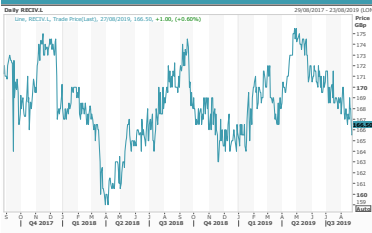




## Diversified Financial Services



Source: Refinitiv

## Market data

EPIC/TKR	RECI
Price (p)	165.5
12m High (p)	175.5
12m Low (p)	162.5
Shares (m)	199.2
Mkt Cap (£m)	330
NAV p/sh (p)	166.2
Premium/Disc	-0.4%
Market	Premium Equity Closed- Ended Inv. Funds

## Description

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

## Company information

Chairman	Bob Cowdell
NED	Susie Farnon
NED	John Hallam
NED	Graham Harrison
Inv. Mgr.	Cheyne Capital
Head of Team	Ravi Stickney
Main contact	Richard Lang
	+44 207 968 7328
	<a href="http://www.recreditinvest.com">www.recreditinvest.com</a>

## Key shareholders

AXA SA	8.4%
Close Bros	8.2%
Canaccord Genuity Group	8.1%
Fidelity	7.7%
Premier AM	7.1%
Smith and Williamson	6.0%
Bank Leumi	4.5%

## Diary

Early Sep	August Factsheet
17 Sep	AGM

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## REAL ESTATE CREDIT INVESTMENTS

## 7%+ yield from well-secured property debt portfolio

RECI pays investors a high dividend yield (7.3%), covered by predictable income streams generated by an increasingly diversified portfolio of real-estate-backed debt. Its credit record has been exemplary. In this report, we detail the procedures that have delivered this performance, in addition to the benefits from the security taken. Much of the superior revenue yield is generated from service and structuring skills – among the many synergies obtained from having Cheyne Capital (Cheyne) as the manager. Corporate governance appears robust, with a strong board. RECI is exposed to the credit cycle, some of its loan assets may prove illiquid, and the (modest) gearing is low-cost but short-term.

- ▶ **Credit management:** Credit is key to any lender. We believe RECI's detailed cashflow analyses (with appropriate stress tests), close borrower relationships and experienced staff will lower the probability of default. In addition, close ongoing monitoring and property security should reduce the loss in the event of default.
- ▶ **Cheyne's competitive advantages:** Having Cheyne as the investment manager provides RECI with economies of scale, access to deal flow and market information, structuring and execution expertise, as well as experienced lenders with a strong network of contacts to improve credit risk.
- ▶ **Valuation:** RECI trades at a 0.4% discount to NAV, in line with secured lending peers. Its yield, at 7.3%, is the highest of its immediate peers and above-average compared with debt investment companies. As we outline below, it is covered by predictable income streams and below-average downside risk from credit losses.
- ▶ **Risks:** Any lender is exposed to the credit cycle and individual loans going wrong. We believe RECI has appropriate policies to reduce the probability of default and the loss in the event of default. The book is relatively short, creating re-investment risk. Some assets are illiquid, and Repos financing has a short duration.
- ▶ **Investment summary:** RECI generates an above-average, but sustainable, dividend yield from well-managed credit assets. It should deliver this return with a relatively modest correlation to equity and bond markets. For property investors, there is less downside risk than direct real estate exposure. To debt/fixed-income investors, the presence of physical security (and excellent management controls) makes RECI lower-risk than the average debt investment company.

## Financial summary and valuation

Year-end Mar (£m)	2015	2016	2017	2018	2019	2020E	2021E
Interest income	15.8	17.7	15.3	18.4	22.3	27.8	35.7
Operating income	21.6	15.1	15.7	20.6	25.3	30.2	38.1
Management fee	0.0	-2.0	-2.0	-2.6	-3.0	-3.8	-5.0
Performance fee	0.0	-0.2	-0.1	-0.3	-0.7	-0.4	-0.6
Operating expenses	-4.2	-3.1	-3.2	-3.7	-4.8	-5.1	-6.6
Total comprehensive income	13.8	8.5	9.1	14.9	19.2	23.8	30.3
EPS (p)	18.9	11.7	12.4	13.0	13.1	12.4	12.6
NAV per share (p)	162.3	163.2	163.2	164.0	165.1	166.2	166.5
S/P premium to NAV	2%	1%	1%	1%	0%	0%	0%
Debt to equity	35%	35%	29%	34%	40%	30%	24%
Dividend (p)	10.8	11.6	11.1	12.0	12.0	12.0	12.0
Dividend yield	6.5%	7.0%	6.7%	7.3%	7.3%	7.3%	7.3%

Source: Hardman &amp; Co Research

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## Executive summary

### Investment positives

Yield 7.3% and generated from diversified portfolio of assets. Covered by earnings – so there has been a stable NAV.

RECI has paid a 3p dividend every quarter since 3Q'17. On the current price, this generates a dividend yield of 7.3%. Critically, this dividend is covered by predictable and sustainable income streams from a diversified portfolio of assets. Dividends have been covered by earnings.

The group's NAV has been remarkably stable, ranging from a high of 167.6p to a low of 161.0p (i.e. just 4% volatility) since the start of 2018. Broadly half this volatility is due to profits being retained before each quarterly dividend payout, which then sees the NAV drop in that month. The only month when RECI's NAV fell since January 2016 was in January 2017. Even then, the driver was a mark-to-market (MTM) hit from uncertainty around the expected level of interest payments on a loan – one where the principal was, and still is, expected to be repaid in full.

Credit record exemplary, driven by company-specific processes and procedures – the benefits of being a property-secured lender and of diversification

One key driver to this performance has been credit. RECI has an exemplary record, with no principal loss since its evolution in 2011. As we detail in the section below on credit processes, this is the result of a structured and considered approach to lending. The manager's (Cheyne's) culture is hugely important to this, and we take considerable comfort in its risk/reward approach. The good credit performance also reflects the benefits of being a property-secured lender, which we believe reduces both the probability of default and the loss in the event of default. The portfolio is increasingly diversified by counterparty, jurisdiction, economic sector and type of borrower.

We like the fact that credit approach adheres to basic Canons of Lending and is cashflow-driven – plus the independence between marketeers and risk controllers

Looking at credit culture and processes in more detail, we note that credit is assessed with proprietary tools to assess all the "Canons of Lending" (CAMPARI – Character, Ability, Means, Purpose, Amount, Repayment, Insurance). Expected cashflow, rather than the value of the security net, is the key metric. Cheyne adopts risk-adjusted pricing with a range of yields to reflect different risk. Finally, in terms of loan approval, there is clear independence between the risk-sanctioning functions and the marketeers/deal originators.

Post drawdown monitoring

Positions appear to be closely monitored once committed, and Cheyne endeavours to be actively involved where there are multiple lenders. Early identification of problems is very important to reducing eventual losses, and Cheyne has processes in place to do that. We note that there are currently no accounts in material difficulty, but management advises that, should they develop, the management of recoveries will utilise the decades of experience of its lenders in restructuring and debt management. An important feature is that the originator "owns" the loans, and so is highly likely to personally spend the considerable time and effort sorting out any problem accounts.

Cheyne provides economies of scale, specialist skills, deal access and market knowledge

The key advantages in having Cheyne as the investment manager are i) economies of scale, ii) specialist credit and structuring skills, iii) access to new deal flow, and iv) market knowledge and relationships. Cheyne also provides more regular disclosure than some of its peers, such as LBOW or SWEF. In addition to the operational economies of scale from the investment manager, we note that the fixed costs of the fund itself are being spread over an ever-increasing asset pool, creating further efficiency gains.

Board is independent, accounting appears conservative, and RECI has a broad appeal to a wide range of investors

Other positive issues to consider are:

- ▶ A strong, independent and experienced board has never been more important to investors. As we note in the *Appendix* of this report, the RECI board has such characteristics.
- ▶ We note that the conservative accounting adopted by the company means that there is no recognition of profit shares until such time as there is hard factual evidence (such as actual bids on units) to support an uplift in valuation. We do not believe such gains are a core reason to buy RECI, but they do provide some icing on the cake, which is not in the NAV.
- ▶ We believe RECI has broad investor appeal across multi-asset funds and wealth managers, and is attractive to a range of portfolios, including property, debt, alternative assets and income mandates.
- ▶ The mix of bonds and loans is likely to provide greater liquidity than a book of loans alone.

No direct Woodford read-across

### Investment-neutral

There is no fundamental read-across from the disturbances at Woodford Investment Management or H2O funds to RECI. As a closed-ended vehicle, RECI has permanent capital, and its limited amount of debt is more than covered by assets that should be relatively liquid or be considered as good security by other sources of funding. RECI is, therefore, extremely unlikely to ever be a forced seller of assets at distressed prices. Looking at asset valuations, RECI has a range of checks and balances to ensure that the values are independently verified. RECI has never been dependent on retail investor platform sales. Its own shares are liquid, which means it should not be affected by any restrictions on potential investors on the tradability of their positions.

Other neutral issues include i) appropriate gearing, ii) fees in line with peers, iii) corporate governance, and iv) shares issued above NAV accrete value to existing holders

Other issues that we have classified as being neutral to the investment case include:

- ▶ Appropriate level of gearing: RECI has access to Repos financing for its bond portfolio at a cost of under 2%. Given that its bonds are yielding over 6%, introducing some gearing adds to shareholder value. The reason we believe this is appropriate is that the total gearing is currently 18% of total assets and 36% of bond assets. Bond assets are more liquid than loans, and we note that the accountants have signed them off on level 2 hierarchy of accounting, reflecting clearly observable and comparable pricing inputs.
- ▶ RECI's overall fees are in line with those of its peers and represent under one-tenth of the revenue yield. We note that the performance fee element (20% above a 7% net return) only kicks in once returns have been such that the current level of dividend would be largely covered.
- ▶ Other issues: i) RECI has consistently traded around NAV, making any discount management policy presently theoretical; ii) Key Information Document (KID) disclosure – RECI's stress performance out-turn appears to show higher risk than its immediate peers, but this is driven by methodology, and not the "real" risk profile of the group; iii) the issue of shares above NAV is likely to create some incremental value, but the effect will be small (on our forecasts <0.3% p.a.), and is uncertain in timing; iv) there is some interest and currency rate sensitivity, but these are managed; v) the flipside of appealing to a broad range of investors is that there may be some uncertainty in sector allocation, which could complicate the issue for some potential investors.



Market-wide, we expect credit to deteriorate steadily from here, but spreads will widen, improving re-investment returns. RECI well positioned to see more benefit relative to likely increased losses.

Market may perceive some risk in higher-yielding lending, non-senior positions, remote lending in several jurisdictions, development finance and higher LTV exposures

Our assessment is that these are sentiment – not real – issues, supported by fact that RECI's NAV was stable through Brexit shock, although the share price showed some volatility

Relatively short average life of assets means new re-investment opportunities required – not an issue at moment, given Cheyne origination volumes

Asset liquidity uncertain

## Investment risks

Credit risk is fundamental to all lenders, no matter how well-secured they are. Credit conditions are unusually favourable at present and we, and most market commentators, expect losses to increase from here. We note the 30 July 2Q'19 Begbies Traynor *red flag alert*, highlighting the steady deterioration in overall credit and a 15% YoY increase in the number of real estate and property companies in significant financial distress. The speed of any deterioration in credit will be critical to falling capital values and, as RECI adopts MTM accounting, it could reflect incremental market sentiment. More positively, this may be offset by wider new business spreads. The balance of increased income against increased credit loss will be dependent on the speed of credit deterioration and the duration of loans (and hence their rollover to higher rates). A slow, steady decline could see greater bottom-line profitability improve, if anything.

For RECI specifically, we note that: i) RECI's reported yields range from 5.1% to 13.5% (FY'18 5.9% to 13.6%), and such yields can be generated from a range of sources, including incremental risk, limited competition, structuring skills and expertise, product flexibility, service levels, or illiquidity premia (however, there may be the perception that this is from increased risk); ii) non-senior debt positions, including mezzanine finance account for 19.5% of the portfolio; iii) there is remote lending in different jurisdictions, as Cheyne does not have local offices in each country, but we note Cheyne's low-risk appetite and approach to lending in new countries; iv) development finance, again noting that Cheyne's long experience is a mitigating factor; and v) some high loan to value (LTV) exposures. We explore each of these issues in detail and conclude that the risks are more around sentiment, with Cheyne adopting the right approach to risk management.

