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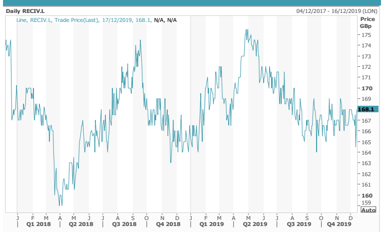
Diversified Financial Services



Source: Refinitiv

Market data

EPIC/TKR	**RECI**
Price (p)	168.0
12m High (p)	175.5
12m Low (p)	162.5
Shares (m)	209.4
Mkt Cap (£m)	352
NAV p/sh (p)	167.1
Premium/Disc	+0.5%
Market	Premium Equity Closed-Ended Inv. Funds

Description

Real Estate Credit Investments (RECI) is a closed-ended investment company that aims to deliver a stable quarterly dividend via a levered exposure to real estate credit investments, primarily in the UK, France and Germany.

Company information

Chairman	Bob Cowdell
NED	Susie Farnon
NED	John Hallam
NED	Graham Harrison
Inv. Mgr.	Cheyne Capital
Head of Team	Ravi Stickney
Main contact	Richard Lang
	+44 207 968 7328
	www.recreditinvest.com

Key shareholders

Bank Leumi	8.6%
AXA SA	8.4%
Close Bros	8.2%
Premier AM	8.2%
Fidelity	8.0%
Canaccord Genuity Group	7.7%
Smith and Williamson	6.7%

Diary

Early Jan	December Factsheet

Analysts

Mark Thomas	020 7194 7622
	mt@hardmanandco.com
Mike Foster	020 7194 7622
	mf@hardmanandco.com

REAL ESTATE CREDIT INVESTMENTS

Delivering on its promises

RECI pays investors a high (7.1%) dividend yield, covered by predictable income streams generated by an increasingly diversified portfolio of real-estate-backed debt. Its credit record has been exemplary. In our initiation report published on 28 August 2019 and titled *7%+ yield from well-secured property debt portfolio*, we detailed how this was achieved. This note reminds investors of these competitive advantages, updates the portfolio and looks at why developments in the UK and France mean the pipeline is likely to see material completions over the next few months. RECI now trades on a small premium to NAV.

- **Pipeline conversion:** Following its October equity raise, RECI is holding above-average cash (18% NAV). With reduced UK uncertainty post the election and over Brexit, more UK deals may close. We understand Cheyne's growing presence in France is also likely to see completions. A further equity issue should be expected.
- **Cheyne's competitive advantages:** Having Cheyne as the investment manager provides RECI with economies of scale, access to deal flow and market information, structuring and execution expertise, as well as experienced lenders with a strong network of contacts to improve credit risk.
- **Valuation:** RECI trades at a small premium to NAV, slightly above secured lending peers. Its yield, at 7.1%, is the highest of its immediate peers and above average compared with debt investment companies. It is covered by predictable income streams and below-average downside risk from credit losses.
- **Risks:** Any lender is exposed to the credit cycle and individual loans going wrong. We believe RECI has appropriate policies to reduce the probability of default and the loss in the event of default. The book is relatively short, creating re-investment risk. Some assets are illiquid, and Repos financing has a short duration.
- **Investment summary:** RECI generates an above-average, but sustainable, dividend yield from well-managed credit assets. It should deliver this return with a relatively modest correlation to equity and bond markets. For property investors, the downside risk is lower than direct real-estate exposure. To debt/fixed-income investors, the presence of physical security (and management controls) makes RECI a lower-risk option than the average debt investment company.

