared by long-dated, low cost debt which generates a significant yield pickup, and it's important to say that gearing amplifies returns as well as losses. Given understandable investor caution about gearing in recent times, perhaps the positive aspects of gearing have been pushed to the back of people's minds, but if an investor is seeking an increased exposure to REITs in anticipation of a recovery, then clearly higher gearing may be something they wish to positively select for. While, as we say above, SREI's gearing is above average for the peer group, it is well within normal limits for real estate and is not the highest in its peer group.

In summary then, SREI has generated further rental growth, has an attractive net initial and reversionary yield compared to government bonds, more so when measured at the share price discount of 26% and a strategy of adopting sustainability performance as a key part of asset management, ahead of the peer group, at a point when in our view such a strategy will only become more mainstream over the next few years.

Click here to read the FY report on RNS

Click here to read our latest research on SREI

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