Investors will note that the NAV at the end of each financial year (March) was £1.62 (2015), £1.63 (2016) and £1.63 (2017), and that the quarterly dividend actually rose over this period. Despite the stable NAV, the share price fell by around 10% immediately following the Brexit vote in June 2016, before fully recovering by September. We believe this evidences that the issue is one of sentiment, rather than real economic risk. In the short term, Brexit has seen bank appetite to lend ease, creating more opportunities for Cheyne, although the long-term impact is unclear.

We note a relatively high turnover in the portfolio (driven by the business model, not manager churn), indicating that the actual life of assets is less than the contractual terms. The risk from this is that RECI will need to continually originate more business to replace the existing book. We further note that i) RECI currently takes only a small proportion of Cheyne's origination, ii) in a downturn, a rapid turnover will create an opportunity to offset any credit deterioration, with new lending on wider spreads, and iii) a high turnover facilitates more rapid changes to the credit profile; for example, in current conditions, there is less appetite for new mezzanine finance, with new facilities being more focused on core senior positions.

None of the assets are valued for accounting purposes off traded prices in liquid markets. However, most of the bond portfolio would appear to be capable of having some liquidity, as there are readily comparable valuation inputs, even where there is no current market price (the bonds are level 2 on the accounting hierarchy). The loans could take longer to sell, although the good track record would suggest that they could be considered as good collateral against which to borrow, if required.

### Short-term financing

We note that the Repos financing is short-term (typically three-month duration). This could see some liquidity strain, potentially for factors outside RECI's control. However, we further note: i) the level of gearing is low, and replacement facilities secured against the entire portfolio may be available; the permanent capital structure of the closed-ended vehicle means that assets do not have to be sold because of potential shareholder redemptions; ii) the bonds have been structured so that they are marketable and can be sold rapidly; in this context, a two-month window should be sufficient to liquidate a significant proportion of the bonds if that is the preferred option; iii) Cheyne's and RECI's business has seen strong relationships built with banks, who will be very familiar with its portfolio should that be the preferred option.

## RECI's portfolio

We explore the market conditions in the *Appendix* of this report and RECI's top exposure from page 34. The trends in the former are intended to provide investors with a background to some of the macro-sector risks and opportunities. We cannot emphasise enough that the lender's due diligence, origination process and the micro-detail of each development project or asset are what drive returns and risks. Taking the portfolio as a whole, we note that:

### UK commercial

- ▶ The past year's downgrades to both rental and capital value for UK commercial property have been relatively modest. For instance, the cumulative shortfall in rents for the three years of 2019, 2020 and 2021 in the most recent estimates versus those of spring 2018 is 2.6%. This market background is one in which RECI can operate with reasonable safety. RECI's exposure is to the right sectors, with no retail exposure, other than as a minor component of mixed-use sites.

### Care homes

- ▶ Care homes are in under-supply, evidenced by good (4%-5%, typically) rises in fees. A major characteristic of this market is the widening differential in income and valuation for establishments of high-quality versus those that are possibly under-investing in upgrades.

### Hotels

- ▶ The hotels market is one where the development pipeline is quite strong. Much of the pipeline is in budget hotels, and this, currently, is not an area of RECI exposure. We have quantified this in our analysis. Hotels, in particular, succeed or fail on a combination of brand and micro-location – so generalisations are particularly dangerous in the sector.

### Leisure

- ▶ RECI has two significant commitments to family-based UK leisure estates. The company owning these centres changed hands a few years ago, and the owners are motivated and well-financed. Importantly, maintenance capital expenditure is strong, supporting the assets. Both occupancy and forward sales are, by nature, high – affording plenty of forward visibility to providers of loan finance such as RECI.

### Housebuilders

- ▶ In our analysis on UK commercial real estate, we looked at the positions on both rents and valuations. The equivalent for UK housebuilders is to look first at housing completions and prices, but then to look at the prices for housebuilders. Quoted housebuilders trade, on average, at a premium to NAV, indicating investor appetite for residential development assets.
- ▶ Our analysis also illustrates how the lack of funding for mid-sized housebuilders – like those to which RECI provides bespoke capital solutions – supports the housing market and also offers good opportunities for RECI's loan finance offering. By definition, this is not a highly competitive market, and each exposure is situation-specific.

## Real Estate Credit Investments

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### France

- ▶ The French commercial real estate market – with a particular emphasis on central Paris – has seen strong rental and valuation growth in the past two years, with the rises starting to fade recently. This does not seem to have triggered a significant expansion in the development pipeline, as take-up is strong.

### Italy

- ▶ In Italy, the exposure is to shopping centres and cinemas in the north. This market is strong relative to other Italian markets. However, we anticipate mixed trends – a straw in the wind, maybe, being recent significant reductions in in-bound investment into retail.

### Brexit

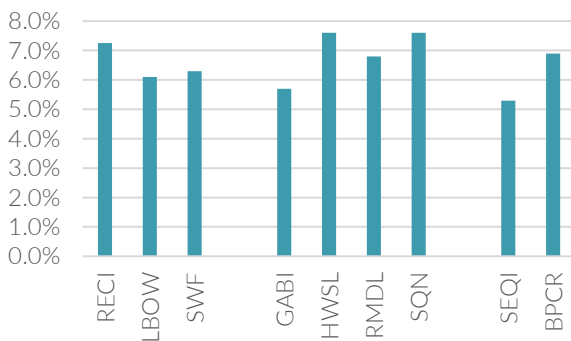
- ▶ Turning away from sectors and looking nationally, Brexit may cause turbulence. It already has (i.e. this is not an “unknown unknown”), although the final effects remain unclear. In the short term, it has contributed to a further reduction in bank lending appetite, and the fall in sterling may even be a compensating factor in London hotels and prime retail. Uncertainty is a major issue for housebuilders, and this may prove a risk to RECI.

### Continental Europe

- ▶ Looking at Continental Europe, the economy is weakening. Recent (1 August) figures show German manufacturing output at an 84-month low, with a 43.2 measure (below 50 being a contraction) on IHS Markit’s manufacturers’ purchasing managers’ index. IHS Markit’s figures show the sharpest EU fall in orders for 6.5 years.

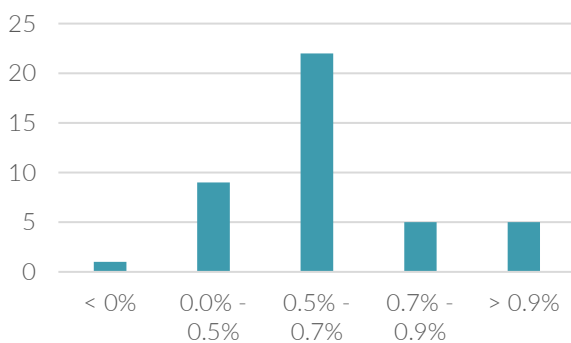
## Real Estate Credit Investments

### Dividend yield for RECI and secured lender peers



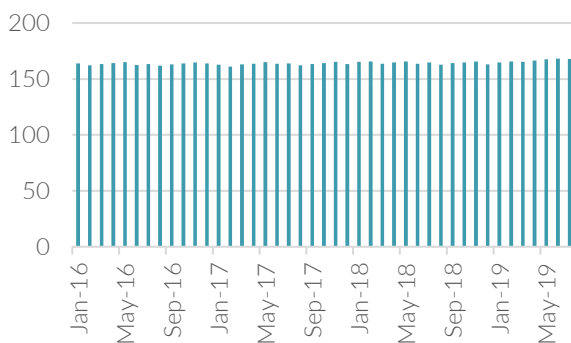
- ▶ RECI has the highest yield among property secured lenders, and is above-average for all secured debt investment companies
- ▶ RECI's yield is generated from predictable net interest income from diversified portfolio of assets
- ▶ RECI has an exemplary record, with no principal loss since its evolution in 2011

### Number of months generating range of NAV returns (adjusted for dividend payments) since January 2016



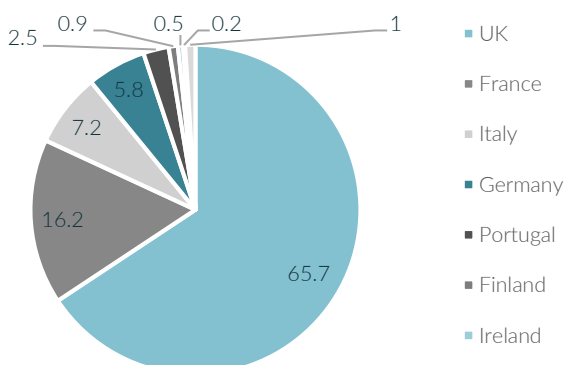
- ▶ Average monthly return since January 2016 has been 0.63%
- ▶ In 52% of months, returns have been between 0.5% and 0.7%
- ▶ All but one month seen positive NAV accretion – loss that month (January 2017: 0.7%) due to uncertainty over interest on a mezzanine loan secured on a fully-let retail park –majority of principal has been repaid since that date, and full recovery of principal is still expected

### Monthly NAV per share (p)



- ▶ Since January 2016, NAV has ranged from 161p to 167.6p (May 2019) – a trough to peak volatility of 4%
- ▶ Around half this volatility is due to accretion of NAV ahead of quarterly dividend payment (since 3Q'17: 3p per quarter)
- ▶ Around Brexit vote (23 June 2016), there was minimal NAV volatility (NAV performance May 2016 +0.49%, June +0.61%, July +0.43%, August +0.8%)
- ▶ Shares have shown some more volatility, but even this has been modest (only ca.10% – even at trough post-Brexit)

### Geographical split of total portfolio (%)



- ▶ Two-thirds of portfolio in UK, one third across Europe
- ▶ UK: accounts for ca.£150m loans and £85m bonds – in total, two-thirds of portfolio. Of the loans, half are in central London, a further sixth in greater London, and a third are regional (accounting for 26%, 15% and 18% of the total portfolio, respectively)
- ▶ Largest commitments: two for £30m and £25m (London mixed-use development), and £21m Commercial Mortgage Backed Securities (CMBS) for UK care homes

Source: Company data, Hardman & Co Research

## Investment attractions

### High dividend yield, with proven sustainability

Dividend yield 7.3%

Sustainability supported by i) gross revenue yield ca.10%, ii) income primarily from predictable sources, iii) credit well assessed, monitored and recovered, and iv) performance fees effectively only after dividend covered

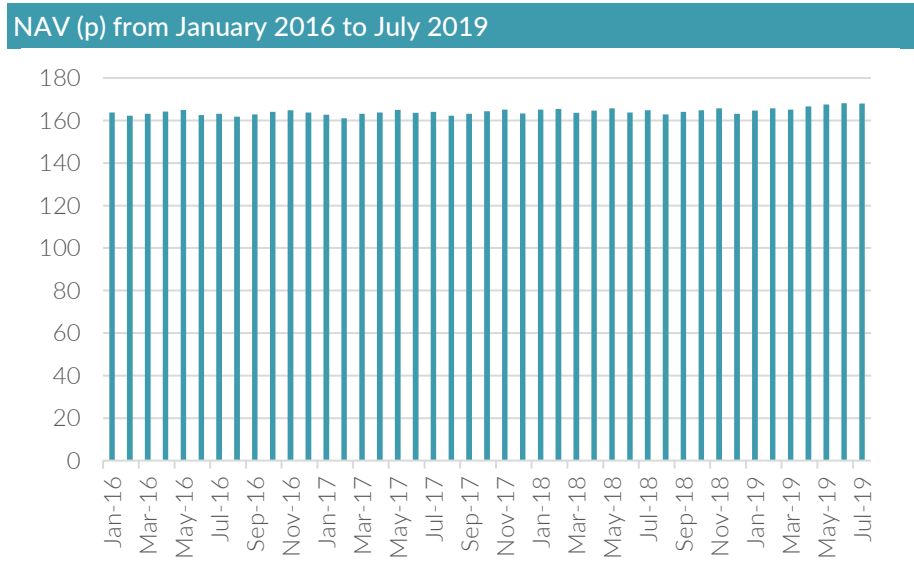
RECI paid quarterly dividends of 2.7p in every quarter from 4Q'15 through to 3Q'17, at which stage the dividend was raised to 3p per quarter, which has been paid ever since. The annual 12p dividend equates to a yield to investors of 7.3%.

