



HARDMAN&CO.



“Secure income” REITs – Safe Harbour Available

By Mike Foster, Hardman & Co Analyst

Table of contents

UK REITs covered	3
Investment case	4
Executive summary	6
Security generates positive returns – yet is priced more cheaply	7
Timing.....	8
Benign long-term rate environments.....	9
REITs that fulfil the criteria.....	9
Are these REITs efficient “absolute return” trusts?	10
Global slowdown implications.....	11
Evidence of pending interest rate cycle turn	13
The yield curve – running out of steam	14
All-property value – running out of steam	16
Real estate asset allocation.....	18
Data on 2007-17 returns in lower-risk UK real estate	20
PHP (REIT): beating other asset class returns and volatility through the cycle.....	20
Returns in the previous economic downturn.....	22
Keeping pace with the recovery	22
The rating on “secure” property.....	25
Risks.....	27
The UK “secure income” REITs	28
Details and metrics on quoted “secure income” REITs.....	29
Investor commentary on each asset sub-sector	30
Unquoted REITs	36
Share price performance and the “security” of leases, assets and funding.....	37
Expansion and dividends.....	38
“Risk/ disclaimer”	40
Appendix:.....	41
Secured-lender investment companies.....	41
Valuations, secured-lenders	43
Risk mitigation, secured-lenders	44
Disclaimer	47
Status of Hardman & Co’s research under MiFID II	47

UK REITs covered

See tables and commentary page 28 onwards.

REITs referenced in this document

REIT	Purpose (no development risk taken unless specified)
AEW UK Long	AEWL invests in a range of UK sectors. A focus is on ultra-long leases.
Assura	AGR invests in UK primary medical assets.
Civitas Social Housing *	CSH invests in UK supported housing for vulnerable long-term tenants.
Empiric Student	ESP invests in UK purpose-built student accommodation.
GCP Student Living	DIGS invests UK in purpose-built student accommodation (mostly non-UK tenants).
Impact Healthcare	IHR invests in UK care homes.
LXi	LXI invests in various UK secure income sectors.
PHP **	PHP invests in UK and some Republic of Ireland primary medical assets.
The PRS REIT	PRSR invests in new-build open market family houses to rent in UK (not within M25).
Residential Secure Income	RESI invests in UK Social Housing, with focus on Shared Ownership, Local Authority, Retirement Housing.
Secure Income	SIR invests in mid-market hotels, and leisure and other assets with long leases. 90% UK.
Supermarket Income	SUPR invests in UK supermarkets.
Target Healthcare	THRL invests in UK care homes.
Triple Point Social Housing	SOHO invests in supported housing in UK for vulnerable long-term tenants.
Tritax Big Box	BBOX invests in large-scale logistics hubs in UK, including a small element in development sites.
Urban Logistics	SHED invests in medium-sized UK logistics assets: hands-on asset management.
Warehouse REIT	WHR invests in medium-sized UK warehouses/multi-lets: hands-on asset management.

* Civitas Social Housing is a client of Hardman & Co. ** PHP is a client of Hardman & Co.
Source: Hardman & Co Research

Our focus in this document is investments which are real-estate-backed, but non-correlated, with annually rising, sustainable cash-backed returns.

In a nutshell

Our investment case is that

- ▶ Current valuations are a modest average discount to historic NAV and a greater dividend yield than the broader FTSE 350 Real estate index;
- ▶ past performance also supports investment;
- ▶ this has prompted ca. £920m of equity fund raises being announced in the past six months alone (and all share prices have risen on these announcements);
- ▶ the sector (unlike the similar stage in the last economic cycle) comprises several highly liquid REITs.

As an Appendix, we also assess four secured-debt investment companies. Hardman’s separate fuller report on debt instruments focuses on debt-related investment companies, across a range of sectors, including certain real-estate specialists. As an Appendix, we add this subset of investment companies investing in debt secured on real estate. As investment companies, these are significantly different structures to the REITs listed in the body of this document. However, a number of financial characteristics display similarities. We consider them a relatively closely related set of investment vehicles, compared to the REITs in the main body of this report. At a minimum, an awareness and understanding of these real-estate debt vehicles should prove rewarding to investors seeking pricing discovery in real estate income-focused REITs. All provide quarterly updates.

Hardman & Co Insight - Debt Investment Companies

Investment case

Investors are voting with their wallets

Many more REITs, £10.9bn market capitalisation

- ▶ There are 17 “secure income” REITs in comparison with three in 2008 and eight in 2016
- ▶ Total market capitalisation of the 17 is over £10.8bn;
- ▶ £920m equity raises announced/executed in the past six months alone.

£0.92bn announced equity raises in the past six months

Investors, as recently as three years ago, had the choice of eight REITs in this “secure income” space, compared to the 17 we assess in this document. PHP’s market capitalisation was £450m. It is now in excess of £1.38bn.

All recent equity raises followed by share price rises

In the past six months, seven (out of the 17) REITs have had a significant equity fund raising (two in the process, not yet closed). GCP Student Living, Impact Healthcare, LXI, Target Healthcare, Triple Point Social Housing, Tritax Big Box and Warehouse REIT have all/ are in the process of raising new equity totalling £920m.

This document is priced as of 13 March 2019

Most recently, Tritax Big Box raised £250m (24 January announcement) at 130p for a specific company acquisition. Since immediately prior to the announcement, the share price has risen and stands at 142p. Impact Healthcare has announced (5 February) a 12-month placing programme of up to 200 million new ordinary shares. Warehouse REIT has announced (12 March) a proposed equity-raise of up to £100m, due to close 28 March: at a 2% share price premium to the previous close.

PHP expansion: shares up 8% to date, since the announcement

On 24 January, PHP and MedicX Fund announced an all-share merger. Immediately prior, the PHP share price stood at 114p. The most recent share price is 123p. (This document was priced on 13 March).

Current valuations and past performance support investment

The expansion of new funding is informed by the resilience and quantum of total returns in “secure income” REITs through the previous cycle.

This “secure income” sub sector has seen continued share price outperformance of the broader sector....

From the 2007 peak to end-2017, primary medical real estate generated total returns of 7.9%, annually. All-property returned an average 4.9% annually and both gilts and equities performed less well than primary health assets, with greater annual volatility of returns.

Valuations in most UK real-estate sectors are running out of steam, with honourable exceptions by sector and by location. See page 16. On this basis, the 3% fall in the All-property UK share prices over the past year (to 13 March) is understandable and has dragged down the share prices of the 17 more “secure” income REITs in this report. These, however, have still risen by 2.7% (2.3% unweighted). This “secure” sub-sector has distinctly different value drivers to the broader UK real estate sector. Investors are starting to recognise this in less volatile (and outperforming) share prices. The modest nature of share price rises over the past year in the “secure income” sector offers a good opportunity to positively explore opportunities in this sector.

- ▶ Primary medical assets (“secure” assets with a long quoted-arena track record) generated greater (7.9% annual) and much less volatile returns through the whole cycle (2007-17) vs. gilts (6.0%), All-property (4.9%) and equities (5.9%).

“Secure income” REITs – Safe Harbour Available

“Secure income” REITs exhibit a weak correlation with real estate

Timing appears attractive, given a ratings background we see as benign

- ▶ While the wider UK “secure income” real estate asset class (REIT) is relatively new, PHP and its primary healthcare assets can be used as a starting point for a proxy to the broader “secure income” sector’s potential. PHP already had an established track record at the time of the 2008 global financial crisis. In the five difficult years from the 2007 market peak, PHP generated a total annual return of 5.6% from its localised hub of primary medical assets (see page 22).
- ▶ The prospect of a benign US and UK long-term interest rate environment provides support for investments offering secure, sustainably growing income. This long-term rate (i.e. 10-year swaps as a benchmark) is much more significant than short rates which may, indeed, rise in the UK, USA and other jurisdictions.
- ▶ Even were long rates to see some upward pressure, there is a useful yield pick-up between the assets in which the overwhelming majority of these REITs have invested and the cost of funds. The typical lease has 10 years or more to run and much of the debt is of medium-term fixed nature, so even were long-term rates to rise, the dividend stream would in most cases not be materially affected.

This is a defensive investment zone. PHP is the only specialist “secure” REIT with a long-term track record. Its total return performance was encouraging in those difficult years, assisted by a progressive dividend each year since its IPO.

Total returns on shares in the downturn years	
End-December 2007 to end-December 2012	% average per annum
PHP	14.3
All-share real estate index	-6.4
FTSE All-share index	4.4

Source: PHP and Hardman & Co calculations

This is now a large sector and its dividend and asset ratings are at discounts to the broader UK REITs sector

- ▶ Admittedly, there is a “health warning” on the PHP statistic above. At end-2007, PHP shares had fallen significantly. Nonetheless, the PHP end-2007 share price (75p adjusted for scrip) was still above the July 2005 level (see page 22).
- ▶ The median dividend yield on “secure” income REITs, at 5.1%, (admittedly 4.7% mean weighted by market capitalisation) is higher than the All-property sector at 4.3%. Its combined market capitalisation exceeds £10.8bn.
- ▶ Share prices have indeed proved more stable (see page 37) as well as outperforming through the year.
- ▶ The NIY on the assets held in these “secure” REITs gives them a good “head start”, at 5.3% (median, see page 37) while All-Property is 5.0%.

Executive summary

Strong evidence of positive returns in bad years for property

Outperformed other major UK asset classes

Income generating “head start” over most other mainstream investments

“Secure income” REITs outperformed other UK-based asset classes both during the five years from the 2007 peak and also through the last cycle, as a whole

The assets in these more secure REITs are valued on a NIY discount vs broader property

This has recently become a sizeable, liquid quoted sector

Dividend yields are higher....

... though NAV discounts are lower

“Secure income” REITs have created wealth rather than merely preserving it. Through the cycle – even investing in 2007, i.e. at the top – our proxy for “secure real estate assets” (primary medical real estate) beat bonds, equities and other real estate by a handsome margin, and with lower annual volatility. Even in the five difficult years from end-2007, Primary Health Properties (PHP), a REIT that invests in localised primary hub medical healthcare assets, generated a total annual return on assets of 5.6%, well above the 0.5% from All-property.

Asset values are attractive. The REITs assessed have an average NIY (net initial yield) of 5.5% mean and 5.3% median, which is above the market as a whole (5.0%). That gives them a good investor income “head start”. It supports the assets’ valuation prospects and, more importantly, makes for a great engine to drive dividend payouts. We think slowing global economic trends point to a repeat of this, with rising (not falling) returns for investors in UK REITs focused on secure income streams. We look at the macroeconomic trends relevant to ratings of such REITs, and assess a range of 17 UK REITs seeking such income streams. Dividends are the surest drivers to sustained, cash-backed total returns and the REITs we assess here offer attractive dividend characteristics. We conclude that now is the time to seek vehicles with visible long-term income streams.

- ▶ **Past “proof of the pudding”.** “Secure” assets such as primary medical assets generated 7.9% average annual returns 2007-17. This compares with 4.9% for All-property, 6.0% gilts and 5.9% equities. Annual deviation of returns was less than half that of the all-properties data. With long leases in place on assets with average net initial yield (NIY) well in excess of 5.0%, the REITs we assess have a strong opportunity to repeat this kind of stable, attractive, repeatable return.
- ▶ **Valuations.** “Secure” assets are not standing at a price premium. On their median NIY of 5.3% median. Most leases are of upward-only nature, rising at CPI or RPI, or modest fixed increments. While share price valuations (see table below) are at a lesser NAV discount than the sector as a whole, they are at an NAV discount, nonetheless.
- ▶ **Risks.** All real estate brings risks, as well as rewards. Security should reduce risks. General UK real estate looks “late-cycle” now. Total returns achieved in UK direct real estate in 2018 were still positive, but lower than in 2017. To be “secure”, REITs need to find attractively priced specialist assets.
- ▶ **The total market capitalisation of specialist UK REITs exceeds £10.8bn**, with wide investor choices: UK investors today have a plethora of specialist UK REITs (with a total valuation of over £10.8bn), offering vehicles to participate in these ostensibly more secure income streams. In the most recent downturn, beginning in 2007, PHP was effectively the only option. Good liquidity draws our attention.

Sector and sub-sector data

Current-year data

	Current-year data
Dividend yield	
UK Real Estate sector	4.3%
17 REITs in this report (unweighted)	5.1%
Share price premium vs. NAV	
UK Real Estate sector	-14.0%
17 REITs in this report	-0.7%

Priced 13 March FTSE 350 Real Estate index 521. Source: Hardman & Co Research, MSCI, Bloomberg

Security generates positive returns – yet is priced more cheaply

Security is the key, especially as it creates wealth, rather than merely preserving it

In a nutshell

This REIT sub-sector has a pedigree of wealth creation, rather than merely preservation. PHP is a REIT investing in primary health local hub assets, listed for 22 years. We highlight the strong returns even in the difficult 2007-12 period.

Five-year total property % mean annual returns on assets for PHP and All-property

	PHP's primary medical portfolio [1], five years	MSCI All-property, five years
End-2007 to End-2012	5.6	0.5

5.6% returns p.a. for PHP in the difficult five years from 2007

[1] Our proxy for the broader “secure income” sector
Source: PHP

And investors are not paying up – quite the reverse

The REITs covered in this report hold (on average) assets valued at NIY above the broader market, and the dividend yields they pay are higher – implying a negative premium for security. Investors seeking “security” are not “paying up”. The median NIY on the 17 REITs in this report stands at 5.3%, vs. 5.0% for All-Property. Security is the key, especially as it creates wealth, rather than merely preserving it.

Dividends are the drivers to cash-backed returns and this sub-sector has higher dividend yields than REITs in general

It is dividends, not changes in share price vs. NAV, which drive cash-backed stable returns. We are not attracted, therefore, by the fact that REITs as a whole trade at a discount to NAV, whereas the average “secure income” REIT trades at a small premium to NAV. NIY, modest cost of long-term debt and efficient management structures drive dividends. The 17 REITs covered in this report benefit from these factors.

We conclude that there is good evidence of asymmetric risk – therefore downside should be limited

Two drivers to outperformance and protection through the cycle

- ▶ There is strong evidence that through-the-cycle, “secure income” assets have outperformed other assets from 2007 to date – while dividend yield and NAV-based ratings (see page 26 and 28) do not appear overly stretched. Evidence points to this historical trend being a repeatable and resilient one.
- ▶ The “typical” late cycle brings declines in longer-term interest rates. Interest rates on long-term Government debt rates fall, which logically means that “secure income” REIT share price ratings should rise.
- ▶ Were economic growth to rebound, there might be a positive re-assessment of more GDP-exposed real estate stocks. However, as noted, the “secure income” ratings are not overly stretched and through-the-cycle, “secure income” returns have been strong in previous cycles.

A re-rating is a possibility, but the main driver is the attraction of NIYs locked in

Locked in NIY, averaging over 5%, are attractive

A slowing global background leads to falling long-term rates and a potential upward re-rating of REITs offering the security of long-term income. We anticipate the search for yield will intensify, especially if, as we expect, long-term bond rates continue to decline. A resulting re-rating is not part of our core investment thesis and would likely be modest. The average “secure income” REIT share price trades in line with NAV. However, the average (median) NIY of 5.3% and the dominance of leases of ca. 20 years, provides fundamental underpinning to investor returns.