Financial summary and valuation

Year-end Mar (£m)	2015	2016	2017	2018	2019	2020E	2021E
Interest income	15.8	17.7	15.3	18.4	22.3	28.8	38.0
Operating income	21.6	15.1	15.7	20.6	25.3	31.2	40.4
Management fee	0.0	-2.0	-2.0	-2.6	-3.0	-3.8	-5.0
Performance fee	0.0	-0.2	-0.1	-0.3	-0.7	-0.9	-1.1
Operating expenses	-4.2	-3.1	-3.2	-3.7	-4.8	-5.7	-7.1
Total comp income	13.8	8.5	9.1	14.9	19.2	24.3	32.1
EPS (p)	18.9	11.7	12.4	13.0	13.1	12.4	12.4
NAV per share (p)	162.3	163.2	163.2	164.0	165.1	165.9	166.5
S/P premium to NAV	4%	3%	3%	2%	2%	1%	1%
Debt to equity	35%	35%	29%	34%	40%	29%	23%
Dividend (p)	10.8	11.6	11.1	12.0	12.0	12.0	12.0
Dividend yield	6.4%	6.9%	6.6%	7.1%	7.1%	7.1%	7.1%

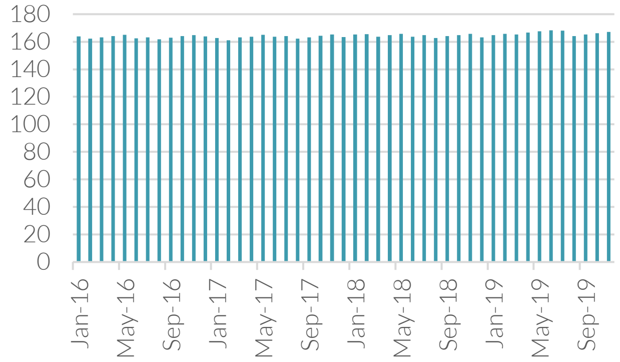
Source: Hardman & Co Research

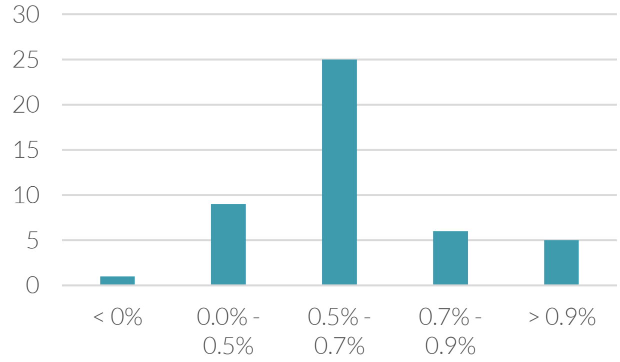
Delivery as promised

RECI continued to deliver as promised

We outlined in our initiation note on RECI (published on 28 August 2019 and titled *7%+ yield from well-secured property debt portfolio*) that RECI pays investors a high dividend yield (7.1%), which is covered by predictable income streams generated by an increasingly diversified portfolio of real-estate-backed debt and that its credit record has been exemplary. As can be seen in the updated charts below, this consistency of performance has continued to be delivered with sustained stability in NAV (left hand chart) and two thirds of the monthly performance since January 2016 have been between 0.5% and 0.9% (three of the past four months have been in the most frequent 0.5%-0.7% monthly NAV accretion bucket). RECI has continued to pay a 3p quarterly dividend, as it has every quarter since 3Q'17.

Monthly NAV (p, LHS) and number of months since January 2016 by monthly return (RHS), both dividend-adjusted





Source: RECI factsheets, Hardman & Co Research

Key messages are stability of NAV/dividend has been delivered by business model with: i) right culture; ii) good quality security; iii) diversification; iv) good corporate governance and risk control process; v) benefits from being part of Cheyne family; and vi) good liquidity if required from bond portfolio

We covered the reasons why RECI has delivered such a performance in our initiation report. As a brief summary:

- The manager's (Cheyne's) culture is hugely important.
- Being a property-secured lender reduces both the probability of default and the loss in the event of default.
- The portfolio is increasingly diversified.
- There is clear independence between the risk-sanctioning and the deal origination.
- The board is strong, independent and experienced.
- Positions appear to be closely monitored once committed
- Cheyne gives: i) economies of scale; ii) specialist credit and structuring skills; iii) access to new deal flow; and iv) market knowledge and relationships.
- We note the conservative accounting adopted by the company.
- The mix of bonds and loans is likely to provide greater liquidity than a book of loans alone.