When considering the sustainability of the dividend, we believe investors should focus on the following:

- ▶ At the end of March 2019 (the last Report and Accounts), the weighted average levered gross yield of the investment portfolio was 9.9%, which, after fees, finance costs and expenses, saw an 8% NAV return, comfortably covering the dividend. The most recent monthly factsheet indicates that this has been maintained with a gross yield on the loan book of 9.2% and a leveraged bond yield of 8.1. The group has (modestly) increased its NAV over recent years, with dividends at or around the current level.
- ▶ An important element of the sustainability of the dividend is the source of revenue. From FY'15 to FY'19, predictable interest income has accounted for 91% of total revenue, and more volatile gains on investments and forex movements just 9%. Some capital gains are a core element of the business model, but the dividend has been broadly covered, even without them (see page 40 adjusted profit).
- ▶ Credit appears well-assessed, monitored and controlled, reducing both the probability of default and the loss in the event of default – both important potential risks to potential dividend cover.
- ▶ We note that the investment manager's performance fee kicks in only when the NAV has grown 7%, i.e. covering the dividend.

### Consistent capital value

NAV shown minimal volatility, even through Brexit vote in June 2016



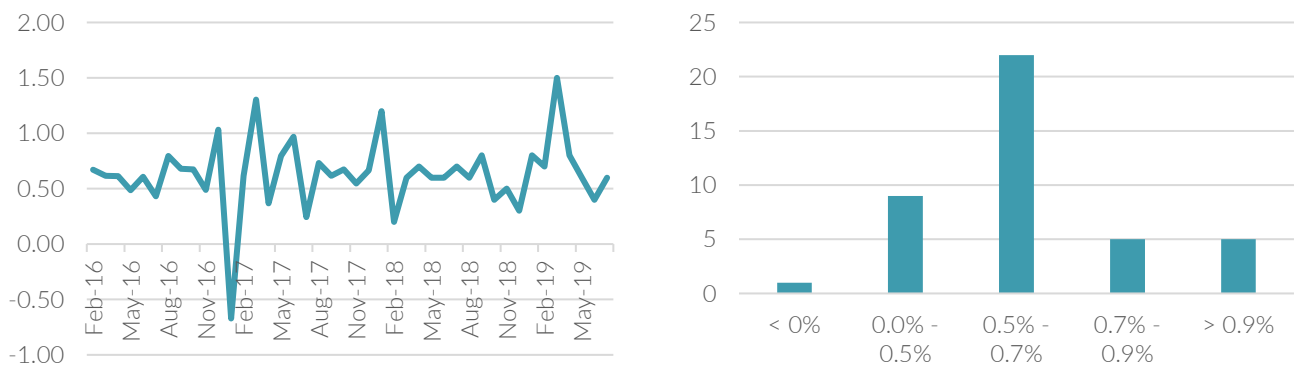
Source: Company factsheets, Hardman & Co Research

## Real Estate Credit Investments

### Long-term record

The chart above shows how stable the NAV has been, with a high to low range of 167.6p to 161.0 (i.e. just 4% volatility) since the start of 2016. This reflects the high proportion of income generated from highly predictable interest income and the quality of assets in the portfolio. The model is not one driven by unforecastable capital gains. It is worth noting that even this volatility is driven primarily by the timing of dividends, with a small build-up in NAV in the months ahead of the quarterly payment, and then modest falls in that month. Taking a longer-term perspective, the NAV at the end of each financial year (March was £1.62 (2015), £1.63 (2016), £1.63 (2017), £1.64 (2018) and £1.65 (2019).

### Change in monthly NAV (% LHS) and number of months since January 2016 by monthly return (RHS), both dividend-adjusted



Source: RECI factsheets, Hardman & Co Research

The chart above shows the remarkable consistency in performance, with over half the months delivering a monthly NAV accretion in the tight band of 0.5% to 0.7%. The issue that could lead to this stability being interrupted is credit, and we review how RECI assesses, monitors and recovers its debt in detail in the section below.

## Credit record, assessment, monitoring and recovery

### No principal losses on loans, and current portfolio reports no problems

For any lender, credit is the key issue. We outline below how Cheyne assesses and monitors credit, and what it will do when accounts run into difficulties. The track record is excellent, with no principal losses since RECI adopted its current form in 2011. We note the comment on page 65 of the Report and Accounts that "At 31 March 2019, the Investment Manager was not aware of any significant movement in the market rates, any indications of impairment, significant credit events or significant negative performance of the underlying property structures, which might affect the fair value of the loans and bonds." This view has been consistent for a considerable time and continues to apply today.

### Experienced manager able to cherry-pick from a huge market, and then build close relationships with borrowers

We believe investors should bear in mind that:

- ▶ The market is huge, and so Cheyne can be highly selective on which loans to make.
- ▶ Cheyne builds relationships with borrowers, and this is critical to originating loans, but also to subsequent monitoring and assessing when early remedial action is required. It is also worth noting that, with Cheyne typically doing debt deals of £50-150m (or currency-equivalent), the equity contributor is usually an institutional investor, providing a further experienced pair of eyes on every deal. RECI can co-invest alongside Cheyne's other funds and so access these attractive deals.

- ▶ Credit is dynamic. Cheyne commented that, in recent years, it has had a preference for senior debt over mezzanine positions, as the market uncertainty has been higher than in the past and senior debt has a lower risk profile.
- ▶ Cheyne is selective. It may find, say, student lending in one town over-supplied but strong demand in another. For some sectors, such as retail, there may be very limited appetite, except where there are deal-specific attractions that make a compelling case.
- ▶ The turndown rate is high. Cheyne sees UK applications of ca.£1bn per month, but its annual lending is £1bn-£1.5bn, a turndown rate of over 90%. Within this, we understand that approximately half of new proposals from existing clients are declined. While Cheyne may be comfortable with the borrower, if the specific proposition and terms are not attractive enough, it will not lend.
- ▶ Cheyne's place in the market, the culture, the short decision chains, and the fact that deals are completed, make it an attractive place to work compared with most mainstream banks. With such rewards, Cheyne can be very selective as to whom it hires, taking only the "best" people. We believe its long experience in the market (importantly including through downturns), and its deep and strong personal networks, providing wide and current market knowledge, are hugely important factors to RECI's successful credit record.
- ▶ We note the importance of Cheyne's originators "owning" their loans and the positive impact this has on credit. RECI is able to buy into this ownership culture.
- ▶ The book has a relatively short life. The latest factsheet indicates that the weighted average contractual life of the loans is 1.7 years, and 2.4 years for the bonds, although we believe the actual life will be shorter. A shorter life reduces the risk of an external economic shock affecting credit quality (and allows more rapid re-pricing).
- ▶ The trend to covenant-lite lending seen in many larger corporate markets has not been prevalent in RECI's markets. We understand from Cheyne that it will not, in any case, enter into such deals.

### Assessing credit

We believe that the basic principles of lending apply just as much to a debt fund as they do to any other balance sheet lender. They are sometimes called the "Canons of Lending", or CAMPARI (Character, Ability, Means, Purpose, Amount, Repayment, Insurance). We are encouraged that the RECI approach, as detailed below, follows these basic principles. In this section, we highlight what RECI says about credit and how each of these core principles is addressed.

If an investment passes the initial risk versus return test, the team progresses to conduct an in-depth credit due diligence. The company's approach focuses on the three layers of analysis, as detailed below:

- ▶ "Asset Level Analysis: assessing the collateral value including cashflows and recovery, rigorously stress-testing by applying worst-case yields and assumptions on factors such as macroeconomic variables, vacancies, rents, defaults and repossessions" (i.e. borrower's ability, means, repayment insurance).
- ▶ "Loan Level Analysis: structuring key loan terms including covenants and triggers, enforcement mechanisms and foreclosure process, timing and costs. In the present distressed environment, it is vital to understand the mechanics and timing to recovery on any given loan" (i.e. insurance).

RECI follows basic Canons of Lending

Three layers of analysis: i) the asset, including stress tests on income generated; ii) the loan features, including recovery potential; iii) bond level – specific characteristics of bonds

- o “We also perform an analysis of the motivations, rights and likely actions of the other parties to a transaction – such as the loan servicers, mezzanine lenders, controlling parties and other large investors in any part of the capital structure” (i.e. character, purpose, amount).
- ▶ “Bond Level Analysis: understanding the key terms of the bond structure including triggers that change the cashflow waterfall, hedging characteristics and modelling of unhedged interest rate risk” (i.e. repayment).

Decision based off “hold to maturity”, using own analysis of cashflows in range of scenarios and not relying on rating agency assessments

Cheyne underwrites each position on a hold-to-maturity basis. The team models out the cashflows in detail, stress-tests assumptions and maps out the decision-trees of likely outcomes in various scenarios. RECI does not rely on rating agencies, but directly gets additional colour on the transaction by engaging with the servicer, analysing property and loan-level data, making site visits, using internet searches/database searches of assets, and reviewing sponsor motivations and refinancing capabilities. Cheyne’s credit assessment is driven by how such factors impact expected cashflows– not lending to security value. We believe this is the right approach.

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

As with all non-mainstream lenders, one key consideration is why borrowers would choose to use them, rather than their own bank. Good reasons for this include service levels, depth of relationship, certainty of finance, dissatisfaction with banks’ overall offering, rates and charges, level of security required, and limited bank lending appetite for that sector. The banks’ appetite has been affected not only by their own loss experience (which has been highly variable) but also by regulatory capital requirements, which have increased sharply for all banks. This has itself been driven by market-wide losses and perceived systemic risk, on top of individual bank experiences. We believe all of the above apply to Cheyne/RECI, and investors may take some comfort that it is not an issue of adverse selection, where the borrowers could not get finance from their banks and go to the alternative provider as a last resort.

It is worth noting that the size of the deals is such that Cheyne is not a loan factory – rather a bespoke provider. Most of the borrowers have been established for many years and have shown proven track records through economic cycles. They are known to Cheyne, have had long-term relationships with the team and are rarely unknown new applications through the door.

### Governance

An important governance point is that loans should be sanctioned independently from the team that originates the loan and that the risk control functions should be able to report directly to boards/senior managers without undue influence exerted by marketeers. In this regard, for RECI, we note that:

- ▶ Any investment requires approval from an investment committee with votes from either of the founding partners (one vote), the heads of risk, legal and finance, and the chief operating officer. While the deal originator may be involved in the discussion, it requires a majority of these five votes before it is approved – thus giving a serious weight to the views of the control functions.
- ▶ The internal process is documented and then supplemented with Cheyne firm-level oversight from a Conflicts Committee that meets at least quarterly.
- ▶ There is a regular review by the independent risk department.
- ▶ Cheyne adopts the good practice of three lines of defence to manage risk: i) internal independent controls in the middle office, including finance and risk functions (Compliance, Legal Risk and Pricing Committee); ii) independent

Independence of risk control vital. For RECI, i) risk functions have the majority vote on investment committee, ii) overseen by conflicts committee, and iii) reviewed by Risk department.



directors; and iii) external verification (external administration, audit by the "big 4" firms and FSA inspection), with all property valuations done by large national professional external valuers.

### Value of security

Security assessed by independent valuers

Security values are subject to external valuers' support, which Cheyne then stress-tests for different scenarios. We understand that, in the UK, the external valuations are all carried out by large national firms, with Cheyne using different firms for their perceived expertise in specific areas. Additionally, all loans will have had direct site visits by Cheyne staff, whose experience provides a further sense-check against the professional valuers' and customers' valuations.

Value of security is only for what it can be sold – often in forced sale conditions

Investors should appreciate that the nature of security materially affects its value to a lender. RECI's property-backed security is more attractive than assets with limited secondary markets, such as specialist equipment, or assets subject to technological obsolescence, or ones that can easily be "lost" in the collection process. As a consequence, RECI may be expected to see a lower loss in the event of default than unsecured lenders or lenders backed by such assets.

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.

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 has not been able to afford to maintain it. Historically, such a forced valuation would, for bank credit purposes, be taken at 70% of the open-market value.

The covenants and documentation of what can be done by the lender are also important practical considerations. Cheyne documentation allows revaluation at any time (paid for by the borrower). We understand the documentation also means that borrowers cannot sell the underlying assets for under 95% of the valuation without the prior approval of Cheyne.