The strong starting point is the long locked-in “positive carry”, with NIY well above cost of money. The latter benefits from the relatively low lenders’ margin applicable

“Secure income” REITs – Safe Harbour Available

to higher-covenant long-term leases. So that is the “theory” and the foundation for future returns. The past bears testimony to the solidity of this foundation.

Long-term outperformance is evidence for future success

Over the 2007 to 2017 cycle (no 2018 finalised data yet), the UK primary medical sector returned 7.9% average annual total returns (6.0% gilts, 5.9% UK equity, 4.9% All-Property). Not only did UK primary medical assets outperform FTSE All-property in the five difficult years from 2007 (namely 5.6% vs. 0.5% total return on assets), but they significantly outperformed across the cycle as a whole.

Primary medical: 7.9% average annual total returns

UK asset % total returns and volatility, 2007-17

	Average annual total returns	Average standard deviation of annualised returns
Primary medical assets [1]	7.9	4.2
Gilts	6.0	7.8
Equities	5.9	16.5
All-property	4.9	11.7

[1] Our proxy for the broader “secure income” sector

Source: PHP, MSCI/IPD, Bloomberg

Ratings of shares and assets generally appear solidly based – investors are not over-paying, at present

What are the risks to the REIT sector’s more “secure income” constituents’ investment returns if we are wrong? We could be too soon in the cycle, if economies return to robust growth. This might rule out a re-rating of the “secure income” sector. However, we note, for example, that PHP shares have been somewhat more highly rated than they are now on several occasions in recent years, reaching a 20% premium to NAV at times (we focus on EPRA NAV). See EPRA.com for full details of EPRA.

Investors are buying assets that are perceived as safer foregoing only 0.2% ppts NIY

We use PHP historical data, as it is the longest-established UK “secure income” REIT. Turning to the assets, UK primary medical assets’ NIYs are ca.4.8%, vs. UK All-property at ca.5.0% – a pick-up of only 0.2 ppts. Given that those assets outperformed through the cycle (see above), this premium appears modest and sustainable.

Investing in leases solely to replicate long bond financial instrument characteristics can be problematic

Risk

The main risk for the sector is relying solely on long, secure leases. It is essential to buy assets which have good residual value i.e. their bringing long, tangible benefits to occupiers. Past cycles have seen steep rises in interest rates late in the cycle. This would damage ratings, including those of more “secure income” REITs. Such REITs have manageable loan-to-asset ratios. The damage would be to the ratings – not the business. . Some REITs here have tenant breaks and, while covenants generally are high, there is a range. . However, we see a balance of probability that rates will trend downwards.

Timing

UK real estate looks “late-cycle” now. The positive total returns in UK direct real estate in 2018 were lower than 2017’s. Global economic growth remains positive, but is slowing. All-property risks to rental income rises over the coming few years. This has begun to have a negative effect on broader REIT share prices and may have spilled over to the sub-sector we are looking at. Brexit is unlikely to harm this sector’s rental income – unless the rating is depressed by rising long-term interest rates. A strong case could be made for Brexit resulting in a reduction of long-term UK interest rates.

Non-correlated real estate assets late in the cycle

Non-correlated assets

This report explores the options for investors in the quoted UK real estate sector. In the difficult years post-2007, REITs exposed to more secure assets with relatively

secure income streams (such as primary medical assets) delivered positive total returns. This is in direct contrast to other REITs and property. Theory would have it that long upward-only leases in assets which create financial and social benefit to the high-covenant occupiers should be non-correlated to other real estate on shorter leases. 2008-2012 proved that was indeed the case. It is now a sizeable UK sub sector.

To most investors, the current macroeconomic situation globally seems to be “late-cycle”. We agree. We cite evidence of the cycle stage. We assess global macroeconomic and interest rate trends, as we consider how UK REITs will be influenced by these global trends.

We are late-cycle, and UK REITs are affected by global as well as UK trends –

Global slowdown – but still not recession

- ▶ US GDP growth is forecast to slow to 2.3% in 2019, from 3.0% in 2018, according to the most recent (19 December) Federal open market forecast. The US Manufacturing PMI is at 53, down from 56.5 in summer 2018.
- ▶ The UK cycle low was March 2009. Changes in employee real earnings have been well publicised as having been anaemic, bar 2015, but have recovered since late 2017. Unemployment is low, but part-time working is high (similar trends to the US), and productivity remains particularly disappointing.
- ▶ The February Eurozone services sector PMI of 52.8 is lukewarm. Italy (31 January) is in recession, with -0.2% GDP in the final quarter of 2018. German retail sales fell 4.3% in December, their sharpest fall since 2007.
- ▶ Germany is also weakening with Bild Am Sonntag quoting an “internal government report” suggesting that there could be a potential €25bn budget shortfall by 2023. Last year, Germany reported a budget surplus of €11.2bn.

We are at a major turning point

Were we to be correct that these indicators are harbingers to further downturns, this is a major turning point. On that basis, investors should shift their focus away from the details of supply-demand cycles in individual property sub-sectors. This is especially the case as the problems of retail are well discounted in share prices, while the good prospects in logistics are also extremely well flagged. The fall in the Tritax Big Box (BBOX) share price in recent months illustrates that there may have been over-rating of the underlying strong news flow and positioning.

Benign UK and US long-term rate environments should support “secure income” REIT ratings

Benign long-term rate environments

Interest rate rises: waning expectations should boost ratings

The FOMC (Federal Reserves Open Market Committee) dramatically changed its tone in its January meeting, meeting as it signalled a premature end to monetary tightening. (Source: Focus Economics) The combination of slowing GDP, a flattening of the yield curve and falling long-term expected risk-free returns should heighten the search for yield.

Benign UK and US long-term rate environments provide additional support for “secure income” REIT ratings.

REITs that fulfil the criteria

We reiterate that timing is only a secondary factor in this document. The “secure income” REITs have in the past demonstrated strong returns and their NIY locked in to long leases, added to efficient funding and management structures, should augment that strength.

Are these REITs efficient “absolute return” trusts?

The valuation basis for the REITs covered is unlikely to be undermined

- ▶ We start from the basis that valuation (capitalisation rates) metrics are anticipated to remain robust. The prospect of a benign US and UK long-term interest rate environment provides support for investments offering relatively secure, sustainably growing income.

In 2018, their performance was robust....

- ▶ Total shareholder returns of the 17 REITs in calendar 2018 were +1.8% weighted by market capitalisation and +2.1% unweighted (Hardman data).

.... in the face of poor returns on many UK real estate listed stocks

- ▶ Total shareholder returns for the UK's ten largest quoted real estate companies were negative £7.5bn in 2018. Although the worst four performers were entirely or largely retail-exposed, notable falls were British Land at minus 19% and Land Securities minus 17% (Source, Bloomberg, Property Week, Jeffries).

Even without concerns about the UK economy, the structure of leases and power of tenants makes for reduced visibility of real estate returns

- ▶ Trends for a shortening in UK commercial leases offer opportunities to tenants and entrepreneurial landlords. Certainty reduces with flexible, hot desk, offices, shorter leases in many sectors, not just retail, and the “mood music” that the UK historically was the odd-man out with frequent 20-year style leases (vs typical five or less in the EU). The average WAULT (weighted average unexpired lease length to break) for the REITs covered in this document (excluding student accommodation) is just over 16 years.

Turning to Absolute Return funds, 2018 was a bad year both regarding performance....

- ▶ 100 out of 117 Absolute Return funds (in the Investment Association sector definition) lost money in 2018. Moreover, 39% underperformed a falling MSCI All-Country World index (data source Investment Week 26 February 2019). The top 10 generated an average profit to investors of 6.8% in the year.

...and fund outflows

- ▶ There is always dynamic tension between simplicity of investment strategy and returns. Absolute return strategies' clarity can vary but in 2018 the facts show that out of 11 funds which showed over £1bn withdrawals, the worst was Standard Life Global Absolute Return Strategies, at £8.3m withdrawals. (Source Numis, Morningstar.)

It seems this lower-volatility income stream is of potential real value

- ▶ This document looks a little deeper at the drivers to each REIT, but there is an over-arching message: here is a sector (UK REITs targeting lower volatility returns) which three years ago had a market capitalisation of £2.2bn across six REITs and whose market capitalisation is now nearly five times the size. “Secure income” REITs have improved liquidity dramatically which in turn has attracted a wider range of investors. At the same time, it has begun to demonstrate resilience in a year (2018) when other Absolute Return quoted vehicles performed poorly (negative returns) and listed real estate vehicles also generated negative returns.

Yes, we conclude the REITs covered in this document do offer efficient alternatives

- ▶ We now turn to timing and the structural drivers to future valuation. We then state our data on for the 2007-17 returns in the type of lower-risk UK real estate asset class which drives the investment returns for the REITs covered.

We conclude that, yes, the “secure income” REIT sector has a high probability of providing positive real total returns. These are comprised of 1) valuations at least keeping pace with rental income growth and 2) tenants being willing and able to meet obligations which (excluding the student accommodation REITs and ca.11% of other REITs) are upwards-only leases of over 10 years' unexpired (to break) duration.

Global slowdown implications

Timing: We think the current global macroeconomy is “late-cycle”

Before we turn to how a slowdown could affect the income, assets and ratings of the REITs assessed in this report, we first look at whether there is an economic turning point imminent. What evidence do we cite?

We focus on the macro trends that could affect UK REITs. In addition to UK trends in GDP, tenant covenant risk and interest rates, the direction of the US economy is particularly pertinent. We also note the Eurozone’s impact on global trends.

Eurozone downturn in growth rates

- ▶ German GDP expanded 1.5% in 2018, compared with 2.2% in 2017 and the weakest growth in five years. This prompted an official governmental forecast reduction for 2019: to 1.0%. January 2019 saw a drop in output of manufactured goods. Announced in February: German factory orders fell 1.6% in December.

US growing well, but a reduction is signalled by some

- ▶ Italy is in recession, with GDP falling 0.2% in the final of quarter of 2018.
- ▶ US economic growth continues strongly from its June 2009 low. US GDP growth will slow to 2.3% in 2019, from 3.0% in 2018, as per the most recent (29 January) Federal open market forecast. The FOMC estimates are for 2.0% US GDP growth in 2020 and 1.8% for 2021. The meeting referred to a global trade slowdown linked to the US tariff war with China and “patience” on interest rates was pledged. 19 March is the next meeting.
- ▶ Meanwhile, the consensus forecasts for US unemployment show a gentle deterioration this year. Ending 2018 at 3.7%, the ratio is followed by 3.5% for 2019, 3.6% for 2020 and a slight rise again to 3.8% for 2021. These rates are below the Federal Reserve’s targets. Notably, though, many workers are part-time and might be seeking full-time work – so perhaps “structural” unemployment has risen. This under-employment should prove a factor in mitigating sustained real earnings growth and inflation.

US consumer spending starts to edge into negative territory

- ▶ US consumer demand is weakening. As announced in March, the December rate was negative 0.5%. Spending was at its weakest since 2009. A report from UBS in March, raised its estimate of the likelihood of a US recession to 73% (from 24% in December 2018).

US factory orders growth, but far less robust

- ▶ The US factory order index (Manufacturing PMI) has been in expansion territory (i.e. over 50), achieving 57 in mid-2018. The February index was 53 (IHS Markit), on a continuing downward trend. To add some gloss, as quoted on Bloomberg, Timothy Fiore, Chairman of ISM’s manufacturing survey committee, said in an interview, “No matter where you look, you’ve got chaos everywhere.”
- ▶ Announced late in February, December US factory goods orders rose 0.1% (they fell 0.6% the previous month). Both these figures were notably weaker than consensus expectations.
- ▶ 21 January saw the announcement of a 6.6% GDP growth rate in China for 2018. This is the lowest since 1990. Vice President Wang Qishan was quoted at Davos as saying, “we are actually pursuing more sustainable growth.” In past cycles, China has, at times, pumped significant amounts of liquidity into its economy. Any similar attempt could be inflationary and cause interest rate rises. This could move global interest rates upwards – damaging the timing element of this report’s thesis.

“Secure income” REITs – Safe Harbour Available

Few data pick up “Brexit” negatives – see chart page 15,

- ▶ IHS Markit’s UK PMI published this March, showed a rise to 51.4, up from 50.3 in January.
- ▶ The UK February PMI survey showed input costs, measured across all three main sectors, rose at the joint-slowest rate for two-and-a-half years.

The UK may be seen as more relevant for UK property stocks. The UK cycle low was in March 2009. Changes in real earnings have been well publicised as having been anaemic (bar 2015), but have recovered since late 2017. Unemployment is low, but under-employment trends might well be similar to those in the US.

Risks to “secure income” REITs if our core economic scenario is wrong

So, a UK, US or Eurozone recession is not at all a “given”, but there are potential signs .

The fact that the “secure income” assets outperformed significantly through the previous cycle de-emphasises the timing issue further

- ▶ If our “core scenario” of benign long-term rates proves incorrect, a rise in long-term rates would probably have a negative impact on the valuation of “secure income” REITs, but not on their income. It would affect the rating of other REITs, but would potentially also affect the income streams of those REITs. Only if there were a continuing robust economy with material expectation of a slowdown would general REITs potentially outperform “secure income” REITs.

Timing is important but the punishment for getting it wrong should be low

What are the risks on the downside for “secure income” REITs, if a GDP slowdown (US and or UK) does not materialise?

- ▶ The consensus inflation forecast is for an increase of ca.25bps (only) in the US and the UK. In any case, it would appear that inflation growth will slow and may then decline below current levels. This would tame interest rate movements.

There is even more reason for modest financial gearing in the REIT and among the tenants

It is essential to keep debt gearing modest, even on a “secure income” portfolio

Therefore, even were there to be a recession, the momentum would remain behind valuations on real estate with relatively secure income attached and that is reasonably modestly financially geared. We analyse this later in the report.

The Bank of England’s November 2018 financial stability report has revealed that exposure to leveraged loans that fund the most debt-ridden companies is around \$405bn. This is within a \$1.4tr collateralised loan market, globally. So, if the lenders’ appetite were to reduce significantly, this lower LTV, longer lease asset class would outperform broader real-estate – but would it outperform cash?

Borrowing options – for when refinancing is required by the REIT – have to be kept as varied as possible

Our starting point is the current rating – a modest discount to NAV and a decent dividend yield, with dividends seemingly reliant on the assets’ income streams, not financial engineering. From there, we look at the sustainability of the balance sheets. Our stock-by-stock table gives the average length of debt but, of course, some finance lines mature sooner.

The risks should be assessed stock-by-stock, but banks, private debt and bonds should be available globally to the reasonably liquid, long lease REITs. Modest financial gearing and strong income cover (promoted by the NIYs of generally usefully over 5.0% and long leases) are a positive in such a possible future environment.