Changes since our initiation report

Portfolio

The portfolio changes since our latest report are detailed in the table below. While the portfolio now has 50 positions (16 loans, 34 bonds), changes in three individual large exposures (one new, two repaid) have driven the modest portfolio mix changes. Overall, the key messages of good diversity, strong asset backing, a balanced geographical mix and robust yields all remain unchanged.

Portfolio summary

	Loans (Jun)	Loans (Nov)	RECI bonds (Jun)	RECI bonds (Nov)
Amount drawn (loans)/fair value (bonds)	**£174m**	**£159m**	**£169m**	**£170m**
Sector (%)				
Mixed-use	38	36		
Office	12	7		
Housebuilder	12	11		
Hotel/hospitality	11	8		
Residential	8	8		
Logistics/Industrial & distribution	6	5		
Serviced apartments	5	15		
Retail	5	4		
Student accommodation	4	4		
LTVS				
0%-50%	13	13		
50%-60%	62	67		
60%-70%	13	11		
70%-80%	6	5		
80%-100%	5	4		
Country				
UK	83	73	48	53
France	8	9	24	24
Portugal	5	15	0	0
Italy	0	0	12	12
Germany	2	2	10	8
Finland		0	2	2
Conduit		0	2	2
Netherlands		0	0	
Ireland	1	1	0	
Largest exposure				
Largest commitment	30.4	33.4	21.0	21.7
Top 5	110.5	129.0	n/d	n/d
No. of investments	18	16	33	34
Features				
Levered yield (%)	9.2	9.2	8.1	7.3
Average LTV (last £, %)	67.6	65.7	61.8	62.1
Average remaining life (years)	1.7	1.5	2.4	2.3

Source: RECI June and November factsheets, Hardman & Co Research

We consider the most important changes are:

Followed major client to the attractive and strongly growing Portuguese market. Largest single commitment now to a Lisbon Aparthotel.

- A new £33.4m senior loan commitment for a Lisbon Aparthotel development at the groundworks/super-structure stage of development (loan-to-value 63%). This drove the increase in the serviced apartments sector and the increase in the 60%-70% loan-to-value mix. It is also a new entry, at number one in top 10 exposures. In recent years, Portugal has become an attractive market for investment in real estate. The market has seen a huge growth in volume of transactions during that time, particularly in Lisbon. This has been eased by the golden visa programme, which allows citizens of non-EU Member States to apply for a residency permit, and also as a result of Europe-wide tax reforms, which have placed Portugal in the spotlight for investors aiming to benefit from the tax regime pertaining to non-residents. Additionally, as the economy has improved, national investors have also regained access to credit, which has in turn enhanced the ability to finance real estate transactions. Furthermore, in 2015 significant changes in the tax treatment of collective investment entities, including Real Estate Investment Funds incorporated either as corporate funds or as contractual funds, came into force and this has served as a further boost to the market. With this positive macro-outlook, we understand Cheyne has followed a substantial client into the Lisbon market with a relatively low loan-to-value proposition.

Most of top 10 unchanged materially

- Eight of the top 10 exposures remain with little changed exposure/comment. The new entries into the top 10 include: i) in August the Lisbon Aparthotel senior loan discussed above; and ii) in September a £17.8m exposure to a regional housebuilder. This exposure is a long-standing relationship for Cheyne/ RECI and has been in the top 10 previously. Cheyne has been significantly involved in the restructuring of the business.

Two material repayments with deal IRRs of 9.45% and 9.8%, respectively

- Repayments included the full repayment of the loan for the development of the Atlas Building on Old Street, London (see RNS announcement 18 November). In summary, RECI was fully repaid 33 months prior to practical completion and it realised a profit multiple of 1.51x at exit and an IRR of 9.8%. RECI's Investment Manager, Cheyne Capital, was approached in 2016 to refinance a mezzanine loan, as the existing mezzanine lender (a US-based credit opportunity fund) was looking to exit the UK market shortly after the Brexit referendum vote. The exit in 2019 was from a combination of residential pre-sales and refinancing of the office space. Additionally, a whole loan to a hotel in Canary Wharf, London, was repaid in July with a realised IRR of 9.45%.