### Benefits from being a property-secured lender

Property company shareholders bear initial strain from lower yields

The simplified example below shows the benefit of being a property-secured lender over a property company in the event of a downturn. It is why we included such companies in our report, [Secure income REITs – Safe Harbour Available](#), published on 22 March 2019. The initial strain of falling yields is borne by the property company shareholders – not the lenders.

	Property company		Property lender	
	Base	Downside	Base	Downside
Rent	100	80		
Costs	-10	-10		
Debt service/income	-70	-70	70	70
Profit	20	0	70	70

Source: Hardman & Co Research

Lower probability of default and lower loss in the event of default than unsecured lenders

When we consider property-backed lenders compared with non-secured lenders, the loss in the event of default for secured lenders is materially lower than that for unsecured lenders. Real estate property as security is especially valuable, in that the asset cannot be removed. The willingness and ability to provide security are also evidence of character per our CAMPARI analysis above. Security not only has a realisation value, but it is also likely to underpin mark-to-model valuations – all to the benefit of investor sentiment.

Limited competition in UK in Cheyne's target market

We understand that the competition in Cheyne's preferred space (£50-£150m) is modest, especially in the UK. Mainstream banks have significantly withdrawn for capital reasons, and Cheyne advises that, in the UK, whereas there may have been 10 competitors for each £100m proposal in 2006, there are now typically three. This varies by market, but the specialist skills required to deliver good service in property lending are another factor to be borne in mind.

Properly executing security is vital. This sounds simple and basic, but for HBOS, for example, ca.52% of cases had issues.

## Execution of security

One further consideration that investors need to make is that execution risk is a material issue. By way of example, we highlight s344, p88 of the FCA's *"The Failure of HBOS PLC. A report by the FCA and PRA"* (Hardman & Co emphasis), where over half of the security HBOS has taken may not have been effective.

*"The risk was increased by failures to perfect the security arrangements. In a meeting with the FSA it was reported that following a sample check of security 52% had issues. Similarly, the Bank of England, when reviewing a pool of property loans put forward as collateral, noted that HBOS had not registered its security interest on the property for a third of the loans. However, risks to the adequacy of security had been known: the CCRC recorded that valuation clauses were often negotiated out of contracts, or that clients would only accept a valuation every seven years, and that in practice it was difficult to get valuations. In February 2007, it had been discovered that almost 20% of valuations recorded in the division's systems were unattributed and therefore could not be relied upon. In effect HBOS had no or very weak security against a significant proportion of commercial property loans and was aware its security cover was potentially ineffective."*

Cheyne different, as loans are "owned" personally by the lender, who is much more likely to be actively involved in documentation

We believe Cheyne has a different culture from mainstream banks. In particular, there appears to be much greater personal ownership of loans, not least as the lender is likely to be personally responsible for restructuring and collecting the debt if it gets into difficulties. We were given a specific example of this in terms of documentation by a former Bank of Scotland lender who is now at Cheyne. At the bank, it would be rare for a lender to review documentation, leaving it instead to the specialist departments to do that. At Cheyne, the lender does review the documentation, even though it has been prepared by external lawyers (who are then on the hook should the documentation be prepared improperly, and whose costs are covered by the borrower), which has also been reviewed by internal legal counsel.

Both customers and value of security need to be monitored regularly. You cannot just do this when the loan is originated.

## Monitoring and review once a loan has been made

The early identification of accounts at risk is crucial to limiting credit losses. This means that lenders need to have effective monitoring of, and to establish a close working relationship with, their borrowers. Where ongoing control is simply left to waiting to see if payments are made, and then chasing at a later stage, the probability of loss will be higher, as will be the loss in the event of default.

On an ongoing basis, the main focus for Cheyne is on underlying asset and loan performance, and building relationships that are very close to the borrowers. This takes time and effort, but ensures that Cheyne has the earliest possible warning of difficulties, and that, when making suggestions for changes, these are from a trusted partner, and not a "Big-Brother" bank imposing its central rules on the borrower. The team engages with the servicer on each deal, and takes an active role, including, when possible, acting as class representative or operating advisor, in order to lead potential restructurings and to gain insight and additional information on the position's performance.

## Collection process

### Collections vital to level of end loss

Collecting debts can be just as important to ultimate returns as the initial lending decision. Cheyne advises that many of its staff have been actively involved in restructuring under-performing debt in previous jobs. We also particularly like the fact that a lender will typically be personally responsible for any restructurings that are required. This is better for the client, as the lender has already established a relationship with that person. It also gives greater ownership of the loan by the lender, which should be positive when making a lending decision.

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.

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 the 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, will be likely to see less of a recovery, and this could, in turn, have an impact on lenders to the property company. We do not believe this will be a material factor in isolation, but it is an unwelcome incremental pressure.

## Diversified portfolio

### Diversified portfolio by name, geography and sector

We note that there is diversity by i) name concentration – there are now 51 positions in the portfolio, with the largest single exposure (including undrawn commitments) being 9% of the NAV, ii) by geography – the UK now accounts for 66% of the portfolio, France 16%, Germany 6% and Italy 7%, and iii) the largest loan sector exposure is mixed-use (nearly 40% of loans, 20% total portfolio). The next-largest loan exposure is housebuilders, at just over 10% of the loan book (5% total portfolio).

## Returns for service, structuring and illiquidity premia

### Yields reflect risk-taking, but also i) structuring skills, ii) all aspects of service, and iii) illiquidity premia

We note that the range of yields is 5.1% to 13.5%, and that the average yield reported in the latest monthly factsheet for loans was 9.2% and for bonds (unlevered) 5.9%. These rates are significantly above the risk-free (gilt) rate of under 1% for the average life of RECI's assets, and investors need to understand how RECI generates them – in particular, how much is earned from risk-taking and how much from other factors, such as:

- ▶ Structuring skills that exploit intellectual capital to deliver appropriate deals bespoke to each client's needs. This may be especially important in development situations. From discussions with Cheyne, we understand that structuring skills are especially important to the return in France, while, in the UK, they are more important as a risk management tool.
- ▶ Service levels: as a specialist house, Cheyne may be expected to develop the niche skills associated with real estate finance and, as such, it can offer a better service level. This is, in part, understanding the client's needs, but also having clearer and quicker decision-making structures.
- ▶ One further aspect of this expertise/service level is that Cheyne may be comfortable at modestly higher LTVs than a mainstream lender – thus providing the borrower with incremental value.
- ▶ Cheyne will not advance an application unless it knows it has the financing in place to fund it. Accordingly, for the customer, there is considerable certainty

that a “yes” means it will get the cash when contractually due – an important element of service.

- ▶ We also understand that Cheyne will provide a “no” quickly – which is an important feature to potential borrowers.
- ▶ Market knowledge is important in delivering a quick solution to the customer. Cheyne lenders do not need to be educated on what is happening with, say, a development, because it is experienced and focused in its lending – unlike generalist bank lenders.
- ▶ Cheyne managers have built long-term relationships with counterparties, who can have confidence that their lender is not a “fair-weather friend”.
- ▶ Illiquidity premium: as a closed-ended investment company with permanent capital, RECI can exploit the illiquidity premia associated with its loans/bonds.

Cheyne also commented that, in many cases, there were limited opportunities for borrowers to access finance – often for factors outside the borrower’s control (e.g. banks’ policy decisions driven by the banks’ own capital requirements).

## Benefits from Cheyne as asset manager

RECI is externally managed by Cheyne Capital Management (UK) LLP, a UK investment manager authorised and regulated by the FCA. The Cheyne group, established in 2000, is one of the top European alternative investment managers by AUM. As at 31 July 2019, Cheyne had 153 employees, of which 30 were in the Real Estate Team, and AUM of \$7.1bn, of which \$3.2bn was managed by the Real Estate Team. It has offices in London, New York, Bermuda and Zurich. Cheyne invests across the capital structure – from the senior debt to the equity positions. It has expertise in the structuring, execution and management of securitisation transactions, involving a broad range of assets, including portfolios comprised of traditional asset classes, such as commercial and residential mortgages, as well as mortgage-backed securities and the management of commercial real estate portfolios, focused primarily on Europe and the UK. The company’s multiple awards are listed at <http://www.recreditinvest.com/awards.html>

Brings to RECI i) economies of scale, ii) expertise, iii) market knowledge, iv) depth in origination, with access to deal flow, and v) regular reporting

Looking through the company PR comments above and incremental to the hugely important service levels in the previous section, we detail below what we believe investors gain from having Cheyne as the manager.

- ▶ Economies of scale: these include operational efficiencies, but we note also that RECI can access much larger deals because of the firepower of the other Cheyne funds. There are various sweet spots of lending, with one being a size of loan below the level where capital markets would be involved, but above the level where banks are most competitive; RECI can access these deals (£50-£150m) because Cheyne has the scale to do so.
- ▶ Specialist skills: we detail in the section above how important it is to understand the implications for each stage of development, and the risks and likely business trends at each point.
- ▶ Market knowledge: the team’s long experience means that Cheyne has the relationships and networks to originate deals. We note that Cheyne originates business from a range of sources, including banks and finance brokers. The origination volumes in 2018 were significantly ahead of any previous year, and have continued at a similar rate this year. This is due mainly to the further retrenchment of banks, and the growth of Cheyne’s origination capabilities into

France in particular (following on from the established origination capabilities in the UK and Germany).

- ▶ Depth in origination: in the European MBS market, the Cheyne team has experience in direct investing, structuring, re-structuring, and trading with a continuous market presence. This provides incremental market information that smaller funds cannot match.
- ▶ Regular reporting: we note that RECI provides monthly factsheets, while SWEF and LBOW do so quarterly.

Asset allocation set by strict criteria within a policy that is policed by Cheyne's risk and compliances departments, who regularly report adherence to policy to RECI board, including personal attestation of the same

### Allocation process

As with any manager running multiple funds investing in the same assets, it is important to have clearly defined rules on allocation, a well-documented audit trail to prove policies have been adhered to, and clear reporting/accountability. We believe RECI follows all these principles.

- ▶ The policy is that deals are allocated to eligible funds *pro rata* on an AUM basis. Each fund has specific rules and internal limits – so they are not all eligible for each deal. There also needs to be sufficient liquidity in each fund to meet the commitments as they fall due (especially important for development loans where drawdowns will be in several tranches). Within this matrix of criteria, it is equally likely that RECI could get more than its “fair” share of a deal as it is that it could be below its “fair” share.
- ▶ Having established the allocation by the criteria above, the proposed split is then provided to the Investment Committee, which decides on whether to agree the loan.
- ▶ Adherence to the policy is also monitored by the risk and compliance departments within Cheyne.
- ▶ The RECI board receives a compliance report from Cheyne's Head of Compliance, confirming that the policy has been adhered to. Additionally, at least annually or on request, the compliance officer will make a personal attestation to the RECI board of the same (i.e. there is personal responsibility taken for adherence to the policy).
- ▶ We understand that intra-fund activity is small (e.g. RECI selling bonds to another Cheyne fund, or *vice versa*), and always done at arm's length. The dealing desk needs to get approval from Cheyne's risk and compliance departments and evidence independent pricing to ensure no conflicts.

Board not only independent of manager but has right mix of experience, and, we believe, the character to challenge the manager when required

### Independent, experienced board

We detail the biographies of the RECI board at the end of this report. We believe it demonstrates the key objectives investors should be looking for in a board, including:

- ▶ relevant experience of RECI's markets;
- ▶ current experience in comparable companies from which RECI's performance and controls can be effectively compared;
- ▶ experience of adverse market conditions; and
- ▶ independence from the fund manager – this applies to business dealings, and we also believe the RECI board's character is such that it would challenge the manager when required.

## Economies of scale at fund level

Fixed costs as % of NAV fall from FY'19 level of 29bps to 18bps by FY'21

Most of RECI's costs are variable, with around two-thirds being the management and performance fees. There has been some volatility in the other operating expenses line, which, over the past five years, has ranged from £577k to £921k, with an average of £734k. If we conservatively take the FY'19 number (£795k) on the latest net assets, this represents a 29bp annual cost. On our forecasts, this falls to 22bps in FY'20 and 18bps in FY'21. This is clearly a welcome improvement, but not one that is hugely material relative to expected returns or the impact of a material account going into default.