Evidence of pending interest rate cycle turn

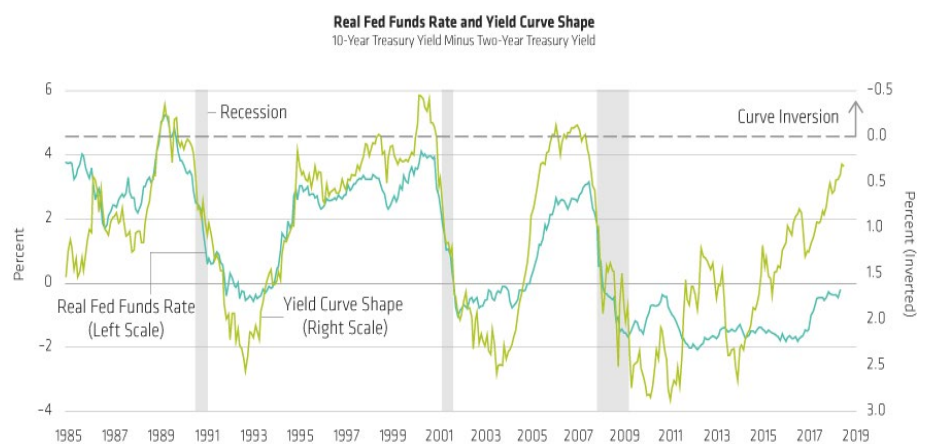
The yield curve indicates a recession, but ignores important factors supporting the value of real estate – as long as it comes with reasonably secure income attached.

The yield curve indicates that the US faces a current risk to GDP expansion

Referencing the chart below, we see clear evidence that the US economic cycle is heading towards a peak. UK trends (in rates, growth and unemployment) are similar to those in the US. We emphasise four caveats in terms of how this affects UK real estate quoted stocks.

- ▶ The UK’s rise in interest rates and its economic growth are more subdued than in the US. This might be taken as a risk that UK economic growth will last longer and rates will rise further in the UK than in the US, i.e. the US rates might peak before those in the UK.
- ▶ However, the UK quoted real estate sector responds to long rates more than base rates, and the correlation between UK and US long rates is high. Even closer is the sentiment overlap between US long rates and UK real estate stock prices, which anticipate future market trends.
- ▶ The labour market’s low unemployment (UK and US), allied to under-employment (UK and US), could delay the recession indicated by monetary trends (see chart below). But, if under-employment were to act as a pool of potential labour supply, it would lead to a mitigation of cost inflation.
- ▶ The risk at end-cycle is that interest rate rises overshoot; although, since the mid-1980s, any such overshoot has been a short-lived phenomenon. It is always best, under this scenario, to be in real estate that is under-gearred, financially.

The yield curve indicates a pending slowdown or recession



Source: Thomson Reuters

The chart above indicates that we are nearing a “curve inversion” on US interest rates – that is to say, long-term rates falling below short-term rates. This would be an indicator of recession, while also supporting valuations of risk-free and low-risk investments, benchmarked against those reducing long-term rates for valuation purposes.

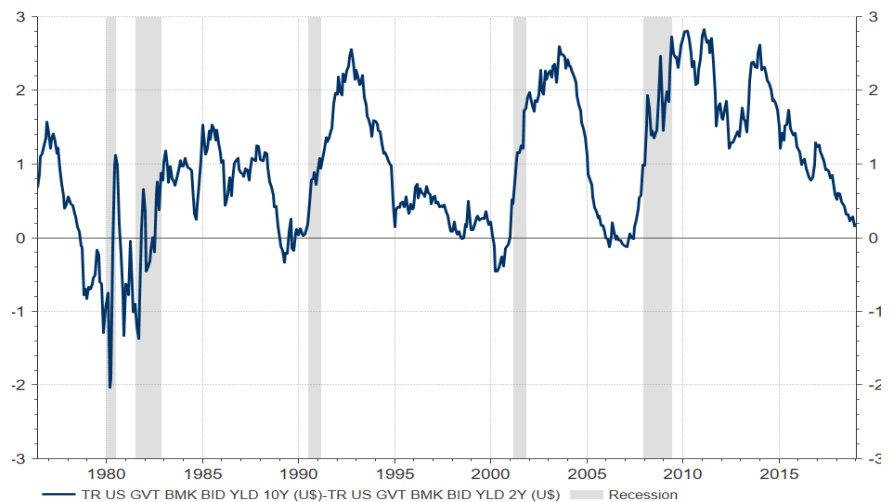
In our view, recession favours REITs that generate relatively secure income, as investors increasingly seek relatively secure income streams.

The yield curve – running out of steam

The US yield curve looks like 2007 and 1989

- ▶ The US yield curve is flattening. We think UK trends are similar to those in the US, although with lower short rates, clearly. Our thesis is that US financial markets are closely linked to sentiment in UK real estate and might be considered to act as a leading indicator. The leading indication is of an imminent peak in the larger economies in the global economic cycle.

US treasury yield curve (10-year minus two-year, %)



Source: Thomson ReutersDatastream

Short-term interest rate rises: expectations wane

Mixed messages on Fed Fund rates

We note that, at the start of the year, market consensus (2 January, Wall Street Journal) for 2019 is for zero rises in the Federal Reserve discount rate. The Federal Reserve Board of Governors raised the rate to 3.0%, with effect from 20 December 2018.

Long-term interest rates: still in a range but failing to break on the upside

We still focus on US rates. See chart overleaf for long rates.

- ▶ If there is a break on the upside, the US, with the stronger economy, should provide it, as opposed to the weaker UK economy. The chart overleaf indicates a failure (in 2016 and again 2018) to break out upwards.

US 10-year treasury yield ranges (%)

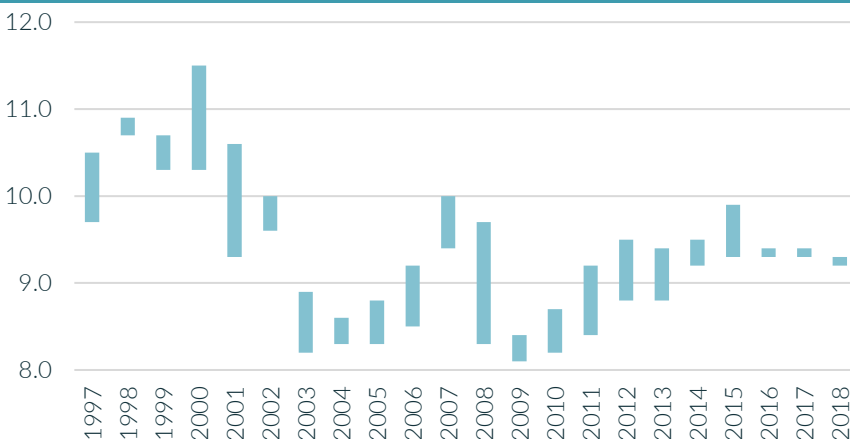


Source: Bloomberg

UK trends currently are (and historically in prior cycles have been) similar to US trends. We refer here to the direction, not the quantum, of long rates.

Focusing on the UK, business investment remains significantly weak.

Real UK business investment as % GDP



Source: EY ITEM Club, Oxford Econometrics, OBR

The question mark over appetite for growth capital....

.... indicates sustained moderate long-term cost of capital...

.... that would heighten the search for income (and security)

Such an investment profile is not seen – in this report – as beneficial or harmful, but it does have a material impact, we consider, on prospects for cost of money in the medium and longer term. Lack of investment reduces one source of demand. We consider it to be a structural issue (Brexit may have a modest impact but this paucity was in evidence before 2016). This is another pointer to surplus of capital and benign long-term interest rate trends.

Action point – intensifying search for secure income

If, indeed, long rates fall, the value of assets delivering secure, long-term income rises. Therefore, in an environment of long-term rates trading sideways or down, a search for opportunities in assets providing secure, long-term income has a good chance of proving rewarding.

All-property value – running out of steam

If All-property runs out of steam, investors are set to bid up the price of secure growth

Our thesis is that falling long-term rates drive investors to seek out secure yields. A range of UK REITs (see page 29) is suitably placed to provide this, we believe. Each has to be assessed on its own merits. Valuations of “secure income” REITs should prove resilient on this scenario. In this section of the report, we assess how the broad property market is faring. We find that UK All-property valuations are rising, but such increases are running out of steam.

Risk-free long rates rose in 2018, yet capitalisation rates are stable to declining across nearly all real estate classes

Decent 2018, in valuation terms – but slowing

USA

US and Sterling interest rates, both long- and short-term, rose in 2018. Looking forward, we see a balance of risks that they will fall at the all-important long end. However, here we point to the divergence in yield trends in 2018 between gilts and real estate. Risk-free long rates rose in 2018, yet capitalisation rates are stable to declining across nearly all real estate classes (with secondary retail an exception).

There is only so far that this trend can go, once investors begin to worry about rising risks in real estate. The CBRE 1H’18 Cap Rate Survey indicated that that US cap rates remained stable. The industrial sector remained “blisteringly hot”, with cap rates falling by 10bps, on average, and 17bps for Class B product. The UK trends are very similar.

UK

Each quarter in 2018 was either flat or recorded a slowing on the previous quarter. This applied to all sectors (see table below).

UK real estate returns still positive but looked wobbly as 2018 progressed...

Total % returns, UK property by sector				
	CBRE: All-property	CBRE: Office	CBRE: Retail	CBRE: Industrial
1Q’18	2.2	2.0	1.1	4.4
2Q’18	1.9	1.8	0.2	5.0
3Q’18	1.6	1.8	0.2	3.6

Source: CBRE

According to the CBRE, in 3Q’18, UK commercial property values increased by 0.3% overall (this represented lower growth vs. 1Q at 0.9% and 2Q at 0.6%). Total returns for 3Q of 1.6% at the All-property level brought 2018 total returns for the total first three quarters of 2018 to 5.8% (or 7.7% annualised). This is a weakening from the 10.3% for 2017 and from the annualised 11.4% average for the prior five years (to end-2017).

...and that is from a high but volatile starting point in recent years

One- and five-year total % returns, UK property		
	MSCI All-property assets 1 year	MSCI All-property assets 5 years
2011	8.1	1.1
2012	2.7	0.5
2013	10.9	7.8
2014	18.6	8.0
2015	13.8	10.8
2016	3.6	9.9
2017	10.3	11.4

Source: MSCI

All-property vulnerable on a few grounds

All-property NIYs have continued to fall in the face of rising US and UK treasury yields. We consider this to be a decline in anticipated return on equity. Were rents to start slipping, that would leave valuations vulnerable. Conversely, were the economy to pick up and long rates to rise, that would also be a drag to real estate ratings.

Seeking out sectors that provide solutions for occupiers through cutting their total costs

Action point – research sectors where rents rise in a recession

Social housing, affordable regional family housing (open market), student accommodation, logistics, health assets – all appear underpinned by supply/demand. Importantly, each of the sectors referred to cut overall costs for their occupiers, vs. alternative accommodation options (or, in the case of logistics, of alternative routes to end-market).

Despite the slowdown in broader real estate values and the looming risk of rental slowdown and worsening covenants, we would still allocate money, specifically to relatively secure income real estate.

We would do so for both shorter-term returns and also for whole-cycle returns, for reasons we outline in the following section of this report.

- ▶ Returns from risk-free assets show every sign of being in a phase of decline; i.e. long US treasury bonds and UK gilts.
- ▶ Rents in general terms might be set to slow down, with risks of GDP-related reductions in demand. This includes changing “habits”, e.g. retail, but also deteriorating covenants and tenants’ willingness to expand or need to retrench. It also, simply, includes “confidence”, which is being impacted by a number of factors. Outside selective sectors and regions (e.g. London), the supply of new stock is not onerous vs. existing available stock. Regionally, uptake (particularly of offices) has been strong in the past couple of years. But this can ebb as well as flow.
- ▶ In addition, changes in delivery of GDP mean likely secular reductions in demand for retail space and (to a less marked degree) office space.
- ▶ A number of UK REITs (see page 29) have been designed to provide relatively secure and growing income. The environment explored in the preceding pages encourages us to point to this sub-sector as offering opportunities for selective investment.

Real estate asset allocation

Specialist REIT assets: historical performance

UK “secure income” REITs performed well – in the latest downturn and through the whole cycle

Good in the difficult times...

We analyse the performance of UK real estate assets generating relatively more secure income (pages 20 to 24) and conclude that such assets registered a 5.6% CAGR total return over 2007-12, vs. All-property at 0.5%.

Turning to the full cycle – 2007 to 2017 (no data yet for 2018), relatively secure UK real estate assets generated annual total returns of 7.9%, “best-in-class”.

UK asset % returns through the cycle: 2007-17

...and good through the cycle

	Average annual total returns
Primary medical assets [1]	7.9
Gilts	6.0
Equities	5.9
All-property	4.9

[1] Our proxy for the broader “secure income” sector
MSCI/ IPD

Source: PHP,

All-property market value increases are running out of steam, as evidenced in the tables on page 16. Empirically, this is not the case for the “secure income” REIT sector. However, despite the progressive slowing in each quarter as 2018 developed, we would still look to this sector. More accurately, we would assess a specific sub-sector, which we loosely define as “more secure income/low risk”.

We have three key hurdles (outlined in questions and answers 1, 2 and 3 below). On each criterion, we are positive for REITs that deliver relatively secure income and that are not overvalued (on a combination of dividend yield and risk-adjusted dividend growth prospects).

Three planks to our positive case

Question 1: Lower-risk assets naturally perform better than higher-risk ones in a downturn, but do they generate positive returns?

Positive returns even in an economic downturn

- ▶ Answer: See table below. PHP invests in low-risk primary health assets. It generated 5.6% positive total returns, on average, between 2007 and 2012.

Safer assets generated positive returns in the bad times

Five-year total property % mean annual returns for PHP and All-property

	PHP portfolio, five years	MSCI All-property assets, five years
End-2007 to End-2012	5.6	0.5

Source: PHP,
MSCI/IPD

- ▶ **Question 2:** Even if lower-risk assets generate a positive return in the “down/risk off” phase, do they beat the market through the whole cycle?

Premium returns through the last cycle (for lower risk)

- ▶ Answer: In the period end-2007 to end-2017, the mean annual total returns in the UK were as follows: primary health 7.9%, gilts 6.0%, All-property (MSCI)

“Secure income” REITs – Safe Harbour Available

4.9% and equities 5.9%. So, yes, primary health did beat returns through the cycle.

- ▶ **Question 3:** How does that plug into ratings in terms of where we are currently with NIYs? Effectively: are investors now paying up for that safety?

Little evidence for a safety cost premium

- ▶ Answer: We develop this point further in the next section of the report (see page 25), but we highlight key data here. They illustrate that PHP's (e.g. the PHP REIT) NIY is only ca.10bps (2%) more expensive than its average through the 2007-18 cycle.

Safer assets are only minimally more expensive than the market as a whole

NIY for PHP portfolio and for MSCI All-property		
	PHP NIY %	IPD All-property NIY %
Average 2007-18	5.5	5.7
End-2017	4.9	5.1
End-2018	4.8 [1]	5.0 [2]

[1] PHP 2019 presentation, [2] Hardman & Co estimate

Source: PHP, MSCI/IPD

Data on 2007-17 returns in lower-risk UK real estate

PHP (REIT): beating other asset class returns and volatility through the cycle

First, what is PHP and why do we outline its returns and volatility in this report?