Levered bond return fallen – same underlying yields but less leverage being employed

- The leverage bonds yield has fallen with a lower level of Repos financing (drawings were £51m, 15% NAV end-November against £61m 19% end-July), which has the effect of reducing the levered return. There is no change to the unlevered yields on bonds or their ability to get attractive financing rates.

Pipeline – opportunities and funding

Cash levels high but we expect pipeline to be close to more completions

The gross cash at end-November was £63.2m, 18% of NAV against £39.5m, 12% at end-July. Part of the increase in cash related to the 1 October 10.2m share placing, which raised gross proceeds of £17m. The business message is that the firepower is above average and so there is slightly more cash drag (the November monthly performance was +0.48% compared with an average 0.63% since the start of 2016). There are a number of factors, which we believe will see rapid deployment form here:

Unwind of UK market-wide uncertainty could see more deals lead to completion

- Many other lenders have commented about how Brexit and political uncertainty have seen the closure of deals delayed. By way of example, S&U commented about property bridging in its 10 November trading statement, "our property lending business, is not immune from the prevailing uncertainty and low level of activity it produces", or Arbuthnot Banking Group's 16 October trading statement, which said "increasing uncertainty in the macro economic outlook lead to a delay in the drawdown of these loans". Given the election result, one may expect that the bottleneck should work its way through relatively quickly.

Benefit from Cheyne's expanding presence in France

- Additionally, we understand there are a number of substantial loan transactions in France which are close to completion. Slides 37-40 of the September Investor presentation (see below) highlighted Cheyne's presence in France, which has generated over £300m of commitments since mid-2017. Cheyne particularly noted that the market had a scarcity of alternative providers to the major French banks, which typically offered a standardised approach to risk and an especially poor availability of development finance. As we detailed in our initiation, Cheyne site-visits every advanced proposition, and has been building an extensive market knowledge well beyond that. This network has established a list of recommended local professional partners – so Cheyne can have confidence in local valuers/project managers/lawyers/financial advisers, etc., as required. It can lend directly to borrowers, in addition to structuring finance through a Luxembourg vehicle/bond markets. This should be a lower-cost and less complex option for customers. We understand that discussions on opening a Paris office are advanced.

Current cash would be used with just three to four deals, so further equity issuance likely

As noted above, there have been two new entrants to the top 10 in the past four months. We believe another three/four material deals would utilise all of RECI's current cash. RECI's Repos borrowings are structured around the bond portfolio and are likely to be increased in the near future. While there may be some opportunities for other debt financing in RECI, we would not be surprised if it came back to the market for a further equity raise in the near future.

Investor Day 11 September 2019

Key takeaways from investor day were the same messages as above – sustainability of NAV and dividend should be high given diversity of book and quality of security

On 11 September, RECI hosted an investor day. The presentation (slides 5-15) detailed how Cheyne operates, its platform, key staff and investment performance. It then focused on RECI with a detailed review of the portfolio (slides17-21) and why the book, NAV and dividend should prove resilient including the risks, opportunities and portfolio management through Brexit (slides 23-30). It finished with a review on how deals are originated in the UK and France and the funding profile. The key takeaways from the presentation were:

- defensive credit exposure to UK and European real estate markets;
- stable dividend delivered consistently since October 2013;
- highly granular book;
- transparent and conservative leverage;
- access to established real estate investment team at Cheyne;
- access to substantial pipeline of originations brought by Cheyne; and
- robust mitigation against a rising rates environment
  - consistent dividend yield of 7%+, a significant buffer over risk-free rates
  - a high yielding portfolio, combined with a short weighted average life of 2.2 years, ensures minimal exposure to yield widening and the ability to redeploy at higher rates quickly.