## Upside not included in NAV

Conservative accounting means potential profit shares recognised only when highly likely they will be achieved

The valuation policy for contingent fees and potential profit participations provided for in contractual arrangements is to mark them at fair value. In most instances, these positions have been obtained for a zero or *de-minimis* accounting cost. They are held at this value until there is sufficient proof that the position should be revalued. We understand this is typically evidential (for example, sale prices achieved on initial units), rather than a theoretical uplift from a comparative valuation tool. RECI has commented that it does not want to mark up positions and increase NAV too early, and potentially then have to mark them back down – so it wants sufficient firm independent evidence that the incremental value will be realised (i.e. bids on assets above carrying value). Currently, none of the positions in the book with potential variable returns report any of the potential upside.

## Broad investor appeal

RECI appeals to investors in i) property, ii) debt, and iii) fixed income. With a high yield, it is attractive to income funds, especially given modest regulatory risk.

RECI is an interesting investment to a broad range of potential investors.

- ▶ For those looking for property-related exposure, it provides asymmetric risk. The downside is reduced, as debt cashflows are paid before property equity investors. There is some upside from the profit-share relationships and, in a rising market, any losses in the event of default are likely to be fewer.
- ▶ For debt investors, the downside risk is again limited, given the value of real estate security reducing the loss in the event of default and the probability of default.
- ▶ For income investors, the high dividend yield is attractive, especially as it is generated from predictable income streams.
- ▶ For investors putting RECI into their “alternative” asset allocation, importantly, unlike some, it has limited regulatory risk.

Property and asset-backed debt companies have broad range of shareholders

RECI has a good institutional shareholder base. This is consistent with the other companies in this space, and we believe it shows considerable confidence and credibility in the sector as an asset class.

### Shareholding structures for property and asset-backed debt companies

Company	Largest shareholders
RECI	Close Brothers 8%, AXA SA 8%, Canaccord Genuity Group 8%, Fidelity 8%, Premier Asset Management 7%, Smith and Williamson 6%, Bank Leumi 5%
LBOW	Close Brothers 18%, Canopus Managing Agents 10%, TDC Pensonskasse 9%, Premier Asset Management 8%, Intermediate Capital 8%, Brooks MacDonald 8%, SG Kleinwort Hambros 5%, Corporation of London 4%, Hawksmoor IM 4%, AXA IM 4%
SWEF	Schroder 10%, Quilter Cheviot 8%, SG Kleinwort Hambros 8%, Close Brothers 6%, Fidelity 5%, Quilter 5%, Blackrock 5%, Premier AM 4%, BMO Global AM 3%

Source: Refinitiv (accessed 21 August 2019), Hardman & Co Research

## Accounting

Accounting valuation reflects management view within rules overseen by external auditors. Management culture more important than methodology, we believe.

54% of loans and bonds have observable pricing, and are not driven by management models

In normal conditions, market expectation of loss likely to be similar on both accounting approaches

Implications: i) value will reflect market sentiment, as well as long-term expected cashflows; ii) introduces interest and currency rate sensitivity

In our report, *Debt Investment Companies: Diving deep finds you the treasure*, published on 25 February 2019, we emphasised the importance of understanding the accounting principles adopted by the company. RECI values its loans and bonds at fair value through the profit and loss, as they are included in a group of financial assets that are managed, and their performance is evaluated on a fair-value basis (as is the case for secured lenders such as GABI or RMDL). In contrast, some other secured lenders (SWEF, LBOW, SQN, HWSL) value their loans at amortised cost. In normal markets, we do not believe the difference is likely to be material, and we see merits in both approaches, but investors need to understand the subtleties that the different accounting methods introduce. Investors should recognise that, adopting either approach, a conservative management will be conservative and an aggressive one aggressive, and that the accounts are a reflection of the management view of the assets within an accounting framework. We believe management culture is more important than the methodology, and RECI's conservative culture should serve it well on this basis.

RECI discloses its investments in a fair-value hierarchy that reflects the significance of the inputs used in making the valuation measurements. The three levels of fair-value hierarchy are i) Level 1 – inputs are quoted prices in active markets for identical assets or liabilities that the entity can access at the measurement date, ii) Level 2 – inputs other than quoted market prices included within Level 1 that are observable for the asset or liability, either directly or indirectly, and iii) Level 3 – inputs are unobservable for the asset or liability. We believe that Level 1 accounted assets are likely to have the greatest investor confidence, as they are a current price in a liquid market. However, as a loan/bond book designed to be held to maturity, we would not expect any Level 1 assets in RECI. Page 64 of RECI's 2019 Report and Accounts shows that an impressive 54% (FY'18 22%) of its loans and bonds actually fall into Level 2, where there are significant observable prices and where the valuation is thus not driven by modelling assumptions. RMDL reports (page 61 of its 2018 Report and Accounts) £45m of Level 2 assets (loans and bonds) and £58m of Level 3 assets (loans). We understand that such a significant element of Level 2 assets reflects the syndicated loan element to RMDL's corporate lending book. GABI, by contrast (page 92 of its Report and Accounts) reports a 100% Level 3 categorisation. For SWEF and LBOW, who use the amortised cost approach, this hierarchy has less value.

In a normal market, we would expect the difference in capital values between the two accounting approaches to be immaterial. While a loan at amortised costs sees IFRS9 impairments driven by an expected loss through the life of the loan, a market valuation (and so fair value) should be driven by the expected loss affecting the discount rate being applied. There are therefore two ways to come to the same answer. Additionally, the 46% of the loans and bonds that are on Level 3 accounting are model-driven, and again may be expected to reach a very similar valuation outturn as the same approach used by adopting the amortised cost approach.

However, by valuing at fair value and not amortised costs, there are a number of implications if market conditions are unusually volatile, as we highlight below.

- ▶ MTM valuations reflect sentiment, in addition to changes in expected cashflows. By being based off market prices, if there is uncertainty, the loans and bonds are likely to have a lower valuation than those based off cashflow-modelled assumptions.
- ▶ It introduces sensitivity to interest rate movements for fixed-rate lending. On an amortised cost basis, the value of a fixed-rate loan does not change if market rates change. For a fair-valued loan, if market rates rise, the value of the loan is likely to fall; if rates fall, the value is likely to rise. There is no change to the

## Real Estate Credit Investments

ultimate cashflows, but there is potentially more volatility under fair-value accounting. We note that the short duration of RECI's book means that any effect is likely to be modest.

Credit impairments go through P&L with no stock of provisions to judge adequacy of cover

- ▶ Under fair-value accounting, there is no visible stock of impairment provisions. We believe some investors get comfort from being able to assess the level of credit impairment provisions against the loans, and they use this measure to assess management conservatism.

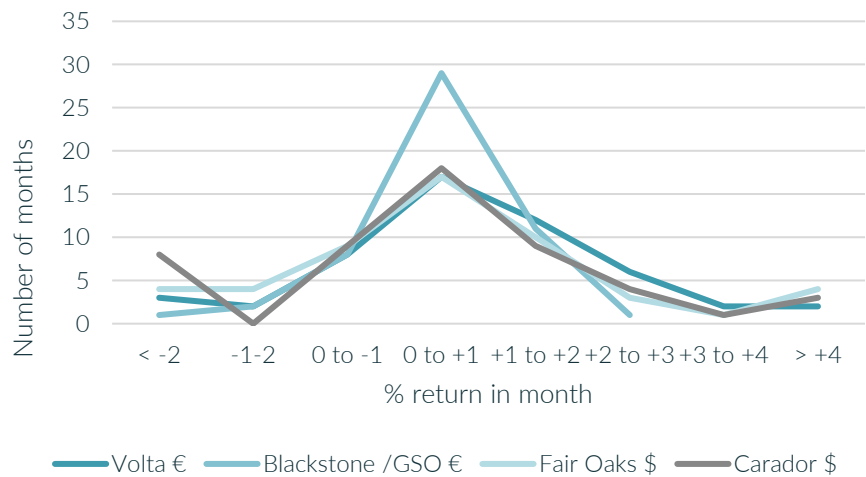
Evidence that accounting approach is conservative

- ▶ RECI does not mark up loans where a loan amortises. If you fair-value a fixed-rate loan, in theory, you could make an unrealised gain through its life. A three-year loan would normally have a higher rate than a one-year loan. When the former has just one year left, it would earn more than a new one-year loan, and so should trade at a higher price. Such a gain is illusory (the loan is repaid at par), and RECI does not write up such loans. The reason we labour the point here is that it is indicative of a conservative approach to accounting, which is likely to be applied across the whole book.

In uncertain times, likely to see lower NAV and more volatility

The overall conclusions are that RECI's approach is a more accurate reflection of the realisable value of assets at any time, and this is especially important when capital is being raised to ensure that any accretion/dilution is fair. However, in periods of uncertainty, RECI is likely to have a lower reported NAV and one that is more volatile than a business adopting amortised cost accounting. In the chart below, we show the effect over time for companies in the CLO space. The exception is Blackstone GSO, which uses a more marked-to-model approach than its peers and which, as a consequence, has a much less volatile NAV performance.

**CLO companies: number of months with different returns over past five years**



Source: Company factsheets, Hardman & Co Research



## Investment-neutral

### Read-across from Woodford and H2O funds

The well-publicised problems with Woodford Asset Management closing its flagship fund to withdrawals and Natixis's H2O funds (ca.30% outflows in a week) mean it is appropriate to consider what potential read-across there may be for RECI and, in particular, why it is different from these investment companies. In summary, we believe there is minimal real read-across, that there may be a business opportunity in gaining assets from open-ended funds, but that there may also be downside in terms of sentiment to illiquid investments.

No real read-across, as RECI has permanent capital, liquid assets whose value is taken from market prices, a visibly independent board, no asset contagion, and minimal dependency on platform distribution

#### Minimal real read-across

The key issues are the following:

- ▶ The permanent capital in closed-ended funds and limited debt gearing mean that RECI will not be, and – very importantly – will not be perceived to be, a forced seller of assets.
- ▶ As noted in the section above, a significant proportion of RECI's assets are on the Level 2 accounting hierarchy, with the valuations taken from identifiable market inputs. While there is an element of management discretion in assessing the Level 3 loans, it is relatively modest compared with valuing the equity of private companies, and we also believe that the inherent conservatism in culture can provide investors with some comfort.
- ▶ The board of RECI (see *Appendix*) is experienced, well balanced and independent from the manager.
- ▶ It is unclear what, if any, liquidity constraints may be applied to institutional investors' holdings of publicly-quoted shares. Anecdotally, we have heard that some managers (especially multi-asset managers) are facing restrictions from their compliance departments based off the liquidity of their holdings. In the past, simply being quoted was enough to be counted as liquid but, post-Woodford, this is now open to question. In due course, there may be additional regulatory requirements on the degree of liquidity, as is seen in the US. For RECI, we note that recent annual turnover has been around 27%-28% of the current market capitalisation (the same for peers). With its largest holders at 8%, RECI is better positioned than LBOW (largest holder 18%) or SWEF (largest holder 10%). As RECI increases in size through new equity issuance, and the largest holders are likely to be diluted by new shareholders, we expect the potential risk from liquidity to moderate even further.

Turnover on LSE			
£m	RECI	LBOW	SWEF
Current market capitalisation	330	120	428
12 months to June 2019	92	33	130
2018	96	27	108
2017	68	92	123

Source: LSE, Hardman & Co Research

- ▶ The other issues from the Woodford/H2O situations also do not appear material. In particular, we note that i) there is no asset pricing contagion risk, as RECI assets were not held by either party, ii) platform distribution has not been a material source of business and changes in rules there will not impact on RECI.

May see shift towards closed-ended vehicles...

## Business opportunity

Once the dust has settled and any new regulations are in place, the benefits of being a long-established, closed-ended investment company are likely to be visible. We believe sentiment may lead to a preference for such structures and that RECI is thus well positioned to benefit from any move from open-ended to closed-ended vehicles.

...but sentiment effect likely to be negative

## Downside from sentiment

Market sentiment can be hard to predict. The August 2007 stopping of withdrawals from two BNP Paribas hedge funds is seen by many as a significant event foretelling the lack of trust between financial institutions and the subsequent financial crisis. We believe that sentiment is more likely to affect investments that are perceived as illiquid than those that are seen as simple, low-risk and liquid. It should not affect RECI but, as noted above, this is hard to predict

RECI can borrow at sub-2%, so introducing some gearing adds value. Leverage is carefully controlled, and was only 26.5%, on average, through last financial year.