PHP is a UK REIT, floated 22 years ago. It has always invested solely in UK primary health assets (i.e. local hub health centres). In the past two years, it has extended its reach in a modest and measured manner, to equivalent assets in the Republic of Ireland (RoI).

22-year record

Government-backed, 99%+ occupancy, tenancies ca.13 years unexpired average

Income is effectively fully government-backed, through commercial leases typically of ca.20 years' duration without break, with rents, upward-only, typically reviewed every three years. Occupancy rates, on average, are 99% throughout the lease (PHP presentation). Some forward funding, but no development risk, is taken on.

Primary medical assets are the only significant “secure income” asset tested in the quoted arena through the whole of the previous cycle

So, why do we focus here on this one REIT, in order to give insight into potential future performance in “secure income” REITs? As the longest quoted UK REIT in this particularly secure income sub-sector, it has a long, measurable track record of returns to investors. No defaults have been stated over this 22-year record. We look at this, in terms of both the assets and as regards the share price and dividends. We can also compare this with All-property and with other asset classes such as gilts and equities. This is all historical data – with no forward estimates, views or analysis.

PHP's assets (a close proxy to the primary medical assets as a whole in the UK) have performed as shown in the chart overleaf.

Comparative returns 2007-17 on various UK asset classes

The chart overleaf shows the total returns on various selected asset classes in the period since 2007.

- ▶ The chart assesses total returns of UK assets in 1) primary medical real estate, 2) gilts, 3) All-property and 4) quoted equities.
- ▶ Primary medical assets outperformed all other mainstream asset classes measured from a 2007 baseline, as regards both quantum of return and low volatility.
- ▶ The x-axis charts those returns from the 2007 starting point. It illustrates the returns for 2007-13, and also for 2007-15 and 2007-17. This is to show how investors in each class have fared over the cycle from its latest peak. It also shows how the average return since 2007 has evolved in recent years (the past five years since 2013, to be precise).
- ▶ The y-axis does exactly the same, but also shows the volatility. It looks at the same time periods. Volatility (which we equate here with risk) is charted with the highest ratios on the y-axis representing the lowest risk.

The x-axis is the total return from 2007 to three end-dates, namely 2013, 2015 and 2017. In addition to returns, it illustrates the steady expansion in annualised returns as the current cycle has progressed. This is all historical, public data, as provided by PHP.

“Secure income” REITs – Safe Harbour Available

PHP’s primary medical asset class (PH coded on the chart) demonstrates steadily rising returns and stable, lowest risk, as measured by volatility of annual returns. Gilts’ returns for 2007-13 were the same as primary medical assets; however, while average returns since 2007 have been rising in recent years, those for gilts have not. Average annual returns to investors for primary medical assets were just over 6% in 2007-13 and were just under 8% in 2007-17 (we do not yet have the figures for 2018). For gilts, the returns were just over 6% in 2007-13 and exactly 6% in 2007-17. Furthermore, gilts (as shown on the y-axis in the chart) have exhibited somewhat higher standard deviations of volatility in those periods since 2007.

This chart shows how four asset classes performed. Each is shown as regards the period: 2007 to 2013, 2007 to 2015 and 2001 to 2017. We hope this helps to show the recent evolution of performance trends.

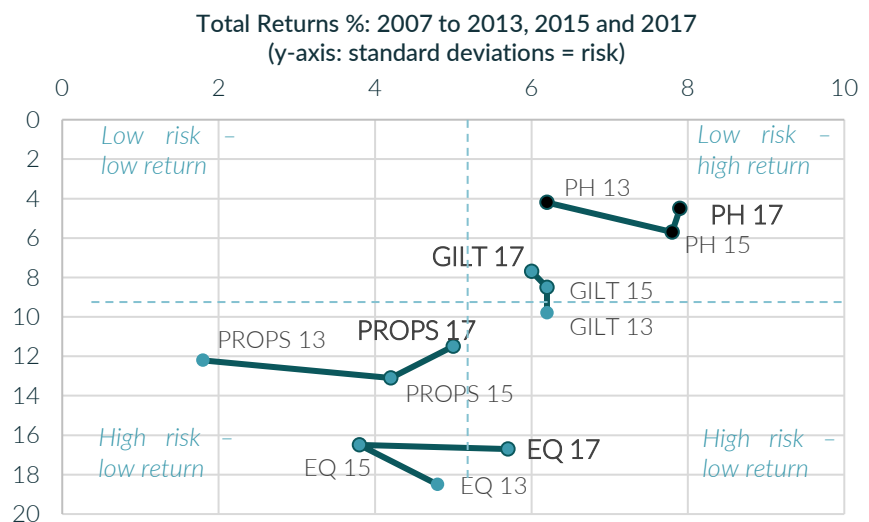
Note that, in the chart below, the nearer the data point to the top-right, the lower the risk and the higher the return (respectively, top and right).

Quantum and volatility of returns on asset classes since 2007

This chart shows how four asset classes performed. Look how well secure assets performed – right through the last cycle.

The line for each is performance from 2007 to 2013, 2015 and 2017

The nearer the data point to top-right, the lower the volatility risk and the higher the return



PH = primary health real estate
GILT = UK government bonds
PROPS = All-property index, MSCI
EQ = UK quoted equities

Source: PHP, IPD, Bloomberg raw data and Hardman & Co calculations

The attractive, top- right, part of the “risk quadrant”

The primary medical assets of PHP are in the attractive, top-right, part of the “risk quadrant” in the chart above.

The chart is derived from a series of tables and charts produced by PHP, with annual data collated into one chart by Hardman & Co, with input also from Bloomberg data. The further to the right the data point, the greater the return since 2007. The higher up, the lower the annual volatility.

Our conclusion is that this shows that primary medical assets (in PHP) are defensively placed, with the lowest volatility, by nature of this asset class. More importantly, it demonstrates that the cycle-long total returns of primary medical assets beat all other asset classes analysed. Further, while it did a little less well in returns in 2013-17, this was at a time when the later-cycle, “risk-on” nature of real estate would naturally boost the less steady-secure type of asset risk profile offered by primary medical.

Returns in the previous economic downturn

In the first five years of the macro downturn, PHP saw a positive real return...

It is important that PHP’s primary medical assets have done well through the whole cycle. However, our investment message is based on the current emerging slowdown in various economic cycles. For this reason, we have referred to the 2007 to 2012 slowdown. Performance in this previous slowdown was 5.6% for PHP’s portfolio vs. 0.5% for the MSCI all-property assets. The case for primary health assets in the downturn and the early part of the cycle is most compelling.

The table above is based on the assets, and the share price returns are better still. Regarding total return on shares, PHP’s was 14.3% p.a., on average, over the five years to end-2012. The same ratio was -6.4% for the FTSE All-share real estate index and 4.4% for the FTSE All-share index (Source: Bloomberg).

...and even better share price returns

Total returns on shares	
End-December 2007 to End-December 2012	% average per annum
PHP	14.3
All-share real estate index	-6.4
FTSE All-share index	4.4

Source: PHP and Hardman & Co calculations

It is noteworthy that PHP has significantly created wealth, rather than merely preserving it. No UK REIT in existence 22 years ago (PHP’s flotation – pre the UK REIT regime) and still operating today has beaten PHP’s total return.

Admittedly, there is a “health warning” on the PHP statistic above. PHP shares fell significantly in 2007. Nonetheless, the PHP share price at end-2007 (75p adjusted for scrip) was still above the level of the shares at end-July 2005.

The above looks at the whole cycle. Were the returns in the more expansive latter half of the cycle poor for this more secure asset-backed investment policy? Investors will decide, based on their required returns, but we contend that the table below shows that the 2012-17 return shortfall at the more secure PHP asset class was modest. We expand on this below.

2012-17 return shortfall for PHP assets was modest

Five-year total property returns for PHP and All-property		
December year-end to five-year period	PHP portfolio, five years	MSCI All-property assets, five years
2007-12	5.6%	0.5%
2012-17	9.1%	11.4%

Source: PHP, MSCI, and Hardman & Co calculations

Keeping pace with the recovery

PHP’s asset returns in more detail: 2007-12 and 2012-17

We highlight two distinct periods of five-year returns (see table above). In the 2007 to 2012 period, characterised by the market downturn, the PHP primary medical property assets generated a 5.6% CAGR. Over the same period, the MSCI/IPD All-property CAGR was 0.5%. PHP’s performance was far more robust in the downturn. Over the period of market growth and rising attraction to risk, PHP’s assets kept pace well: PHP’s property assets generated a 9.1% CAGR, compared with the MSCI/IPD All-property’s 11.4%. Expanding on the detail of data, above, the table overleaf states all individual years from 2011 to 2017.

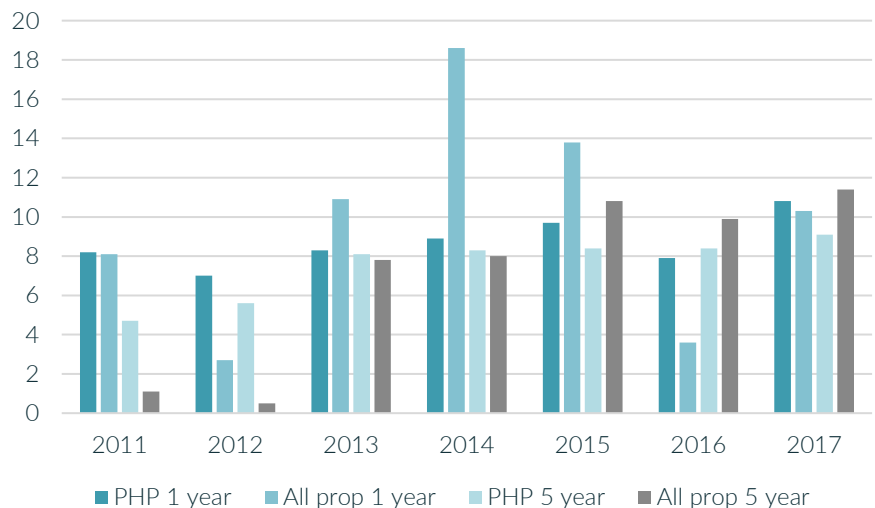
One- and five-year total % property returns for PHP and All-property

	PHP portfolio, one year	IPD All-property assets, one year	PHP portfolio, MSCI five years	All-property assets, five years
2011	8.2	8.1	4.7	1.1
2012	7.0	2.7	5.6	0.5
2013	8.3	10.9	8.1	7.8
2014	8.9	18.6	8.3	8.0
2015	9.7	13.8	8.4	10.8
2016	7.9	3.6	8.4	9.9
2017	10.8	10.3	9.1	11.4

Source: PHP, MSCI and Hardman & Co calculations

The above table is reproduced below in chart format. All-property returns are significantly more volatile.

One- and five-year total % property returns for PHP and All-property



Source: PHP, MSCI and Hardman & Co calculations

Summarising historical data on PHP

We have illustrated the following historical data on PHP.

- ▶ That it has performed much better than general UK real estate over 2007-12.
- ▶ That, in the whole period 2007 to 2018, it progressively returned a higher and less volatile financial performance than other asset classes.
- ▶ That underlying assets are not being priced in at a statistically significant premium to more general UK real estate. There is some logic to expect them to be premium-priced in such a well-performing, low-volatility asset class, now that we seem nearer the mature end of the UK property cycle, but our investment thesis is not based on such a revaluation. We assess prospects from the starting point at which we currently stand. The next section of this report quantifies this.

PHP shares and its primary medical assets performed better than the selected other asset classes between 2007 and 2012, and they also did better between 2007 and 2018. This has not been as a result of a strong asset price premium.

“Secure income” REITs – Safe Harbour Available

PHP has handsomely beaten equities, grade-A bonds and broader real estate indices (all data, UK) over the cycle (see pages 8 and 21).

In a pending recession, secure income has a clear attraction, if it is available at the right price. The attraction of long-term relatively more secure income streams increases as long-term gilt yields fall. The two are a similar asset class. That is a very different matter to any comparison between sector-wide real estate yields and gilt yields, and the risks are very different.

The rating on “secure” property

We note the following for our 17 “secure” REITs (see table on page 29 for more details):

- ▶ a 0.7% share price discount to EPRA NAV;
- ▶ 5.3% average NIY of the underlying assets;
- ▶ a 5.1% dividend yield (4.7% weighted by market capitalisation);
- ▶ loan to value typically 30%;
- ▶ leases typically around 10 years (plus) remaining to break or expiry; and
- ▶ a large majority with rents predominantly growing at CPI.

This report is aimed at the higher-order drivers to the REITs, and only a limited summary analysis of each REIT is provided in the section of this report following our ratings assessment. It should be noted, for example, that student property predominantly has tenancies of a year (or indeed 42 weeks).

One established, “secure income” REIT, PHP, existed in the UK in 2007 – approaching 20 now

Investors seeking UK “secure income” streams in real estate now have a much wider choice than just primary medical assets. In 2007, it was just PHP with the track record. Now, many more REITs are available (see page 29). A problem for those forecasting how a broader range of such speciality REITs might perform is that the latest cycle (from 2007) had only primary medical assets in this whole REIT universe. Further research is required into each sub-class – from care to warehousing (alphabetically). This report focuses on the established proven track record of that primary medical assets class, in order to make a springboard for analysis of the sub-sectors subsequently.

Lower-risk real estate is not being priced too expensively

The rating risk in primary health assets (which we use as a proxy for “low risk real estate”) appears modest. With a maturing cycle, there would be some justification for a “low-risk” premium to attach to the assets and the shares. Such a premium does not currently exist. The table below states PHP’s NIYs.

The assets in which PHP typically invests are not on measurable premium prices to the average wider market

NIY for PHP portfolio and for MSCI All-property		
	PHP [1] NIY %	MSCI All-property NIY %
Average 2007-18	5.5	5.7
End-2017	4.9	5.1
End-2018	4.8	5.0 [2]

[1] Data provided by PHP; [2] Hardman & Co estimate Source: PHP, MSCI

The valuation basis on primary health assets is very similar to the broader market. There is a small premium (i.e. lower NIY) currently attached to the lower-risk assets, but it is no more than the whole-cycle 2007-18 average, which, in any case, is only ca.10bps (or 2%) within the “margin of error”.

We take primary medical assets as a proxy for the premium attached to established, relatively secure asset classes. Most of the assets in our 17 UK quoted REITs are residential, or logistics-/health-related, and each needs individual attention as to its covenant strength, future income stream volatility, growth and asset and share price rating. However, the table above, in our view, is an important cornerstone to our

confidence that we are not in an environment where lower-risk real estate is being priced too expensively.

NIY for average of the 17 REITs and for MSCI All-property

17 REITs have a higher asset yields vs. the market...

	Median NIY %, 17 REITs listed in this report	MSCI All-property NIY %
End-2018	5.3	5.0 [1]

[1] Hardman & Co estimate
Source: REITs' presentations, reports, MSCI

Total % returns, UK property by sector

...a higher dividend yield than the broader UK REIT sector...