Valuation

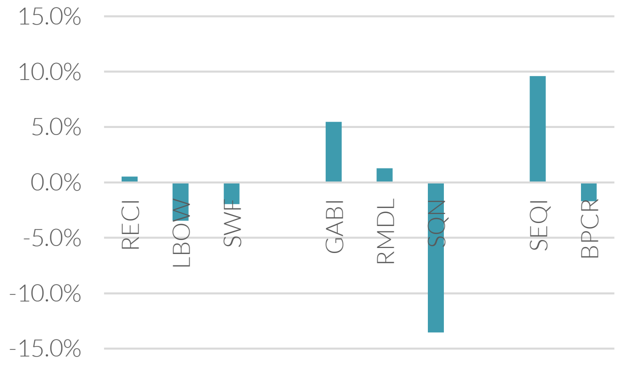
Yield attractions above those of peers and NAV rating in line

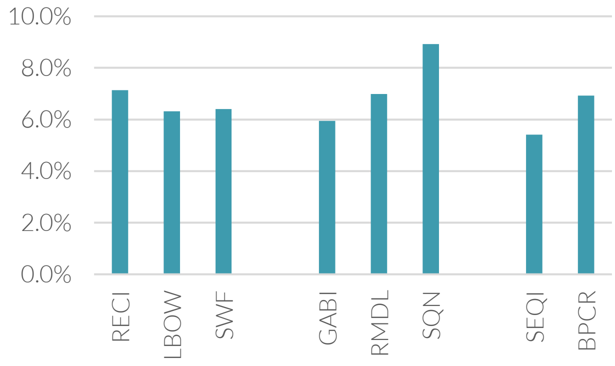
We discussed the yield and its sustainability in our initiation report. We believe this is a key attraction for investors. In the charts below, we compare the premium/discount to NAV of RECI with its immediate peers (ICG-Longbow Senior Secured UK Property Debt Investments and Starwood European Real Estate), as well as a broader group of secured lender investment companies (GCP Asset Backed Income Fund, RM Secured Direct Lending, SQN Asset Finance Income Fund). From the left-hand chart, we calculate that the average rating for the close peers is a 2.7% discount to NAV. RECI's 0.5% premium is thus a noticeably higher rating than peers who have much less diversified portfolios. The wider peers – not unsurprisingly, given their broad sensitivity, history and perceived risk – have a much broader range of valuations. We have removed Hadrian's Wall Secured Investments from this group as it announced on 9 December it would no longer trade in its current format. It is also on a big discount.

RECI's dividend yield (right-hand chart) is the also the highest among the close peers and second highest of the broader group. One may infer from SQN's significant discount to NAV that there is uncertainty over the NAV and, from that, the sustainability of the discount.

For illustration purposes, we have also included: i) Sequoia Economic Infrastructure Income (SEQI), which has a diversified portfolio of senior and subordinated economic infrastructure debt investments, and which shows that specialist lenders can trade at a significant premium, noting the market's current strong appetite for infrastructure funds (average premium to NAV for straight infrastructure funds ca.12%); and ii) the specialist lender BioPharma Credit (BPCR), which trades at a discount, with a significant cash drag following a large loan repayment.

Premium/discount to NAV (% LHS) and dividend yield for RECI and selected peers (RHS, %)





Source: Latest factsheets, priced at close 17 December 2019, Hardman & Co Research

Upside from issuing shares above NAV

Like several debt investment companies, we believe further equity issuance is probable in order to fund growth. Should RECI issue equity at a premium to NAV (its rating over recent months of trading), this would enhance the value for existing shareholders. We discussed the need for further issues in the section on Pipeline above.

Financials

Our forecasts were updated for the October equity raise and have not be changed since.