## Appropriate level of gearing

RECI utilised short-term leverage at an average cost of borrowing of 1.8% in FY'19, which is well below the yield earned on assets. Gearing to an appropriate level is thus value-adding, through leverage and also by having flexibility with cash management for issues like the timing of large loan repayments and limiting the cash drag ahead of an equity issue. The average leverage was 26.5% of NAV during the last financial year and, at the last monthly report, it was down to 18%. The board and Cheyne continually review the pricing and structure of a range of potential leverage options and have set a 40% limit relating to specific recourse leverage (there is also a 500% AIFMD regulatory limit, the calculations of which include areas like FX exposure, but as RECI is so far away from this limit that it is a meaningless measure). We note that the Repos facility is from a range of providers – so there is limited risk of a counterparty being unable to renew facilities, as they are squeezed for liquidity.

RECI marginally above peers in management fee, but difference is immaterial in relation to overall returns earned

## Fees

We detail below two aspects of cost disclosure.

Firstly, looking at management fees and performance fees, RECI appears to be above LBOW but in line with SWEF (taking into account origination fees). The KID disclosure on costs can be unhelpful (not least as it includes finance costs), but we understand that some in the smaller institutional market consider it helpful. As can be seen on this basis, RECI and SWEF have the same impact on returns, while LBOW is rather smaller. We note the zero transaction costs reported in the LBOW KID. For us, the important conclusion is that any differences are immaterial in the context of expected returns (7%-8%) and risks. A single account going into a loss situation is likely to be much more significant to investor returns.

### Fee structure for RECI and selected peers (%)

	Management fee	Performance fee
<b>Real Estate Credit Investments</b>	<b>1.25% NAV</b>	<b>20% &gt; 7%</b>
ICG-Longbow Senior Secured UK Property Debt Inv.	1.0% NAV	Nil
Starwood European Real Estate Finance	0.75%NAV *	20% > 8%

Source: Latest factsheets/Report and accounts, Hardman & Co Research  
\*plus an origination fee of 0.75%

### KID disclosure of costs for RECI and selected peers (%)

Year-end Dec (£000)	RECI	LBOW	SWEF
Transaction costs	0.06	0.00	0.41
Other ongoing costs	2.19	1.93	1.64
Impact on return in year	2.25	1.93	2.25

Source: Company KIDs, Hardman & Co Research

RECI earned better returns than immediate peers post fees

We also believe it is important to put fees into the perspective of returns. Over the past five years, post fees, RECI has delivered a shareholder return of over 7% p.a. Over this period, its cumulative return has been ca.10% above the levels reported by either Starwood or Longbow, despite their lower fee structure.

## Bonds and loans

Investors will note that roughly half the RECI portfolio is in direct loans and half in bonds. This split reflects specific deal opportunities, rather than being a strategic objective to have such a balance. The bonds are a mix of self-originated deals and third-party ones. Cheyne's approach is to invest in bonds that it is willing to hold to maturity, rather than trying to generate short-term trading profits. Having bonds in the portfolio means that:

There is a greater element of liquidity

- ▶ As at end-March 2019, all the bonds were Level 2-accounted i.e. there are observable inputs to value these bonds. We believe that having such observable inputs means that, should RECI need to sell the bonds, it is probable that there would be a market for them. To date, there have been only modest partial disposals, but the record gives management confidence that there is liquidity, if required.
- ▶ This liquidity, in turn, means that the bond element of the portfolio can be used for the low-cost Repos, increasing returns through leverage. There are other financing options more appropriate for the loan portfolio's characteristics. The nature of bonds makes them more suitable for Repos financing, while loans are more suitable for other types of financing.
- ▶ There is flexibility in product structuring to the advantage of either Cheyne/RECI or the issuer, or both. To date, there has been more European bond creation than in the UK, reflecting specific opportunities in those markets, including Italy.

Credit process the same

We note that the approach to assessing, monitoring and recovering for self-originated bonds is the same as for loans, and has all the rigorous procedures identified elsewhere in this report. The underlying assets to the bonds have the same high-quality core assets, are typically in prime geographical locations, and go through the same control processes as the loans. Cheyne believes that, for bonds, its flexibility, certainty of end-financing and strong service record mean it can charge a small premium to other issuers, such as investment banks. Management believes the third-party-originated loans have a nearly identical feel and look to self-originated loans (and hence, it is confident that self-originated bonds would be liquid, if required).

## Other issues

### Discount management

#### *Principles*

There are a number of tools that can be used to manage the discount. Many companies have policies that allow them to buy back shares if the discount is above a certain level for a specified time. Others use intermittent tender offers. We believe the key considerations are as follows.

Discount can be helped by buy-backs, but this can create liquidity issues, worsen expense ratios and send mixed messages re growth prospects

- ▶ On the upside:
  - It creates a buyer for the shares. The immediate effect of a large tender offer may be more effective in removing potentially bulky sellers. If future offers are expected, it may also mean that such sellers do not continually

drip shares into the market. Where there are likely to be a larger number of small-sized sellers, an ongoing programme may be more effective.

- The liquidity provided by buy-backs may encourage buyers, as it provides them with an exit route without disrupting the market price.
- It may be perceived as putting a cap on the discount, which the market could then close itself.
- It is “fairer” to all shareholders. A seller may arise for specific reasons (such as death, divorce or liquidity calls) and, by keeping the discount tightly controlled, such sellers do not lose out to discount variability.
- Where the discount is large, the returns on the cash used in the buy-back may be above the levels targeted in the investment company.

► On the downside:

- It could create liquidity problems.
- The capital could be better deployed in the fund.
- By shrinking the business, it worsens the total expense ratio, and increases leverage where there is debt.
- It sends a very mixed message, to investors especially, if the company later returns to the market for further equity funding.
- It can also send a very mixed message to staff. We note that, in its results call, JZCP, when announcing a buy-back and debt repayment plans, very clearly outlined why it would not be shrinking the business, by still originating assets but placing them in a different vehicle. Given the scale of RECI relative to Cheyne’s other real estate businesses, any shrinkage in assets is unlikely to affect, for example, staff morale.
- An active buy-back programme may reduce the likely return of capital by way of dividends, and thus benefit capital investors over income investors.

### *RECI’s approach*

RECI has consistently traded at around NAV or at a premium and, with such a track record of high-quality assets, this makes any discussion of discount management rather theoretical. There is a continuation vote every four years (next one due September 2021), and there is the standard buy-back authority for up to 14.99% of the share capital (this is renewed annually). We understand its discount management is kept under regular review and that all the issues above will be considered. We would expect a pro-active response should a sustained discount be probable.

## KID disclosure

We totally support the market’s antipathy towards the KID disclosure and its value to understanding risk. Having said that, in our report, *Investment Companies: Understanding the deepest discounts*, published on 14 May 2019, we did identify a correlation between the KID stress-test scenario and companies with the biggest discounts. We recognise that this calculation is driven by historical share price movements but, given the correlation we identified, we believe that at least some investors do view it as indicative of prospective risk. For RECI, the stress-test scenario outcome, at -69% one year, is above the peer average (LBOW -30%, SWEF -28%). We also note that RECI is classified as risk five (on a scale of one to seven, with seven being high), while both LBOW and SWEF are risk three. The upside in the favourable scenarios for RECI is 31%, against LBOW’s 17% and SWEF’s 19%. We understand from the company that the differences are methodological, as the share price and NAV performance, and underlying risk in the business, do not justify such a relative volatility.

**KID disclosure – RECI appears higher-risk than immediate peers, but this is driven by methodology, and not the “real” risk profile of the group**

**Capital raises at premium to NAV****Issue of shares at above NAV**

RECI is still in a growth phase, and we believe further capital issues are likely. Assuming they are done at a premium to NAV (RECI's share price has recently traded mainly above NAV), this is enhancing for existing shareholders, although we believe the effect is likely to be modest (on our forecasts <0.3% p.a.).

**Interest rate and currency risk****Interest and foreign exchange rate exposure**

RECI has longer duration assets than liabilities, and so rising interest rates have an adverse effect. Liabilities (mainly the £61m Repos as at end-July, which have a three-month maturity) re-price before assets. Should interest rates rise by 100bps, the estimated impact on the NAV is a decrease of £7.1m (ca.2%). We note that the book has a short duration and, given the likely trend in interest rates, such a change looks extremely unlikely in the foreseeable future. Hence, we categorise the direct exposure to interest rate risk as a relatively minor "other" risk.

RECI manages its foreign exchange risk on a portfolio basis and may bear a level of currency risk that could otherwise be hedged where it considers that bearing such risks is appropriate. Operationally, it manages its foreign exposure via forward foreign currency exchange contracts. Cheyne advises that it has looked to put on macro portfolio hedges in the past but has often found the correlations to be lower than expected. It still monitors this and maintains the ability to do so but, given the current strategy, Cheyne does not have any immediate plans to utilise such hedges.

**Sector allocation by investors**

We note that how RECI is treated within institutions is open to debate. Some will treat it as an "alternative investment". They may, like the AIC, classify it as a property company that invests in debt. Others will see it as a debt investment company whose lending is secured on property. Another option is to view it as a fixed-income investment. We believe that RECI could thus be attractive to considerable and different pools of capital. While positive in terms of the potential numbers of investors, it also potentially introduces uncertainty for investors as to how they should classify the investment. In our view, the economic fundamentals of the business mean that it is best analysed as a debt investment company with consideration for the property security, as for any other type of security.

# Investment risks

## Credit risk: turn in cycle

As for any lender, credit is key, and we expect conditions to steadily deteriorate from here. May also see further pricing uplift and reduced competition.

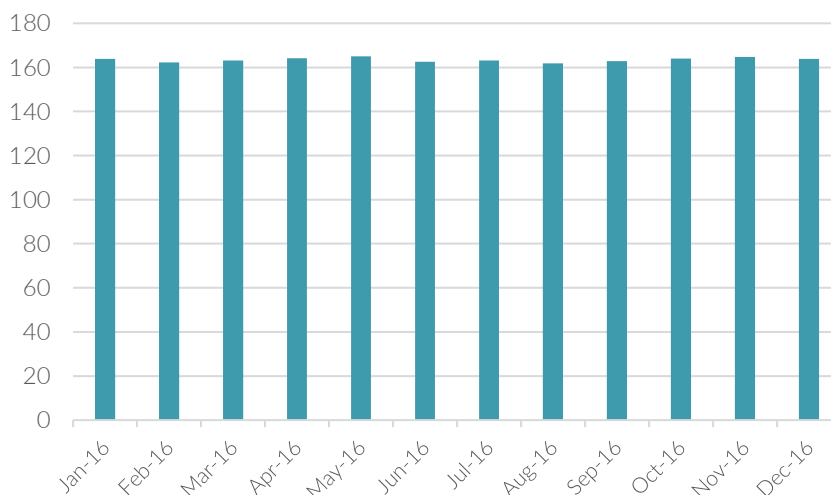
Credit risk remains the key issue for any lender. We believe that market-wide credit impairments will rise from their current levels and that investors should be prepared for this. By way of example, *CYBG on 15 May* reported exactly this trend, noting that impairments were showing "a return to more normal levels in SME". We note the recent *Begbies Traynor* "red flag alert", which showed a moderate rise in all levels of businesses in distress.

## Actual performance during shock periods

Stable NAV through Brexit

Investors will note our earlier comments that the NAV at the end of each financial year (March) was £1.62 (2015), £1.63 (2016) and £1.63 (2017), with the quarterly dividend unchanged over this period. Through the Brexit vote shock, RECI's long-term stable NAV performance remained unchanged. As can be seen from the chart below, there was no NAV impact in the period following the Brexit vote at the end of June 2016. This continued into 2017 – so there was no time lagged effect either.

NAV (p) through the 2016 Brexit period



Source: Company factsheets, Hardman & Co Research

Despite the stable NAV, the share price fell by around 10% immediately following the vote in June 2016, before fully recovering by September. This fall is significantly lower than that for most debt investment companies, and the recovery was rapid. Consequently, we believe that the issue for investors becomes more one of short-term sentiment.