Sector and sub-sector data	Current-year data
Dividend yield	
UK Real Estate sector	4.3%
17 REITs in this report (unweighted)	5.1%
Share price premium vs. NAV	
UK Real Estate sector	-14.0%
17 REITs in this report	-0.7%

...but a LESSER discount to NAV vs. the broader sector

Priced FTSE 350 Real Estate sector index 521
Source: Hardman & Co Research, IPD database, Bloomberg

Even at the current 14% discount to NAV, the broader sector offers a significantly lower dividend yield of 4.3%, vs. 5.1% for the 17 REITs we assess here. It should be noted, however, that the 5.1% figure includes some more recently floated REITs' last half-year annualised run-rates. It should also be noted that, with a number of the 17 REITs in our report floated as recently as 2017, the deployment and the commencement of dividend payments has been on schedule (bar one stock). The larger “secure” REITs tend to have lower dividend yields currently.

Conclusion

18 REITs have every chance of providing good, real returns to shareholders, we consider

Even at the large discount to NAV offered by current share prices, the large cap/legacy-conversion REITs still offer significantly lesser dividend yields than the 17 REITs in this report. These income-focused REITs are more effectively replicating direct commercial real estate, where the majority of total returns in the past has been (and, we anticipate, will continue to be) from income.

The 17 REITs' share prices trade at a modest discount to NAV. That NAV is based on a 5.3% average NIY of the underlying assets. With an element of financial gearing and the costs of running the REIT – and average share prices almost exactly in line with EPRA NAV – this 5.3% NIY translates into a 5.1% dividend yield (lower on a weighted basis). With average loan to value (of the debt) typically 30%, and with leases typically around 10 years (plus) remaining to break or expiry – the large majority with rents predominantly growing at CPI – we believe such structures have every chance of providing good, real returns to shareholders.

Risks

- ▶ Real estate, by its nature, has risks of ownership, but a crucial series of risks comes from the liabilities side of the balance sheet.
- ▶ Refinance risk (when lines of credit mature) are minimised if the borrower has a wide range of possible sources of finance. Accounts state all finance break/termination dates. By their nature, assets with long-term, relatively secure (high-covenant) income streams will be preferred by lenders.
- ▶ Fixing interest costs may prove onerous if the rate struck proves to be above future market rates. However, this does not affect the cashflow beyond what was budgeted when the debt was taken on. What has proved a risk in the past is when debt interest costs have been fixed by hedged instruments, and that debt is then repaid before the end of the hedge. In a different incarnation, this proved a difficult factor for Assura, for example. In contrast, virtually no income received by the 17 stocks covered in this report is not in Sterling – so currency mismatch to assets is not an issue.
- ▶ Some of the more subsector-allocation managed funds (AEW, LXI) and some of the warehouse owners, for example, do enhance returns through capturing value created by asset management programmes or well-timed and priced purchases. No REITs in this report rely on such uplifts to support dividends.
- ▶ The younger REITs are still in the investment phase. Many (the 2017 cohort) have invested all equity and are now investing debt finance. This means that a limited number has a limited proportion of income required to pay the target dividend mentioned in the IPO Prospectus still to be secured. It is important that assets are bought for intrinsic value (and value to occupiers hence not over-rented).
- ▶ REITs listed here undertake no (or very limited) development risk. Some (e.g. BBOX) are now enhancing their NIYs through undertaking their own development. This has some risk, but it does not rely on selling the asset created to a third party.
- ▶ Naturally, all the REITs rely on their tenants paying rent. Nonetheless, in terms of accounting *transparency*, this is all very clear. Either they pay or (in a *de minimis* number of cases) they do not. This is reflected immediately in the cashflow and reported in the results as announced. There are no issues, anywhere near a size that could be registered at all, of recognition of trade debtors and creditors, and there are no revenue recognition policy issues. That said, the care homes are very clear in the recognition of fixed increment rental contracts and how the accounting standards require non-cash accounting. This affects others with fixed rising rents, but the mismatch (mandated by accounting standards) between accounting and cash income is minimal – indeed, it is almost irrelevant. There are *de minimis* late payers, too.
- ▶ There are no pension fund liabilities, and management contracts are clear and simple (including contingent termination costs). In addition, expenses and uncovered property service charges or business rates are not serious issues. If there are “machines needing to fuel growth”, they are all very clear. The REITs are designed to match the performance of the underlying assets. That said, Empiric and MedicX (subsequently merged into an enlarged PHP) used to over-distribute, but they no longer do so. The dividend growth is matched to the underlying growth generated by existing rental contracts, although, naturally, the leases do end after a varying number of years. That is why over-rented assets are dangerous things and markets can change.

The UK “secure income” REITs

The 17 REITs covered in this report have risen over 12 months, but only by 2.3%...

...while a 3% sector-wide fall has been registered

Small discount to NAV

Much less volatile

We identify 17 quoted REITs in the UK investing in assets with lower-risk characteristics. We propose to publish more detail on each in a subsequent report. We summarise some key investment characteristics. Not all should yet be considered fully “safe harbour”.

Share price-related data

FTSE 350 real estate sector index change in past year	-3.0%
17 REITs in this report	
Unweighted share price change in past year [1]	+2.3%
Weighted share price change in past year [1]	+2.7%
Unweighted average historical dividend yield [1]	5.1%
Unweighted average share price/NAV [1]	99.4%
Market capitalisation [1]	£10.88bn

[1] Data for 17 REITs in this report. Share prices to 13 March
Source: Companies, Bloomberg, Hardman & Co calculations

We look for transparent, fully covered, progressive dividends. Note that a number of these REITs have been floated in the past two years, and are therefore in asset deployment phase.

How lower-risk real estate beats other assets

In calendar 2018, the average “secure income” REIT share price fell 2.9% in contrast to fall of 7% in the FTSE 350 Real Estate index. At the 27 December 2018 low-point, it was worse for the index, which was down 18% in a year. This, we consider, has dragged down performance and ratings in the “secure” sub-sectors but they have shown a strong bounce back.

We point to the important considerations for investors seeking moderate-risk, real returns through investment into selected REITs. This should ensure the bounce-back is more than that – a start of a sustainable, positive total return.

We ask four key questions:

- ▶ What are the returns over the cycle (from the 2007 peak) for this particular asset class? (See previous section of this report – chart on page 21.)
- ▶ What is the NIY on the underlying assets (with REITs being designed to pay out ca.90-100% of EPRA income (See pages 4 and also 36 for stock-by-stock data.) EPRA income excludes revaluation gains.
- ▶ What is the trend in risk-free yields (e.g. 10-year US treasuries or UK long gilts)? (See page 15.)
- ▶ How secure are the long-term returns on the underlying assets? (See page 30 onwards.)

Having outlined the case for the first three points, we now turn, stock-by-stock, to the fourth. So, we turn to this last question and provide a little more detail on each REIT and each sub-sector in the following section.

Details and metrics on quoted “secure income” REITs

Key investor statistics							
REIT	Ticker	Main asset class	Share price (p) *	Historical year (or half-year annualised) dividend (p)	Historical dividend yield	Historical EPRA NAV ** (p)	Share price/historical NAV
AEW UK Long	AEWL	Managed property	90	5.5	6.1%	97	93%
Assura	AGR	Primary medical	57	2.7	4.8%	53	107%
Civitas Social Housing	CSH	Social housing	98	5.0	5.1%	106	92%
Empiric Student	ESP	Student accomm.	95	5.0	5.3%	106	90%
GCP Student Living	DIGS	Student accomm.	154	6.1	4.0%	158	98%
Impact Healthcare	IHR	Residential care	104	6.0	5.8%	102	102%
LXi	LXI	Managed property	123	5.5	4.5%	113	109%
PHP	PHP	Primary medical	123	5.4	4.4%	105	117%
The PRS REIT	PRSR	Open market housing	102	5.0	5.0%	96	105%
Residential Secure Income	RESI	Social housing	93	5.0	5.4%	106	88%
Secure Income	SIR	Hospitals, leisure	405	13.9	3.4%	401	101%
Supermarket Income	SUPR	Supermarket grocers	102	5.5	5.5%	96	106%
Target Healthcare	THRL	Residential care	116	6.6	5.6%	107	108%
Triple Point Social Housing	SOHO	Social housing	101	5.0	5.0%	102	99%
Tritax Big Box	BBOX	Distribution centres	141	6.7	4.7%	152	93%
Urban Logistics	SHED	Urban warehouses	120	6.0	5.0%	129	93%
Warehouse REIT	WHR	Urban warehouses	101	6.0	6.0%	106	95%
Unweighted average	-	-	-	-	5.1%	-	99.4%

* As at 13 March 2019

** Where appropriate (e.g. DIGS and others) NAV is stated ex-div.

Note: 5.0p PRSR dividend is a target for year to June 2019

Source: Company data, Hardman & Co Research

Note that we have referred to one of the attributes of the sector as a generally efficient management cost structure. In this regard, it is noteworthy that a recommended merger between PHP and MedicX has been completed (March 2019). An efficient combined management cost structure reduces the merged entity’s EPRA cost ratio (as stated by PHP). PHP has stated a £4m p.a. run rate cost saving within a year.

Calendar 2018: a difficult year for stock market investors in real estate

The “secure income” sub-sector proved its worth, we consider.

- ▶ Down 2.9% vs 7.0% for the FTSE 350 real estate index:

In calendar 2018, the average “secure income” REIT share price fell 2.9% (in contrast to a rise of 2.7% in the 12 months to 13 March 2019). But the FTSE 350 Real Estate index fell 7%. At its low point (27 December), the index was down 18% year on year.

Even so, investors looked to have lost some of their nerve in the darkest December 2018 days as regards the strong last mile logistics sector. Share prices here succumbed more (and have bounced back strongly) than certain other sub-sectors, but significantly less than the broader sector.

Key investor statistics, continued

REIT	Commentary on table above
AEW UK Long	AEWL invests in a range of UK sectors, with scope to rotate over time, accruing value. A focus is on ultra-long leases.
Assura	AGR invests in UK primary medical assets, slightly smaller in average value than PHP and MXF, its peer group. [1]
Civitas Social Housing	CSH invests in supported housing, providing life-time secure, bespoke configured buildings, each with 5-10 flatlets. [2]
Empiric Student	ESP invests in purpose-built student accommodation (PBSA). An asset management efficiency drive is paying off. [3]
GCP Student Living	DIGS invests in PBSA, involving an element of development and at middle/upper-end cost range, south east UK. 14% EU; 23% UK; 63% other overseas students. 30% postgraduate. [3]
Impact Healthcare	IHR invests in care homes, with a focus on funding the expansion of existing, successful operators' businesses. [4]
LXi	LXI invests in various “secure income” sectors. It has one of the stronger NAV uplifts of the more recent IPOs. [7]
PHP	PHP invests in UK primary medical assets, expanding into Rol. 22-year track record is longest of its peer group. Note the 14 March 2019 completion of an all-share merger with the listed MedicX Fund [1] [8]
The PRS REIT	PRSR invests in new-build open market houses to rent. [5] [9]
Residential Secure Income	RESI invests in UK Social Housing, with focus on Shared Ownership, Local Authority, Retirement Housing.
Secure Income	SIR invests in mid-market hotels, and leisure and other assets with long leases. 90% UK. TSR ca.25% since IPO. [10]
Supermarket Income	SUPR invests in supermarkets. Assets' ranges of NIYs are wider in this “secure income” type than others.
Target Healthcare	THRL invests in care homes. [4]
Triple Point Social Housing	SOHO invests in supported housing: life-time secure, bespoke configured buildings, each with 5-10 flatlets. [2]
Tritax Big Box	BBOX invests in large-scale logistics hubs. Holds an amount of development land (ca 7.5% yield on development cost). [11]
Urban Logistics	SHED invests in medium-sized logistics assets. Hands-on management and good purchase yields have delivered one of the stronger NAV uplifts of the more recent IPOs. Forward funding is undertaken. [6]
Warehouse REIT	WHR invests in medium-sized warehouses/multi-lets: hands-on asset management and crystallising value uplifts. [6, 12]

Notes [1 – 12]: see section immediately below
Source: Hardman & Co Research

Investor commentary on each asset sub-sector

Primary medical

Note 1

[Note 1] The recent merger of PHP and MedicX Fund, completed 14 March, creating an entity with approaching £2.4bn investment property assets owned.

Primary medical: the investor value driver is the ultra-long, upward-only lease income. The quantum of rent rises, however, has been “unexciting” in the past few years, effectively throughout this decade. This gives rise to scope for current acceleration. Some rents are CPI-/RPI-linked or fixed increments, but we calculate open market rents as being only ca.5% above where they were five years ago (based on public data from Assura, MedicX and PHP results statements), and we estimate barely double figures up since the 2008 global financial crisis. Why would that crisis affect this sector? There is a need to see new stock brought to the market, which means developers developing new stock. The developer costs (land plus labour and materials) fell post 2008 (especially land). The source is data from housebuilders, commercial developers and valuers such as Savills.

Rents are upward-only, contractually, as stated by Assura, MedicX (since March 2019, part of PHP) and PHP. (For single-figure percentage of total income received by PHP from their Rol investments, the income is in part linked to Rol CPI upwards or downwards. Further, sub-10% income is from pharmacies co-located in the

building – as stated by PHP.) It has taken until very recent years for the rise in land and build costs to catch up with this upward-only rent. (Our land cost input is from various sources, including Savills.) This has now happened (Hardman & Co calculation) and so, in order for developers to continue to bring the much-needed stock to fruition, logic would dictate that rent rises have to modestly accelerate.

Background: demand is driven by a generally out-dated estate of converted houses in the UK and Rol. GP practices are tending to consolidate into larger entities and tend to have more services (diagnostics, screening), which can be taken out of hospital contexts. More importantly, these are localised hubs, at the centre of the delivery of medical services to the local community. The demand is a function of the local community size, the nationally ageing demographics and also the stated (Government, NHS reviews of 2019, 2018 and prior years) desire to emphasise taking some services performed currently in hospitals out into community primary medical assets.

Both the UK and the Rol governments have publicly committed to investing in this sector, supported by demographics and the lesser cost and greater flexibility of primary versus secondary (hospital-based) for certain common types of service delivery. The NHS five year plan where pertinent to primary care is referred to in this document: <https://www.england.nhs.uk/five-year-forward-view/next-steps-on-the-nhs-five-year-forward-view/primary-care/>

The sole financial interaction from governments to PHP is through rental payments on lease contracts, obviating any complexity and giving full transparency as to flow of funding. The private sector has always had a role in the NHS. 40% of GPs are self-employed, they are part of the private sector. The NHS is a co-operative between the public and private sectors.

Note 2

Supported housing

[Note 2] The main driver to value, we think, is the occupants’ perceived outcomes and the value proposition. The latter is referenced below. Over time, some commentators claim it is possible that this sector will expand and delivery efficiencies increase. However, we note that each patient has his/her own personalised needs, and this is a fairly bespoke product. Selectivity in purchase of assets is important, and the main driver, by far, is ranking how attractive they are to those who ultimately pay the rent of the occupants: the local authority commissioners. The quoted REITs all confirm their selectivity on purchasing assets whose room/flatlet rents are no higher than the local median.

This is a sector that offers ultra-long, upward-only lease income, provided (not guaranteed) by the government. Leases are typically to specialist, and thus smaller, Housing Associations. The total costs by (third parties) delivering care through these assets are significantly below other (more traditional) asset-located alternatives. The vulnerable occupiers remain in these properties for the long term. So, compared with primary health assets, while there are differences, there is a similarity in that regard. Both are replacing assets that are offering poorer outcomes. Note the difference in NIYs on the assets.