Profit and Loss							
Year-end Mar (£m)	**2015**	**2016**	**2017**	**2018**	**2019**	**2020E**	**2021E**
Interest income bonds	6.4	4.7	2.6	5.4	6.9	12.9	17.4
Interest income loans	9.5	12.9	12.5	12.8	15.2	15.6	20.4
Other interest income	0.0	0.1	0.2	0.2	0.2	0.2	0.2
Interest income	**15.8**	**17.7**	**15.3**	**18.4**	**22.3**	**28.8**	**38.0**
Net (losses)/gains on investments	-0.1	4.7	4.6	2.8	-0.1	2.4	2.4
Net losses on options	3.2	-1.6	-2.4	-0.9	0.0	0.0	0.0
Net gains on foreign exchange instruments	2.6	-5.6	-1.8	0.2	3.1	0.0	0.0
Total net gains on fin. assets at FV through P&L	5.7	-2.6	0.5	2.2	3.0	2.4	2.4
Operating income	**21.6**	**15.1**	**15.7**	**20.6**	**25.3**	**31.2**	**40.4**
Management fee	0.0	-2.0	-2.0	-2.6	-3.0	-3.8	-5.0
Performance fee	0.0	-0.2	-0.1	-0.3	-0.7	-0.9	-1.1
Other operating expenses	-4.2	-0.9	-1.1	-0.8	-1.1	-1.0	-1.0
Operating expenses	-4.2	-3.1	-3.2	-3.7	-4.8	-5.7	-7.1
Profit before finance costs	**17.3**	**12.0**	**12.5**	**16.8**	**20.4**	**25.5**	**33.3**
Finance costs	-3.5	-3.5	-3.4	-1.9	-1.2	-1.2	-1.2
Net profit	**13.8**	**8.5**	**9.1**	**14.9**	**19.2**	**24.3**	**32.1**

Source: RECI Report and Accounts, Hardman & Co Research

Hardman & Co adjusted Profit & Loss							
Year-end Mar (£m)	**2015**	**2016**	**2017**	**2018**	**2019**	**2020E**	**2021E**
Statutory profit	13.8	8.5	9.1	14.9	19.2	24.3	32.1
Capital gains & FX movements	5.7	-2.6	0.5	2.2	3.0	2.4	2.4
Profit excluding capital gains & FX movements	**8.1**	**11.1**	**8.6**	**12.8**	**16.3**	**22.0**	**29.7**
Adjustment to performance fee	0.0	0.2	0.1	0.3	0.1	0.1	0.1
Adjusted profit	**8.1**	**11.3**	**8.7**	**13.1**	**16.3**	**22.1**	**29.8**
Cost of dividend	13.8	8.5	9.1	14.9	19.2	24.3	32.1
Statutory cover	5.7	-2.6	0.5	2.2	3.0	2.4	2.4
Excluding capital gains cover	8.1	11.1	8.6	12.8	16.3	22.0	29.7

Source: RECI Report and Accounts, Hardman & Co Research

Balance sheet							
@ 31 Mar (£m)	**2015**	**2016**	**2017**	**2018**	**2019**	**2020E**	**2021E**
Bonds	59.4	39.6	49.8	97.3	163.1	235.0	300.0
Loans	87.1	113.2	109.3	148.1	139.4	190.0	226.5
Financial assets at FV through P&L	**146.5**	**152.8**	**159.0**	**245.4**	**302.5**	**425.0**	**526.5**
Cash and cash equivalents	8.1	5.3	24.9	7.2	38.6	10.3	-6.7
Cash collateral at broker	0.0	0.0	0.0	2.4	1.4	1.4	1.4
Derivatives	4.8	3.2	0.9	0.2	0.7	0.7	0.7
Other assets	3.5	2.5	4.4	4.9	12.0	12.0	12.0
Receivable for investments sold	0.0	0.0	0.0	48.1	0.0	0.0	0.0
Total current assets	16.4	11.0	30.2	62.8	52.7	24.4	7.4
Total assets	162.9	163.8	189.3	308.2	355.2	449.4	533.9
Current liabilities							
Derivatives	0.5	0.5	0.0	0.0	0.0	0.0	0.0
Financing	0.0	0.0	0.0	78.3	100.1	100.1	100.1
Cash collateral due to broker	0.0	0.0	0.4	0.0	0.1	0.1	0.1
Preference shares	41.7	41.8	41.9	0.0	0.0	0.0	0.0
Other liabilities	2.6	2.7	2.7	1.3	1.7	1.7	1.7
Total liabilities	44.8	45.0	45.0	79.6	102.0	102.0	102.0
Net assets	**118.1**	**118.8**	**144.3**	**228.5**	**253.2**	**347.5**	**432.0**

Source: RECI Report and Accounts, Hardman & Co Research

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(Disclaimer Version 8 – Effective from August 2018)

research@hardmanandco.com

35 New Broad Street
London
EC2M 1NH

+44(0)20 7194 7622

www.hardmanandco.com