Potential for spreads to widen and income to increase

## Upside opportunities

For several years, credit spreads have been tightening and covenants on new loans have been weakening (anecdotally to a level of enforceability in some areas that has been weaker than in 2007). While this has been most visible in corporate debt markets, we believe there has been some market-wide pressure on all lenders. This trend has created some capital gains (the older wider-spread business being more valuable than newly-issued lower-spread loans), but it can make for a challenging reinvestment environment. Concern about credit is likely to see wider spreads, meaning that the underlying income on reinvestment is likely to improve. The balance of increased income against increased credit loss will be dependent on the speed of credit deterioration and the duration of loans (and hence their rollover to higher rates). A slow, steady decline could see greater bottom-line profitability. Cheyne commented that its spread pressure had been modest (perhaps reflecting the degree to which its rates reflect factors like structuring skills), and so the upside may be more muted.

There may also be volume upsides for alternative financiers, as mainstream lender appetite to lend reduces. For example, historically, banks' willingness to lend to commercial property has significantly weakened in downturns, and current capital regulations and the inherent pro-cyclicality in IFRS9 accounting may exacerbate this historical trend. Competitive pressures may also ease, as non-bank financiers withdraw from the market, where they have difficulties raising their own funding. We note the comments in the Secure Trust Bank 2019 AGM statement that "The Group has been presented with additional opportunities to successfully deploy its capital and funding in the first four months of 2019 as a result of a number of non-bank lenders citing difficulties in obtaining or renewing credit lines."

Rising defaults likely to see MTM losses compounded by MTM effect of wider spreads seeing lower values for existing assets

## Downside risk

The speed of any deterioration in credit will be critical to losses relative to reinvestment opportunities. Increased defaults and covenant breaches are likely to see capital values fall. In a risk-on environment, spreads will typically widen, which is good for new investment, but may be adverse for the capital value of the existing book and lead to a reversal of the capital gains RECI saw from tighter spreads in 2016-18.

Volume upside as mainstream lenders withdraw  
Effect on sentiment-driven MTM hard to predict but highly probable market will over-react

In addition to likely actual losses, a further and potentially more important unknown for those marking to market is the effect on sentiment and the degree to which market prices are likely to over-react relative to long-term value. When credit losses are rising, the market applies a higher discount rate than it applies over a whole cycle, and consequently market prices might be expected to fall below long-term values. Not all assets are likely to show the same rate of deterioration and, in particular, sentiment towards specific sectors/sub-sectors is likely to create mispricing opportunities. Cheyne's active presence in the MBS market gave RECI access to exploit such opportunities in the past, and we would expect it to do so again in the future.

A portfolio with yields ranging from ca. 5% to 14% may be perceived as riskier than one with yields ranging from 7% to 9%.  
While variety of factors drive yield, the higher rates may be seen as high-risk.

## Perception of non-linear risk

We note that the management of the portfolio has led to a wide distribution of expected yields. RECI's reported yields range from 5.1% to 13.5% (FY'18 5.9% to 13.6%). Such yields can be generated from a range of sources, including limited competition, service, acceptable gearing levels, structuring skills, etc. They may also be generated from taking more risk, or – perhaps very importantly – perceived as taking more risk, while we note that the majority of the book is senior loans in the range of 8% to 10%, and this has been the focus for new lending over the past couple of years. However, RECI's outlier yields may be perceived as being at greater risk than a portfolio capped at this lower level.

Mezzanine finance higher-risk than senior debt

## Non-senior debt positions

We note that RECI has assets across nearly all aspects of the seniority scale. 19.5% is in non-senior-debt, mainly mezzanine finance. Mezzanine financing bridges the gap between debt and equity financing and is one of the highest-risk forms of debt, because i) these loans are subordinate to senior debt (i.e. paid later), and ii) usually, mezzanine finance is a bullet, rather than an amortised, repayment. Three of its top 10 exposures are mezzanine loans, and we note that the write-down in January 2017 was to such a loan. By way of comparison, LBOW's assets are 98% senior loans (2% cash), and SWEF reports 65% of its portfolio in whole loans, 30% in mezzanine and 5% in other debt instruments. Like-for-like, a greater concentration in mezzanine finance over senior debt indicates higher risk. However, the assessment of each credit exposure, how it is monitored and recovered, and the overall portfolio and diversity management, are important to understanding the real risk.

Cheyne has sophisticated approach to risk/reward management, and will take incremental risk where it is properly rewarded

In our discussions with Cheyne, it was clear that the business is run on a risk-adjusted return basis. In France, for example, the typical range of gross revenue yield on senior debt is 4.5%-5%. Given the relatively low risk of this lending, it can be levered to achieve gross returns in the mid-teens. This lending thus has relatively low credit risk, but has introduced liquidity risk. In contrast, the typical gross revenue for mezzanine finance in the French book is 7.5% to 14%. Given the higher credit risk from this type of lending, there usually is no leverage.

Lending at a distance is riskier than lending to geographically close projects

## Remote lending in different jurisdictions

We believe there is a direct correlation between the distance between a customer and the lender (from both a geographical and relationship perspective), and the risk in lending. To use the old cliché, the local bank manager is much more likely to know if a major factory is on partial shutdown than a distant lender, and is also likely to know which local businesses will be affected by that. This concept is compounded if the "distance" to the borrower involves cross-jurisdictional issues that can impact market knowledge but also recovery rights, and cultural willingness to pay, etc.

Cheyne's expertise is multi-jurisdictional. For strategic markets, Cheyne builds close relationships to fully understand the market. Where specific opportunities arise, it will take low-risk entry approach.

We discussed this issue in detail with Raphael Smadja, who has been heading Cheyne's drive into France over the past two and a half years. This operation is currently run out of the London office. Raphael outlined the Cheyne approach to getting close to such markets, so as to mitigate this risk, including:

- ▶ The dynamics of each market are different. For example, in France, the incumbent domestic banks are more active than, say, UK banks in RECI's target markets. To understand this needs networks of contacts in that market and local cultural knowledge (Raphael is French).
- ▶ Many of Cheyne's core competencies are cross-jurisdictional. For example, while French banks are quite aggressive on pricing and willing to accept greater leverage than, say, in the UK, they are constrained in the flexibility of their offering. RECI's core competency in structuring deals gives it a clear competitive advantage that is not dependent on taking risk.
- ▶ A willingness to commit resources to regularly visit in person, not only potential borrowers, but also key network partners, such as developers, brokers and banks. As we detailed earlier, RECI site-visits every advanced proposition, but it is building extensive market knowledge well beyond that. This network has established a list of recommended local professional partners – so Cheyne can have confidence in local valuers/project managers/lawyers/financial advisers, etc, as required.
- ▶ Cheyne has had the scale to establish a French lending vehicle – so it can lend directly to borrowers, in addition to structuring finance through a Luxembourg



vehicle/bond markets. This should be a lower-cost and less complex option, again enhancing customer service.

- ▶ We understand that discussions on opening a Paris office are advanced. This would reduce the risk from remote lending, although it introduces management control issues to ensure that group policies, approaches and cultures are maintained.

**Low-risk entry to marginal markets**

We also discussed with Cheyne its approach to some of its more marginal markets, such as Portugal (2.5% of the portfolio). We understand that, while there is a strategic desire to broaden the geographical footprint/portfolio diversity, the approach to more marginal markets is very cautious. Specifically, for Portugal, Cheyne followed an established and experienced borrower and was willing to take less risk (both security cover and in the debt structure). While France and Germany are clearly key strategic investment markets for Cheyne, and so have the resource investment detailed above, it would appear that, for other markets, the more opportunistic approach is based on low-risk appetite.

We note that Italy represents 7.2% of the portfolio and that Cheyne has principal exposure through bonds to this market. We understand that this book was largely bought at primary issuance, with Cheyne staff negotiating certain structural features and obtaining sizeable allocations across several tranches. Cheyne has emphasised that the credit analysis is identical to other situations, including site visits by Cheyne staff to a substantial proportion of the assets (by value), and verification of a business plan and underwriting assumptions with a network of local industry contacts. In our view, visits to all sites would have been ideal, but investors can take considerable comfort from the fact that the exposures have been subject to Cheyne's own processes (with the proven track record discussed elsewhere) – but also subject to other institutions' credit reviews. These multiple pairs of eyes offset the risk that some small (by value) properties have not been seen directly by Cheyne staff.

In our view, these are sensible approaches to entering new markets where there is more remote lending. The kicking of tyres for every loan is important, as is building the network of local knowledge and expertise. We believe remote lending is riskier than neighbourhood lending, but that Cheyne is adopting the right practices to mitigate this risk.

## Development finance

**Development finance been area of historical loss for banks. RECI has different approach, with lending primarily when developments are out of ground, lender has personal ownership of loans, and with experienced staff who have been through the cycles and know the market.**

We note that development finance has been an area of major losses for mainstream banks in the past. More recent increases in regulatory capital, reflecting historical losses, have seen a significant withdrawal of banks from this lending category. There have been a number of challenger financiers, although we note that their progress has not always been smooth – e.g. Urban Exposures (ticker UEX) has seen its share price nearly halve from its peak in September 2018.

We believe it is important that investors understand what RECI is doing differently, and we discussed this issue in detail with Arron Taggart, who leads the UK lending side of the business. The key differentiators identified were:

- ▶ We understand that, as a general rule, Cheyne will lend only to developments once they are out of the ground, rather than at the riskier stage of buying the land upfront. There are exceptions to this rule (e.g. with a Lisbon development) but, in such circumstances, other criteria are more tightly controlled (e.g. only senior debt, no mezzanine, lower LTV, longer relationship with the borrower, etc).

- ▶ Cheyne's culture is clearly aligning the originator of a loan with its performance, not least by usually making the originator head any restructuring/recovery process. To the staff, it is therefore "their" loan and not that of the "banks".
- ▶ Arron made the point that the Cheyne staff was highly experienced in this niche element of lending. This means that it knows and understands the risks at each stage of development and, with this experience, can tell at an early stage when something is not going to plan. Additionally, such experience builds a network of the contacts to double-check any borrowers' claims/credibility.
- ▶ As discussed above, we believe Cheyne can hire the "best" people, which ultimately is the key differentiator in this market.
- ▶ Cheyne lends only to experienced, substantial developers, most of whom they have known directly for many years, and over many projects. It is a personal relationship business, not a factory churning through standard deals.
- ▶ For developers, finance is not their core interest, and having certainty in finance, with a provider who can be flexible in structuring the product and understands their market (and so does not waste their time), is important. As noted above, the price they pay reflects this service.

As with Cheyne's remote lending, we view development finance as above-average risk. Cheyne is again adopting the right approaches to mitigating the risk. We note that principal losses since RECI adopted its current format in 2011 have been zero.

### Higher LTV exposures

While the overall portfolio has a modest LTV (loan book average LTV 67.5%, bonds 61.8%), this average hides a range of covers, with over 75% of the loan portfolio on an LTV below 60% and only a small tail of high exposure. We note that RECI has a maximum commitment to a regional housebuilder, at 82% LTV, and we discuss this profit-sharing mezzanine loan later in the report. In summary, Cheyne is actively engaged in the project, and has an appropriate risk/reward with the profit share.

### NAV includes expected value of interest, not just principal

The calculation of the NAV values all the expected future cashflows using an appropriate discount rate. As a consequence, it includes the value of coupon and payment in kind (PIK) payments. Even where the principal is fully expected to be repaid, if there is uncertainty over these receipts, this could affect the NAV to the extent to which they have already been included in the accounts.

As noted earlier, the one month that showed a fall in NAV since January 2016 was driven by a 2.1p per share (£1.5m) drop on the fair-value revaluation of a mezzanine loan secured by a fully-let retail park in Essex. Since January 2017, RECI has received over two-thirds of the outstanding balance, having worked closely with/and encouraging the sponsor to get back on track. The issues were due primarily to delays to the business plans post-Brexit, and the retail park's asset management has improved considerably. As at July 2019, the majority of the principal had been repaid, with the outstanding loan just over 1% of NAV, and RECI expects full recovery of the principal. This loan will not have incurred a loss on cost, although the IRR and NAV have seen a hit.

75% of loans have LTV below 60%. One exposure is at 82% LTV, with project-specific risk management and appropriate upside potential.

Valuation will be impacted if there is adverse change in expected interest, not just principal repayment risk

Heavy concentration in London – unlike peers

### London concentration

We note that 26% of the total portfolio (i.e. £87m) is in central London loans, with a further 7% (£26m) in greater London loans. The major London facilities are low LTV (£30m at 45%, £25m at 64%, £18m at 38%, £16m at 75% and £16m at 63%), but this still creates a geographical concentration in the portfolio. While LBOW's is 100% UK, London is only 25% of its portfolio (with a further 7% in the South East). SWEF has just 12% in central London exposure.