Note that RESI does not invest in this asset class.

Background: the National Housing Federation predicts the shortfall in supported housing assets to increase by 86% between 2015 and 2020. Supported housing is compelling, due not only to the quality of life it can afford occupants, but also because of the potential cost savings for local authorities. Research recently commissioned by Mencap (a leading UK charity for people with learning disabilities) showed that demand for new supported housing properties is expected to grow over the next 10 years. The report (referenced by Triple Point) found that it costs, on average, £1,596 per week to house and care for a person with learning disabilities

living in supported housing, compared with £1,760 per week for a residential care placement and £3,500 per week for inpatient care.

Note 3

Purpose-built student accommodation

[Note 3] Purpose-built student accommodation (PBSA) is in a long-term growth trend. This is driven by rising numbers of students, an element of obsolescence in PBSA stock in some locations owned by the universities (who wish to invest in education, not real estate), regulatory pressure on houses in multiple occupancy, and prospectively a rise in the number of 18-year olds in the UK (after declines in the past decade). Even five years ago, this sector asset class was not regarded as “mainstream”, so, as is noted in the table below, the sector NIY has now reduced to a 4.8%-5.7% range for the quoted stocks.

The two stocks we discuss in this sector, ESP and DIGS, have divergent strategies. ESP has expanded into a wide range of locations and is now honing efficiencies, including the trade-off between in-house and outsourced management of the assets and occupants. Without much attention, the gross-to-net leakage of income in this sector is higher than general renting of modern assets. DIGS’ assets are concentrated at somewhat higher room rents. 76% of DIGS’ tenants are non-UK, including ca. 20% EU.

Background: this is a growth market, but rents are not upward-only; it just so happens that, to date, they have been for many years (and held up well post 2008). One potential risk is that the occupancy of PBSA is slightly flexed to international students. The UK does well. It has 10% of the global international student market (Source OECD; Watkin Jones). This is second only to the US, where degree costs are significantly higher, and above Australia’s 6% share, where costs are higher too. One risk from Brexit is not only fewer European students (who comprise 7% of the total UK and somewhat more of PBSA), but also fewer non-EU students who seek a UK visa as a hassle-free door to some years’ visiting Continental Europe. The market has pluses and minuses, but does not seem overly-exposed to shifts in supply-demand and is favoured by regulatory trends. Pricing and minimal voids (with houses in multiple occupancy being more in the marginal supply-demand swing sector) seem benign.

The number of student purpose-built bed new beds delivered in the year rose to 31,248 in 2018: a record (source: Cushman & Wakefield). This strength in supply appears set to continue into next year. Knight Frank research indicates 29,000 beds to be completed in 2019/2020, up from a more modest 23,000 forward delivery plans a year ago. Knight Frank also notes that “Affordability will remain a key focus for owners, operators and students and our analysis shows a shift in development towards shared accommodation. Schemes that provide clear and obvious elements that add value will attract the strongest demand.”

Note 4

Care homes

[Note 4] Care homes: this is a significant growth sector with regard to the stock market. Impact Healthcare (IHR) rightly highlights that its philosophy is to work in long-term partnerships with selected tenants. This means that there is an element (controlled) of development – added extensions, for example. This is not asset management solely, but IHR does bring asset management as an inherent value creator. This brings risks and rewards, as does the market-funding trend we outline below. We highlight that both IHR and THRL (Target Healthcare) take income from long-term leases, not from occupiers. They do not take a risk on occupancy (albeit, of course, occupancy and operating margins drive the tenant covenants). It should be noted that THRL has an uncovered dividend, which relates to the effects of cash drag, as it patiently builds its portfolio. They have recently indicated the intention of using more debt to minimise this impact and expect to be paying a covered dividend for the year to June 2020.

Note that we do not list Caretech (CTH) in the “secure income” REITs above, as it operates care pathways through five divisions. Some of this is asset-heavy residential care, but the company could be best classed as an “opco-propco balance sheet model”. Its business, covering adult learning and disabilities, mental health, young people’s residential services, foster care and learning services, has an indirect overlap with care homes. CTH has more of a focus on growth, as well as income stock.

Background: Care homes have differing NIYs based on the quality and positioning of the homes in the local markets they operate in. There are three distinct classes of care homes, Modern purpose built homes complete with wet rooms for every bedroom, (called in the sector market Standard) around 20% of the market, older homes sometimes conversions of older homes sometimes purpose built, but usually less well laid out and with en-suites which are no longer market standard, ie they only have a WC and Wash Hand Basin, around 60% of the market, and even older homes whose bedrooms are smaller and have no en-suites at all for a final 20% of the market. These latter homes, often smaller are exiting the market. Government austerity has constrained the public pay market, and private pay is predominant among operators of the top 20% of the stock, and public pay percentages tend to rise as the quality of the asset declines. NIY’s for the 3 classes of homes vary between 4-6% for market Standard, 7-8.5% for the middle product and above this for the exiting stock. THRL invests in the market standard product, with almost 100% of its rooms wet room provided, whereas Impact has a high percentage proportion of wet room bedrooms, and nearly 40% of the rooms with no en-suite facilities of any kind, hence the need for asset management.

Note 5

Open-market family rental houses

[Note 5] Purpose-built rental homes on open market rents: residential is the dominant UK real estate class. However, only 0.5% of total UK real estate comprises privately rented property held by non-buy-to-let investors – the institutions. The largest quoted REIT (by a country mile and more) is The PRS REIT (PRSR). PRSR takes all the occupancy and rent risk. However, it has a strong relationship with a developer, Countryside (and some other developer partners), and is acquiring assets on the NIYs listed in the tables below. These NIYs are driven by a number of factors. The developer receives consideration upfront by PRSR, and so PRSR can unlock a larger site both financially and operationally, with a portion of the site built and occupied at the earliest stage.

The NIYs – by definition – are driven by costs and rents. Average rents required to drive such NIYs are ca.£760 a month for a family house, affordable at or somewhat below the UK national mean income. The valuation per property – these are well presented, efficient, pleasant new houses (small minority of apartments) – is below the open market vacant value and also somewhat below the UK national average. The NIYs are driven by the net yield, and the gross-to-net rent ratio is a most important factor in residential. As this (very much) emerging asset class becomes more familiar to valuers, and as the managers build experience and data bases, it is becoming evident that large, efficient operators of new assets are achieving strong gross-to-net ratios.

Optimising gross-to-net rent ratios is crucial as regards rolled-up cash income and the valuation basis of the assets. We believe, ultimately, that these ratios are heading from the more typical 25% “leakage” levels regarded normal by established operators (including in the US), towards 22.5% as best-in-class. PRSR, being predominantly comprised of housing, is targeting 22.5%, and is currently well within this budget. With rents appearing affordable to a large target clientele and the possibility that net rents could outperform headline rent growth – with valuations assisted as the emerging asset class is understood better – this is a new type of residential asset, which appears to possess command of a “following wind”.

PRSR rents are affordable. They stand at ca.30% of the household incomes of the tenants and, of course, are fully competitive in the open market, and are not subsidised by the Government. Any newer class does exhibit inherent risks, and the individual estates are not immune from the possible competition of cheaper or larger houses, without the benefit to PRSR of long leases. There is, however, every likelihood that tenants (predominantly families) do not move often. Moves, or “churn”, are a risk on upside and downside, and experience so far on re-letting speed and rates is favourable.

Open market family housing outside the southeast of England is a distinct market segment. By contrast, London rents may be considered less affordable. Mayor Khan has indicated exploratory consideration of rent controls (see, for example, *Property Week*, 1 February 2019).

Background: the UK residential market value is calculated at £7.8tr (Green Street Advisors, ONS.), while commercial stands at £0.88bn. Out of the £7.8tr, 19% is privately rented (i.e. more than 16% of all UK real estate is in private rented), but, of that, ca.3% (i.e. 0.5% of total UK real estate) is privately rented institutional (i.e. not buy-to-let or other “individual owned” lets). This is a potentially huge market.

Mortgage providers may lend no more than 15% of new mortgage contracts, in a given quarter, at a loan-to-income ratio of over 4.5 times, due to controls imposed by the Mortgage Market Review (Sources: CML and PRSR). However, the median household income to the median house price now stands at almost eight times. Mortgage deposits have also become a hurdle to ownership – now at approximately 19% of the purchase price. This represents more than 60% of annual household income. In the 1990s, buyers typically needed a 5% deposit, representing ca.12% of household income. It is counter-cyclical. When the market to develop and sell homes suffers reductions in demand and or confidence, land prices fall. Developers of purpose-built rental homes can secure land at cheaper rates and still make acceptable margins by selling to operators such as PRSR more cheaply. In this scenario, however, rents are usually not affected – and the preference of “consumers” for renting rises.

Thus, while PRSR is not – in our view – in danger in a strong market for house prices, it can expand on better returns when the market is less buoyant; hence our comment earlier regarding dividends vs. NAV. The rental market is counter-cyclical; in a downturn, residential rental demand tends to increase, and asset creation costs tend to moderate, as land values and other costs may reduce.

It is worth noting that “institutional” owners are growing fast in percentage terms, from a very small base. The buy-to-let market is still by far the biggest. Here, ca. 75% of owners own one or two properties (only). For an insight into the so-called “professional” buy-to-let owners, the lender Paragon reported strong lending on 28 January. New lending in the three months to end-December 2018 was 140% of the comparable in the prior year. 64% of its lending was to the buy-to-let “professional”.

Note 6

Medium-sized and ‘last-mile’ logistics hubs

[Note 6] Structural changes are significant positives here, and have further to go, with e-commerce and modern technology driving demand. Supply constraints are significant as, in most locations, new build costs are still above market values. The sector rewards more active management, including taking an “enhancing of occupancy” view at the time of purchase, and being “hands-on” with multi-let, modest-cost asset enhancement (based, for example, on presentation of the estate). In its 5 February statement, WHR stated for 4Q’18: “the Company completed fourteen new lettings and seven lease renewals across 121,000 sq ft of space, achieved at 14.2% ahead of 30 September 2018 ERVs.”

Rents generally are well below £10 per square foot, and building new assets – even if land is found and at the right price – is not yet viable. For example, the WHR portfolio is valued, on average, at £65 sq ft, vs. ca.£91 sq ft for the current re-build cost. This is in contrast, now, to some larger logistics asset locations (e.g. BBOX undertaking value-add new development). These logistics parks achieve higher rents per area and also command a lower capitalisation yield, because of the length of leases and covenants of the tenants. See section below, on logistics.

This structural change, allied to the fact that much stock trades at below replacement (with land) cost, is a compelling factor on which to focus attention. We list below some market-dynamic headlines. Another compelling factor is that the NIY on both SHED and WHR (Urban Logistics and Warehouse REIT, respectively) is 6% or more. This is also quite an active investor market, with a workable lot size. It offers the scope to take value gains on a granular basis. Both the above REITs have done this. Value can be locked in by using expertise to secure under-rented or void assets and then optimising income.

Background: the impetus to demand remains, naturally, the online retail sector, which, at 5.6m sq ft in 1H'18, represented 32% of overall market take-up. 1H'18 saw more take-up than the whole of 2017 (17.42m sq ft vs. 17.26m sq ft), despite the backdrop of some weaker economic data on the retail side of the UK economy. UK take-up (Savills) reached provisionally 34.1m sq ft in 2018, a 32% increase on 2017. This compares with a long-term average of ca.20m sq ft. It is not in the "super shed" market, where the demand for space is greatest. The most significant "space race" going forward is set to be focused around urban locations. Radius Data Exchange shows that units of ca.45,000 sq ft have been taken up with greater intensity recently; growing from 54% to 61% of overall letting activity this year. (Data sourced via Urban Logistics REIT.)

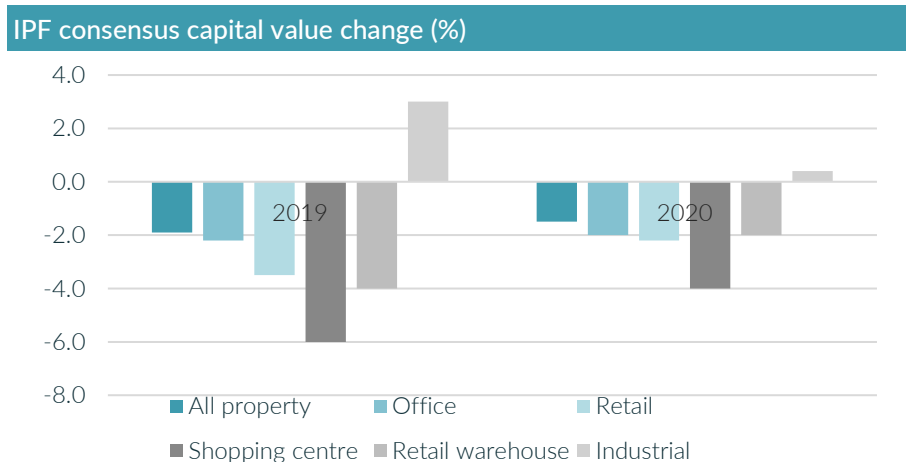
This is a liquid market. As Warehouse REIT stated in its 5 March update on the pipeline of acquisitions: the "Company continues to see opportunities to purchase assets at prices below replacement value, with the potential to secure robust and growing income streams which can be distributed to shareholders through the Company's quarterly dividend programme. Occupational take-up remains resilient... Tilstone Partners Limited, on behalf of the Company, continually reviews the market for potential investment opportunities, typically involving a potential pipeline of £1 billion over a 12-month period, with in excess of £2.5 billion of assets screened during 2018." This active market benefits all participants, including Urban Logistics REIT among the quoted players. This liquidity is a key component of the alpha created by both SHED and WHR.

Logistics

The NIY on large, modern logistics hubs is some way below that of the urban logistics (small-medium assets). This does not mean they are worse value, but it does throw total return requirements more onto the valuation element. BBOX is a large player in this sector, as is London Metric (LMP) BBOX's NIY stands at 4.4% and LMP's at 4.3%. An important contrast between BBOX and SHED and WHR is the length of the average lease, at 14.4 years at BBOX's leases are, much longer than SHED and WHR. We note the recent equity fund raise by BBOX to facilitate an acquisition and expand new building.

Our investment rationale is the long-term secure nature of the rental expansion, not short-term movements either in rent markets or capital values. In the context of logistics, it is relevant to note the stand-out performance anticipated at least for this year and next. IPF states the consensus rental growth year-on-year for industrial and logistics at 3.0% for 2019 followed by 2.7% for 2020. This compares with 0.2% for All-property this year, followed by 0.7% (with regional offices and industrial/logistics the only commercial rental-growth sectors) in 2020.

Data (Cushman & Wakefield) for Q1-Q3'18 shows take-up in 2018 rising 95% to 22.1m sq. ft., albeit availability is up also, a more modest 21% to 28.7m sq. ft. In the largest region, however, Q1-Q3'18 shows take-up in 2018 increasing by 79% to 4.5m sq. ft., and availability up 49% to 6.5m sq. ft. These data series refer specifically to warehouses over 100,000 sq. ft. in size.



Source: IPF

Unquoted REITs

Very much worth a look

A number of interesting and well-established, growing non-quoted REITs operate in this more secure income sub-sector. We would draw attention to this avenue open to this non-quoted investor-class.

Share price performance and the “security” of leases, assets and funding

Share prices and leases, assets and funding “security”							
REIT	Market cap (£m)	Share price (p)	Price, % change past year	Lease remaining, years to break	Debt maturity, years (see note)	Asset EPRA NIY	LTV historical or prospective target [*]
AEW UK Long	73	90	-7	27	7	5.5%	30% [*]
Assura	1368	57	-2	12	8	4.8%	30%
Civitas Social Housing	610	98	-5	25	Modest debt	5.8%	30% [*]
Empiric Student	573	95	13	1	8	5.5%	31%
GCP Student Living	634	154	9	1	6	4.7%	26%
Impact Healthcare	200	104	0	20	5	7.5%	35% [*]
LXi [note 7]	435	123	20	23	12	6.0%	30%
PHP [note 8]	1365	123	10	13	8	4.8%	48%
The PRS REIT [note 9]	508	102	0	4 [note 9]	Modest debt	5.2%	35% [*]
Residential Secure Income	158	93	-6	7**	Modest debt	5.0%	50% [*]
Secure income [note 10]	1297	405	9	21	7	5.1%	43%
Supermarket income	188	102	1	19	4	4.9%	35%
Target Healthcare	449	116	6	28	4	6.4%	6%
Triple Point Social	356	101	0	29	Modest debt	5.3%	30% [*]
Tritax Big Box [note 11]	2407	141	-3	14	4	4.4%	27%
Urban Logistics	102	120	1	5	5	6.0%	37%
Warehouse REIT [note 12]	168	101	1	4	4	6.2%	37%
FTSE 350 Real Estate index	-	-	-3	-	-	-	-

Note: Debt maturity: Residential REITs are in strong expansion phase: debt lines typically 10+ years’ duration, only modestly drawn; Note [*] Prospective target once fully invested

** Effectively lifetime security for retirement and ca. 7 years for the Local Authority portfolio
Source: Company data, Hardman & Co Research

We turn (notes to table page 30) to specific REIT-related points, the focus being on background information on fund raises and deployment.

Note 7

With reference to LXi

The NIY on acquisitions averages 6.0%. Recent (7, 28 January) disposals generated 23% and 19% annual IRRs, not untypical of rates achieved on recycled LXi capital.

Note 8

With reference to PHP

The all-share merger of PHP and MedicX REITs was announced on 24 January 2019 and has now completed, with MedicX shareholders receiving new PHP shares. This increases the conjoined ‘fire power’ to execute growth investment plans, in structure with even greater efficiency. The gross assets (table overleaf) include £807m historic assets within MedicX now owned by PHP. All PHP figures have been adjusted to merge with MedicX pro-rata. All data is based on historic data and ratios (e.g. LTV), but is MedicX and PHP data merged (bar share price, which is PHP performance).

Note 9

With reference to The PRS REIT

PRSR is rapidly deploying funds and has arrangements for a significant committed pipeline of developments from Countryside and other housing developers, funded by PRSR. Admittedly there have been slight planning-permission related delays. Nonetheless, growth is high and the move through development (no risk is taken) through to ‘on-rent’ is highly visible and progressing fully to plan. Gross assets totalled £121m end-June 2018 and £269m end-December. As such, the particular historical data we summarise in these tables on the REITs assessed is not reflective of the secured pipeline, nor of the ongoing expansionary prospects. Adding the contracted sites (i.e. a more conservative assessment than the full current pipeline) £603m capital (£530m at the previous update) has been committed. Note, also, we estimate that a typical tenancy would be for four years (or longer). This is an estimate, but annual renewal rates are 88%: these are families over half with children at local schools.

Note 10

With reference to Secure Income REIT

The Secure Income REIT had a three-month cash drag on a £315m equity placing, which affected the historical EPS and dividend per share (which is driven off the EPS). Our 6% dividend growth figure is an adjusted figure excluding this effect. Its portfolio benefits from fixed uplifts on 48% of passing rents and upwards only RPI-linked reviews on 52% of passing rents.

Note 11

With reference to Tritax Big Box

To fund an acquisition and future growth, including expansion into new developments, a £250m equity placing and open offer has been proposed (24 January). The company has announced the issue of 192.3m new shares at 130p. Neither these new shares, nor the asset acquisition (yet to be completed), are included in our data, as these are future events. This will have some EPS drag in 2019 and 2020, but still with dividends over 100% covered by EPRA EPS. It is worth noting that while the NIY is 4.4% at valuation, it is 5.5% at cost (excluding Dartford).

Note 12

With reference to Warehouse REIT

Warehouse REIT, on 12 March, announced a proposed equity-raise of up to £100m. Interestingly, the raise is at a 2% premium to the previous closing share price. The company had increased its target dividend for the year ending 31 March 2019 to 6.0 pence per share from 5.5 pence, as set out in the prospectus issued in connection with the IPO. Payment is due 28 March for new placing and open offer stock.

Expansion and dividends

The table below should be taken as a broad-brush guide to possible dividend outcomes. It should also be used to recap on a sober assessment that many of the REITs referred to in this report are less than five years’ old. Only three are more than five years’ old, and all of those are in one sector, primary medical assets.

The column headed ‘Likely * (and past) dividend growth relates to dividend per share. The figure is a broad-brush Hardman estimate of the typical dividend rise which might be expected in the next few years. This is neither a straight extrapolation of recent past growth nor an estimate for the current year. It takes a range of factors into account, not least the likely rent rises, the dividend cover and changes in the cover ratio. This is a solely Hardman-extrapolated estimate.

PHP assets include MedicX’s latest balance sheet plus announced further acquisitions.

“Secure income” REITs – Safe Harbour Available

Dividend growth and funding						
REIT	Recent dividend annualised growth (%)	Likely* (and past) dividend growth	Total finance cost (historical % rate)	Inception	Gross assets ** (£m)	Latest raise
AEW UK Long	Acceleration phase post IPO	CPI+ (91% rent grows RPI/CPI)	3.2%	2017	112	IPO – fully invested
Assura	5.0	RPI+	3.3%	2003	1,910	Nov'17 £310m
Civitas Social Housing	Acceleration phase	CPI+	2.8%	2016	679	Nov'17 £302m
Empiric Student	0% (previous, cut)	1% (previous, cut)	3.3%	2013	971	Jul'17 £110m
GCP Student Living	3.4	2%+	3.0%	2013	886	Oct'18 £38m
Impact Healthcare	Acceleration phase	2% +/-	N/A	2017	199	Nov'17 £33m
LXi	Acceleration phase	RPI	2.9%	2017	520+	Oct'18 £175m
PHP	3.1	RPI+	4.0%	1999	2,380	Apr'18 £115m
The PRS REIT [note 9, above]	Acceleration phase	RPI	2.8%	2017	269	Feb'18 £250m
Residential Secure Income	Acceleration phase	RPI+	N/A	2017	225	Jul'17 £180m
Secure Income	6.0 [note 10, above]	6%	5.1%	2014	2,307	Mar'18 £315m
Supermarket Income	3.0	RPI	2.4%	2017	265	May'18 £65m
Target Healthcare	2.0	2% +/-	5.0%	2013	464	Nov'18 £50m
Triple Point Social	Acceleration phase	CPI+	N/A	2017	295	Oct'18 £108m
Tritax Big Box	4.7	2% +/-	4.3%	2013	3,420	Feb'19 £250m
Urban Logistics	1.4	RPI / 4%	3.2%	2016	174	Apr'18 £20m
Warehouse REIT	Acceleration phase	RPI+	3.0%	2017	284	Sep'17 £166m

* Hardman estimate of the typical dividend rise which might be expected in the next few years

** Investment property assets. The assets are calculated on most recent balance sheet, adjusted by any announced net acquisitions post balance sheet.

Of course, PHP is the enlarged post-merger figure

Source: Company data, Hardman & Co Research

- ▶ Impact Healthcare has announced (5 February) a 12-month placing programme of up to 200 million new ordinary shares.
- ▶ Warehouse REIT has announced (12 March) a proposed equity-raise of up to £100m, due to close 28 March: at a share price premium to the previous close.

“Risk/ disclaimer”

Not all REITs listed above should yet be considered a “safe harbour”. This report focuses on the stocks investing in lower-risk UK real estate and is not making individual stock recommendations. We have analysed the historical performance of lower-risk, more secure income REITs, and we have also analysed where we might be in the sector cycle right now. We are comparing key indicators and valuations on the REITs investing in lower-risk UK real estate, but we are not making recommendations.

The main focus of our research is firstly dividends, and then total returns from NAV per share growth. Of course, the outcome sought is growth in a secure environment. None of the REITs listed is analysed in depth in this report. We focus on the “risk-on/risk-off” benefits of long leases, good covenants, and portfolios with strong attractive assets. We are keen to avoid mere bond substitutes, where it is all about income streams and nothing about the assets’ relevance to tenants. The sections and tables above seek to give some initial overview.

We would point to the historical fact that both Empiric Student saw recent cuts in dividends. We are in no manner implying that such cuts reduce their current investability. Indeed, having rebased the payout to levels that are more sustainable than before, such decisions should be applauded, in our view.

Appendix:

Secured-lender investment companies

Here we turn to a different property-based investment class

Secured lenders include property secured, but these are investment companies, not REITs

See the separate Hardman report, recently published

In this Appendix, we assess four secured-debt investment companies. Hardman’s report on debt instruments: *Diving deep finds you the treasure*, published on 25 February, reviewed debt-related investment companies, across a range of sectors including a number of real-estate specialists. As investment companies, these are significantly different structures to the REITs listed in the body of this document. However, a number of financial characteristics display similarities. In this report we have focussed on safe harbour REITs. We include the debt investment companies because, like the other companies in this report, they have an extra resilience to a downturn compared with many real estate businesses. We note, for example, that should rents fall, the payments on debt may still be made even if equity investors see their returns cut. Debt investment companies with property backing are likely to see continued positive cashflows even when the property owners’ net cashflows fall to zero. We consider them a relatively closely related set of investment vehicles, compared with the REITs in the main body of this report. At a minimum, an awareness and understanding of these real-estate debt vehicles should prove rewarding to investors seeking pricing discovery in real estate income-focused REITs. All provide quarterly updates.

Looking across the sub-sector, its key advantages include predictable income streams (many multi-year) and multiple levels of security often in business-essential assets. The sector largely adopts IFRS9 accounting.

As yet, these four specialists deploy medium-sized balance sheets. The 2018 Cass UK Commercial Real Estate Lending Report stated that non-banks have increased their share of new lending from 10% in 2017 to 18% 2018. Non-bank lenders, particularly the investment companies, have radically different balance sheets compared with banks, and so should be less exposed by their own internal cashflow dynamics than many banks. These four demonstrate the ability to distribute steady returns – albeit only one has a track record through the most recent major downturn. They operate in a market which is growing and which is taking market share.

Secured lenders – summary

Name	Ticker	Flotation	Net assets (m)	NAV 1-year growth***	NAV 3-year growth***	NAV 5-year growth***
Property-backed						
ICG-Longbow Senior Secured UK Prop. Debt Inv. *	LBOW	Feb 2013	121	4.5%	17.4%	28.3%
Real Estate Credit Investments	RECI	Dec 2005	250	7.2%	21.6%	44.5%
Starwood European Real Estate Finance	SWEF	Dec 2012	385	6.9%	21.7%	36.2%
UK Mortgages **	UKML	July 2015	228	2.4%	2.5%	n/a

Source: Company latest portfolio reports, Hardman & Co Research; * October report **November report ***Growth in NAV calculated as change in reported NAV + reported dividends

Note 21 February pricing for this Appendix section

The tables in the Appendix are extracted from the Hardman published report, dated and priced at 21 February.

LBOW’s performance has been of level dividend payments of 6.0p per annum during and since FY ended January 2015, which was up from a previous 5.0p run rate and, thus, dividend distribution commencing in relatively short order from flotation.

RECI’s track record dates to 2005. The top 12 exposures by size are UK, including just over £40m to three separate UK regional housebuilders. Of the top 15 assets

“Secure income” REITs – Safe Harbour Available

where regional location is stated, the exposure is to London (at £89.2m in February 2019).

SWEF's latest (December 2018) currency split is 31% UK (33% of funds provided), 69% Euro, the latter broadly spread but including 21% of total loans portfolio exposed to Republic of Ireland.

UKML started paying dividends within a year of flotation at a rate of 1.5p, continued since, as the quarterly rate. The most recent transaction (2 October 2018) is “expected to generate a gross IRR significantly in excess of 7% (from date of purchase)”.

Summary company descriptions

Ticker	Company description
LBOW	The objective of the Company is to construct a portfolio of UK real estate debt related investments predominantly comprising loans secured by first ranking fixed charges against Commercial Property investments, with the aim of providing Shareholders with attractive, quarterly dividends, capital preservation and, over the longer term, a degree of capital appreciation. https://www.lbow.co.uk/ Manager: CG-Longbow, the real estate debt division of Intermediate Capital Group plc.
RECI	RECI's investment objective is to provide shareholders with a levered exposure to a portfolio of Real Estate Credit Investments with stable returns in the form of quarterly dividends. The Company invests and will continue to invest in real estate credit secured by commercial or residential properties in Western Europe, primarily in the UK, France and Germany. Assets include i) secured real estate loans, debentures or any other forms of debt instruments. (ii) listed debt securities and securitised tranches of real estate related debt securities, (iii) other direct or indirect opportunities, including equity participations in real estate. http://www.recreditinvest.com Manager: Cheyne Capital Management (UK) LLP
SWEF	The investment objective of Starwood European Real Estate Finance Limited is to provide Shareholders with regular dividends and an attractive total return while limiting downside risk, through the origination, execution, acquisition and servicing of a diversified portfolio of real estate debt investments (including debt instruments) in liquid markets in the UK and the wider European Union's internal market. http://www.starwoodeuropeanfinance.com Manager: Starwood European Finance Partners Limited, an indirect wholly-owned subsidiary of the Starwood Capital Group.
UKML	UK Mortgages is a listed closed-ended investment fund which invests in a diversified portfolio of good quality UK residential mortgages. The fund has nearly 9,000 underlying borrowers with buy to let and owner-occupied loans. https://twentyfouram.com/funds/uk-mortgages-fund/ Manager: TwentyFour Asset Management LLP.

Source: Descriptions taken directly from company websites accessed February 2019, Hardman & Co Research

Some key portfolio highlights

Ticker	Asset mix (% GAV)	Largest exposures	Regional/rating split
LBOW*	Retail 19%, Industrial/Distribution 27%, Mixed use 31%, Office 15%	£22.4m (51% LTV), £20m (69% LTV)	London 27%, South East 9%, North West 21%, National 21%, South West 13%
RECI	52% loans, 48% bonds Loans: 38% Mixed use, 32% Residential	London £30.4m (45% LTV) London £24.9m (68% LTV)	UK 70%, France 11%, Germany 9%, Italy 5%
SWEF	Hospitality 41%, Retail 13%, Light Indl. 11%, Res for sale 9%, Office 8%	£54.1m (Dublin hotel) £45.9m (UK regional hotels)	Spain 30%, Ireland 23%, UK 33%, Hungary 10%, France 3%
UKML	Buy to let (purchased) 78%, fwd. flow BTL 4%, fwd. flow owner-occupied 17%	8,855 underlying borrowers, average loan size £157k	National coverage

Valuations, secured-lenders

Note: this Appendix relates to the recent Hardman & Co publication

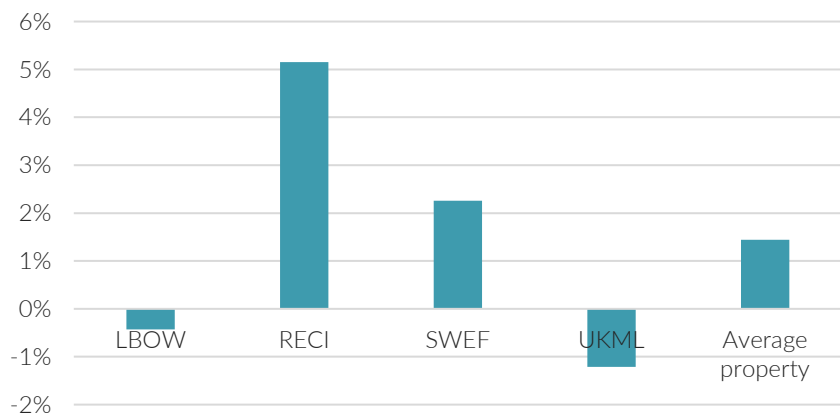
Debt Investment Companies - Diving deep finds you the treasure

This was priced as of 21 February and this date forms the basis of all valuations given.

The average UK property-backed debt investment company is trading at a premium of 1.4% to December 2018 NAV. The highest premium for a property-backed company is Real Estate Credit Investments (at 5.2%). See overleaf.

The tables in the Appendix are extracted from the Hardman published report

Discount/premium to December 2018 NAV for secured lenders (%)

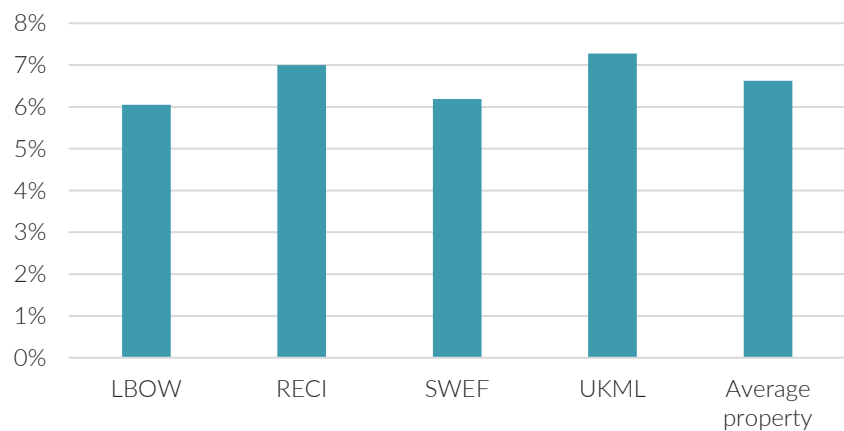


Note 21 February pricing for this Appendix section

Source: Company Factsheets, Hardman & Co Research; prices as at 21 February

The average UK property-backed debt investment company has a yield of 6.6.

12-month historical yield (%)



Source: Hardman & Co Research; prices as at 21 February

Summary company descriptions	
Ticker	Company description
LBOW	<p>The objective of the Company is to construct a portfolio of UK real estate debt related investments predominantly comprising loans secured by first ranking fixed charges against Commercial Property investments, with the aim of providing Shareholders with attractive, quarterly dividends, capital preservation and, over the longer term, a degree of capital appreciation.</p> <p>https://www.lbow.co.uk/</p> <p>Manager: CG-Longbow, the real estate debt division of Intermediate Capital Group plc.</p>
RECI	<p>RECI's investment objective is to provide shareholders with a levered exposure to a portfolio of Real Estate Credit Investments with stable returns in the form of quarterly dividends.the Company invests and will continue to invest in real estate credit secured by commercial or residential properties in Western Europe, primarily in the UK, France and Germany. Assets include i) secured real estate loans, debentures or any other forms of debt instruments. (ii) listed debt securities and securitised tranches of real estate related debt securities, (iii) other direct or indirect opportunities, including equity participations in real estate.</p> <p>http://www.recreditinvest.com</p> <p>Manager: Cheyne Capital Management (UK) LLP</p>
SWEF	<p>The investment objective of Starwood European Real Estate Finance Limited is to provide Shareholders with regular dividends and an attractive total return while limiting downside risk, through the origination, execution, acquisition and servicing of a diversified portfolio of real estate debt investments (including debt instruments) in liquid markets in the UK and the wider European Union's internal market.</p> <p>http://www.starwoodeuropeanfinance.com</p> <p>Manager: Starwood European Finance Partners Limited, an indirect wholly-owned subsidiary of the Starwood Capital Group.</p>
UKML	<p>UK Mortgages is a listed closed-ended investment fund which invests in a diversified portfolio of good quality UK residential mortgages. The fund has nearly 9,000 underlying borrowers with buy to let and owner-occupied loans.</p> <p>https://twentyfouram.com/funds/uk-mortgages-fund/</p> <p>Manager: TwentyFour Asset Management LLP.</p>

Source: Descriptions taken directly from company websites accessed February 2019, Hardman & Co Research

Risk mitigation, secured-lenders

Attractions of secured lenders

Security can reduce probability of loss, as well as loss in the event of default

The loss in the event of default for secured lenders is materially lower than that for unsecured lenders. The willingness and ability to provide security are also evidence of “character”, for which lender and borrower need to be assessed. This will among other matters focus on the rationale and use of the loan as well as methodology for servicing financial commitments. Real estate property as security is especially valuable, in that the asset cannot be removed.

Should underpin accounting

Security not only has a realisation value, but it is also likely to underpin mark-to-model (including IFRS9) valuations. Compared with unsecured lending, we would expect: i) a lower assumed loss rate; ii) lower stress case loss rates; iii) a lower probability of worst-case loss scenarios; and iv) greater confidence in loss numbers. All these factors are also likely to benefit investor sentiment.

Nature of security critical to its value

The nature of the security affects these values. A large portfolio of residential mortgage debt is likely to see more benefit than a concentrated portfolio of specialist developer borrowers. The premium attributed to UK Mortgages may, in part, reflect this relative benefit.

Invoice financing should be low-risk business

A well-managed factoring/invoice finance business can rely on the income stream from the borrower, but also from the end invoice payer. In most cases, the invoice payer has a very different credit risk profile from the borrower. This may be in the form of scale (SME borrowers may have large corporate clients), sector (a manufacturer may have retail clients) or geography (e.g. exporters). The benefit for investors is that having two diversified cashflow streams to repay debt is materially lower-risk than relying on one. Deployment of data management and technology solutions is important to the sector.

Managing security is important to its value

Multiple valuations for same assets, depending on how they are to be sold. Forced sales in distressed markets can easily be 30% below open market valuation

Change in UK crown preference likely to be adverse for floating charge holders. Unlikely to affect property secured, but could have an impact on other asset-backed

Need to be sure borrower is with alternative lender for the right reason and not adverse credit selection

Risks for secured lenders

As we noted earlier, the execution of security documents, regular independent valuations, security that is unlikely to move during borrower distress and security that can be sold in liquid markets are all important to the scale of benefit received from being secured.

It is also worth noting that there can be several valuations for the same property. The current, well maintained value, with a seller that is willing to wait some time, will be materially higher than the forced sale of an asset that has fallen into disrepair, as the borrower can no longer afford to maintain it. Historically, such a valuation would, for bank credit purposes, be taken at 70% of the market value (and banks still incurred material losses on, say, commercial real estate).

From 6 April 2020 in the UK, HMRC will become a secondary preferential creditor. This claim will rank in priority to floating charge holders and unsecured creditors, but not certain primary preferential creditors, such as employees. Floating charge holders and unsecured creditors could see increased losses, as the prior ranking of HMRC's claim will dilute the realisations available to pay their claims. HMRC's claim will still rank behind lenders' fixed charges, but this could have an indirect impact on borrowers if their customers then default. An example could be a property company whose retail customers fail to see less of a recovery, and this could, in turn, have an impact on lenders to the property company.

Potential currency risks

As with all non-mainstream lenders, one key consideration is why borrowers would choose to use them rather than their own bank. There are many good reasons for this (service levels, depth of relationship, certainty of finance, dissatisfaction with banks' overall offering, rates and charges, level of security required, limited bank lending appetite for that sector), but investors need to be confident that it is not an issue of adverse selection, i.e. that the borrowers could not get finance on the same terms from their bank, and went to the alternative provider as a last resort.

It should be noted that a certain minority of companies have significant non-UK and non-Sterling exposures, which investors seeking Sterling secured dividends should bear in mind.



About the author

Mike Foster is an equity analyst at Hardman & Co and covers a wide range of clients in the Support Services, Building and Property sectors.

He spent his early career working in fund management with British Rail Pension Fund and Eagle Star Investment Management. He then spent two decades in sell-side research at several firms, including Peel Hunt and Credit Lyonnais. He has covered sectors including Construction, Support Services and Real Estate. In his fund management career, he was responsible for both bond and equity portfolios.

Mike was part of the group of investors that acquired Hardman & Co in late 2012. He holds a BA (Hons) in Geography from the University of Cambridge.

Disclaimer

Hardman & Co provides professional independent research services and all information used in the publication of this report has been compiled from publicly available sources that are believed to be reliable. However, no guarantee, warranty or representation, express or implied, can be given by Hardman & Co as to the accuracy, adequacy or completeness of the information contained in this research and they are not responsible for any errors or omissions or results obtained from use of such information. Neither Hardman & Co, nor any affiliates, officers, directors or employees accept any liability or responsibility in respect of the information which is subject to change without notice and may only be correct at the stated date of their issue, except in the case of gross negligence, fraud or wilful misconduct. In no event will Hardman & Co, its affiliates or any such parties be liable to you for any direct, special, indirect, consequential, incidental damages or any other damages of any kind even if Hardman & Co has been advised of the possibility thereof.

This research has been prepared purely for information purposes, and nothing in this report should be construed as an offer, or the solicitation of an offer, to buy or sell any security, product, service or investment. The research reflects the objective views of the analyst(s) named on the front page and does not constitute investment advice. However, the companies or legal entities covered in this research may pay us a fixed fee in order for this research to be made available. A full list of companies or legal entities that have paid us for coverage within the past 12 months can be viewed at <http://www.hardmanandco.com/legals/research-disclosures>. Hardman may provide other investment banking services to the companies or legal entities mentioned in this report.

Hardman & Co has a personal dealing policy which restricts staff and consultants' dealing in shares, bonds or other related instruments of companies or legal entities which pay Hardman & Co for any services, including research. No Hardman & Co staff, consultants or officers are employed or engaged by the companies or legal entities covered by this document in any capacity other than through Hardman & Co.

Hardman & Co does not buy or sell shares, either for their own account or for other parties and neither do they undertake investment business. We may provide investment banking services to corporate clients. Hardman & Co does not make recommendations. Accordingly, they do not publish records of their past recommendations. Where a Fair Value price is given in a research note, such as a DCF or peer comparison, this is the theoretical result of a study of a range of possible outcomes, and not a forecast of a likely share price. Hardman & Co may publish further notes on these securities, companies and legal entities but has no scheduled commitment and may cease to follow these securities, companies and legal entities without notice.

The information provided in this document is not intended for distribution to, or use by, any person or entity in any jurisdiction or country where such distribution or use would be contrary to law or regulation or which would subject Hardman & Co or its affiliates to any registration requirement within such jurisdiction or country.

Some or all alternative investments may not be suitable for certain investors. Investments in small and mid-cap corporations and foreign entities are speculative and involve a high degree of risk. An investor could lose all or a substantial amount of his or her investment. Investments may be leveraged and performance may be volatile; they may have high fees and expenses that reduce returns. Securities or legal entities mentioned in this document may not be suitable or appropriate for all investors. Where this document refers to a particular tax treatment, the tax treatment will depend on each investor's particular circumstances and may be subject to future change. Each investor's particular needs, investment objectives and financial situation were not taken into account in the preparation of this document and the material contained herein. Each investor must make his or her own independent decisions and obtain their own independent advice regarding any information, projects, securities, tax treatment or financial instruments mentioned herein. The fact that Hardman & Co has made available through this document various information constitutes neither a recommendation to enter into a particular transaction nor a representation that any financial instrument is suitable or appropriate for you. Each investor should consider whether an investment strategy of the purchase or sale of any product or security is appropriate for them in the light of their investment needs, objectives and financial circumstances.

This document constitutes a 'financial promotion' for the purposes of section 21 Financial Services and Markets Act 2000 (United Kingdom) ('FSMA') and accordingly has been approved by Capital Markets Strategy Ltd which is authorised and regulated by the Financial Conduct Authority (FCA).

No part of this document may be reproduced, stored in a retrieval system or transmitted in any form or by any means, mechanical, photocopying, recording or otherwise, without prior permission from Hardman & Co. By accepting this document, the recipient agrees to be bound by the limitations set out in this notice. This notice shall be governed and construed in accordance with English law. Hardman Research Ltd, trading as Hardman & Co, is an appointed representative of Capital Markets Strategy Ltd and is authorised and regulated by the FCA under registration number 600843. Hardman Research Ltd is registered at Companies House with number 8256259.

(Disclaimer Version 8 – Effective from August 2018)

Status of Hardman & Co's research under MiFID II

Some professional investors, who are subject to the new MiFID II rules from 3rd January, may be unclear about the status of Hardman & Co research and, specifically, whether it can be accepted without a commercial arrangement. Hardman & Co's research is paid for by the companies, legal entities and issuers about which we write and, as such, falls within the scope of 'minor non-monetary benefits', as defined in the Markets in Financial Instruments Directive II.

In particular, Article 12(3) of the Directive states: 'The following benefits shall qualify as acceptable minor non-monetary benefits only if they are: (b) 'written material from a third party that is commissioned and paid for by a corporate issuer or potential issuer to promote a new issuance by the company, or where the third party firm is contractually engaged and paid by the issuer to produce such material on an ongoing basis, provided that the relationship is clearly disclosed in the material and that the material is made available at the same time to any investment firms wishing to receive it or to the general public...'

The fact that Hardman & Co is commissioned to write the research is disclosed in the disclaimer, and the research is widely available.

The full detail is on page 26 of the full directive, which can be accessed here: <http://ec.europa.eu/finance/docs/level-2-measures/mifid-delegated-regulation-2016-2031.pdf>

In addition, it should be noted that MiFID II's main aim is to ensure transparency in the relationship between fund managers and brokers/suppliers, and eliminate what is termed 'inducement', whereby free research is provided to fund managers to encourage them to deal with the broker. Hardman & Co is not inducing the reader of our research to trade through us, since we do not deal in any security or legal entity.