### No read-across from financial crisis

Investors with long memories may recall that RECI used to be called Queens Walk Investments Limited and that its share price fell from ca.1,200p to ca.50p at the trough of the financial crisis. While the fund was managed by Cheyne, its investment policy was totally different. In 2006, 80% of the book was residential mortgage-backed securities (all top 10 holdings were RMBS), 9% SME and 11% asset-backed securities. The approach and business mix mean there is no read-across from that business to RECI now.

Actual turnover of book faster than contractual life, which means it must find re-investment opportunities. However, Cheyne takes tiny part of Cheyne origination, is in growth mode, and turnover of book allows for rapid re-pricing of book if credit environment turns.

Loans are less liquid than bonds. Compared with peer investments, the presence of bonds makes RECI more liquid.

Financing is low-cost but short-term

## Re-investment from rapid turnover

Investors will note the short contractual duration of the book (as noted earlier, latest factsheet weighted average lives of loans was 1.7 years and 2.4 years for bonds). We note, from an examination of note 16 of the 2019 Report and Accounts, that the actual life has been closer to 1.5 years. Such a turnover has both advantages and disadvantages. On the upside, should this trend continue, it allows for a rapid re-pricing of the book should spreads widen, thus increasing income more quickly than a long-life book. On the downside, RECI has to continually find new opportunities to replace maturing business. In terms of the scale of Cheyne, this should not present a problem, but it is a potential risk for the future.

We note that the turnover in the book also reflects the fact that RECI will opportunistically purchase bonds, which have experienced some level of stress. There may be opportunities for early sale in the secondary market as pricing recovers, due to technical factors or an improvement in collateral fundamentals (e.g. post-restructuring). While such bonds may not have been bought with trading in mind, such positions are likely to have a relatively shorter life than the book as a whole, and RECI believes that a core Cheyne competency is its ability to assess when an early sale optimises returns.

By way of comparison, LBOW has an average life of just over 1 year and SWEF 2.8 years.

## Potentially illiquid market for some assets

Conditions in loan markets have been favourable over recent years, with spreads compressing and covenants easing. While there have been occasional hiccups (e.g. in 4Q'18), there appears to be demand for loan assets, which suggests that, today, RECI would be able to sell its loan positions at fair prices. However, it is unlikely that RECI would want to sell positions – it is, after all, in growth mode.

Should market conditions deteriorate, it is unlikely that demand would be as robust. It may be that the funders themselves will have difficulty accessing finance, in addition to concerns about credit. RECI can do nothing about the former, although its property-secured assets should be more likely to retain their value than, say, unsecured lending.

## Short-term financing

We note that RECI has structured its borrowings at the short end (three-month Repos), which mean that its liabilities mature much more rapidly than its assets. In normal market conditions, RECI will generally post additional collateral if the market value of the underlying securities declines (the Repos are governed by standard GMRA contracts, and any MTM movement on the bonds is covered by the counterparties charging a variation margin). However, there is the potential to see some liquidity strain in extreme market conditions for factors outside RECI's control, as the MTM move, and so margin call, could be extreme. Having such an event could see RECI being an unwilling seller of assets at prices below their current level. We note:

Gearing kept low and from diversified group of funders. Capital is permanent and bonds structured to be marketable.

- ▶ Cheyne conducts regular detailed analyses of cashflows on RECI, as well as on potential borrowers. All its obligations are modelled during this process, and liquidity is benchmarked against this in a range of scenarios.
- ▶ The level of gearing is low (latest monthly factsheet indicates £61m of debt against NAV of £331m). RECI's policy is to limit gearing to 40% of NAV (historically including preference shares), which is well below the level seen in most property REITs.
- ▶ RECI has diversified its Repo providers and does not take facilities from banks, which may face their own funding strain. This counterparty selection is reinforced by Cheyne staggering the maturity of Repos. By using only high-creditworthy, liquid banks and diversifying maturity dates, the risk from market liquidity issues is reduced.
- ▶ Compared with long-term facilities, the main covenants on Repo facilities are very light – typically limited to MTM asset coverage. As such, RECI is not facing cashflow or profitability targets, which it could trip over for reasons outside its control. The risk of finance-induced action against shareholder interests is thus reduced.
- ▶ The permanent capital structure of the closed-ended vehicle means that assets do not have to be sold because of potential shareholder redemptions.
- ▶ The self-originated bonds have been structured so that they are marketable and can be sold rapidly. In this context, a two-month window should be sufficient to liquidate a significant proportion of the bonds.
- ▶ The excellent long-term track record should give lenders comfort in providing facilities to the portfolio as a whole. Clearly, the issues that would see short-term Repo providers unwilling to renew facilities are likely to have a material effect on counterparties' willingness to provide different facilities, but it may be an option.
- ▶ As at the last factsheet (April), LBOW had cash of £2.3m and drawings under its working capital facility of £3.5m (net debt to equity gearing of 1%, gross 3%), with borrowings capped at 20% of NAV. SWEF reported June 2019 cash of £28m, with the amount drawn under its revolving facility of £46m (net debt to equity of 4%, gross 11%). SWEF caps its aggregate short- and long-term borrowings at a maximum of 30% of NAV, with longer-term borrowings limited to 20%. The actual drawings will vary with the timing of equity raises, loan drawdowns and repayments. We do not believe that the differences in policy are material.

# Current portfolio

## Summary

The investment policy guidelines are detailed in the *Appendix* of this report. The result is presented in the table below.

Portfolio summary				
	RECI loans (£174m drawn)	RECI bonds (£169)	LBOW (£121m)	SWEF (£447m)
<b>Sector (%)</b>				
Mixed-use	38		27	
Office	12		14	13
Housebuilder	12			
<b>Hotel/hospitality</b>	11		17	41
Residential	8			10
Logistics/Industrial & distribution	6		24	16
Serviced apartments	5			
Retail	5		18	14
Student accommodation	4			
<b>LTVS</b>				
0-50%	13			
50-60%	62			
60-70%	13			
70-80%	6			
80-100%	5			
<b>Country</b>				
UK	83	48	100	33
France	8	24		3
Portugal	5	0		0
Italy	0	14		0
Germany	2	10		3
Finland		2		1
Conduit		2		0
Netherlands		0		7
Ireland	1	0		15
Spain				30
Hungary				8
Czech Republic				0
<b>Largest exposure</b>				
Largest commitment	30.4	21.0	22.4	53.8
Top 5	110.5	n/d	88.2	227
No. of investments	18	33	10	17
<b>Features</b>				
Levered yield (%)	9.2	8.1	7.2	7.4
Average LTV (last £, %)	67.6	61.8	63.1	64.7
Average remaining life (years)	1.7	2.4	1.15	2.8

Source: Factsheets – RECI June, LBOW April, SWEF June, Hardman & Co Research

As can be seen, the portfolio construction among the property-secured debt investment companies is very different. RECI has the broadest diversity by sector and the largest exposure overall. Its yields are the highest and its LTVs broadly in line.

## Top 10 commitments

Look at RECI origination philosophy before looking at individual assets

Our starting point to analysing risk is the quality of the sponsor/bond issuer and the quality of the prior relationship between Cheyne and the sponsor. We consider the cashflows (and risks thereon) to be of crucial importance. These are influenced by a number of factors, and we touched on some in the descriptive analysis earlier. Certain of the top 10 commitments should be substantially de-risked through security with low LTVs and being senior loans. All are de-risked in their own way, and so, for some, we provide further description.

A little bit about a “typical” RECI CMBS

It is worth noting that the typical structure of the bond is a three-year duration with potential shorter extensions on tightened covenants (subject to milestones and investment KPIs being met). The bonds typically are “bullet” repayment. Bonds on RECI books originated post-2016. Most were originated by Cheyne but some, which were not, would have had Cheyne materially involved in their construction.

Let's look at the RECI commentary on the larger exposures, and then add some of our own

This segment of our research addresses the principal risks by size of commitment, but we also consider it noteworthy to touch on some of the overseas markets addressed, by virtue of the fact that these positions – cumulative by country outside the UK – are substantial investments.

Our analysis of the top 10 holdings is in two tables, followed by further descriptive detail on some of the commitments. The first table is as published by RECI in its most recent public factsheet.

### Top 10 commitments – as per RECI published investor factsheet

Code	Description	£m commitment	LTV	Strategy	Type	Manager commentary
1	London Mixed Use Development	30.4	45%	Senior Loan	Development	Substantially complete, fully pre-let and pre-sold
2	London Mixed Use Development	24.9	64%	Senior Loan	Development	Substantially complete, partially pre-let
3	Regional UK Housebuilder	21.3	82%*	Profit Sharing Mezzanine Loan	Real Estate Op-Cop/ Prop-Co Loan	Secured by a real estate company, as well as its individual properties
4	UK Care Homes	21.0	73%	CMBS Senior Loan	Core	Stable, income-producing assets
5	London Office to Residential	18.3	38%	Loan	Development	Development completed, now in fit-out stage
6	UK Leisure	16.7	65%	CMBS	Core	Stable, income-producing assets
7	UK Leisure	16.7	65%	CMBS	Core	Stable, income-producing assets
8	London Mixed Use Development	15.6	63%	Mezzanine loan	Development	Substantially complete, sold and let
9	London Hotels	15.0	75%	Mezzanine loan	Value add / transitional	Assets that require asset management (typically refurbishment) to secure a core income profile
10	German Office	15.0	62%	CMBS	Core	Stable, income-producing assets

Source: RECI; \*For housebuilders, values are calculated on loan to cost, not to current value (cost being lower)

The second table, below, provides the briefest of overviews of Hardman & Co's views on some of the risk characteristics of the RECI commitment.

Top 10 commitments – Hardman & Co analysis overview		
Code*	Description	Hardman commentary
1	London Mixed Use Development	Significantly de-risked, with modest LTV, senior loan, physically advanced.
2	London Mixed Use Development	Part of a series of large buildings on a long-term strategic development site in zone 4 north-west London. 50% office, 50% private residential for sale.
3	Regional UK Housebuilder	An established housebuilder based in the Home Counties. We note the opportunities that pertain to the profit-sharing element of this exposure. We understand Cheyne has representation on the client board.
4	UK Care Homes	A national portfolio managed by one operator, which is a well-established, growing, family-run business. Around 50% private pay rooms, and 70% of rooms are en suite. The average fee indicates "upper-mid" market.
5	London Office to Residential	Significantly de-risked, with modest LTV, senior loan, physically advanced. We understand this loan is near repayment.
6	UK Leisure	The bond is secured against a portfolio of family holiday parks located across the UK, and sponsored by a global private equity firm with specialism in UK operating assets.
7	UK Leisure	The client is the same as client code 6, and the bond is similar in nature.
8	London Mixed Use Development	Significantly de-risked (see manager comment in table above). There is relatively modest LTV, but this is a mezzanine loan (not a senior-ranked loan).
9	London Hotels	Relatively high LTV and mezzanine loan on assets, which require some work. The covenant is of high quality and supported by parental guarantees from a substantial, quoted, pan-European business.
10	German Office	Nationally, German office take-up and rents have been strong. This exposure is to a Grade A office and hotel complex next to Frankfurt Airport. In Frankfurt, we note rental yields rose 7% 2018 on 2017, and vacancy rates are 7%, with 11.7m of stock and 0.5m m2 under construction. We see this as a low-risk market supply/demand situation.

Source: Hardman & Co Research; \*this refers to code in the table above

## An illustrative example on residential development lending

The following commentary is the Hardman & Co overview. We are not commenting on the structure of the loan or bond, and we are not commenting with the benefit of undisclosed detail on matters such as specific covenants. Underwriting criteria evolve over time and are tightly customised by commitment, but some characteristics are worth alluding to. They provide a qualitative insight into typical (but not "one-size-fits-all") criteria. For example, as regards residential, it might often be the case that the developer is not free to sell at any chosen price. Typically, there may be a restriction (e.g. 5%) as to the discount versus the pre-appraised price. RECI will have a detailed view of the track record of sales prices over the cycle for "comparables", as well as a detailed view of competing schemes and market potential. Typically, it might seek to be exposed to no risk until sales prices fall by, maybe, 25%. This would be after factoring in a possible extension in the timeline of the developer's sales too. It may seek to bring in sub-ranking new lenders also, to reduce that 25% downgrade breakeven significantly further. These are all realistic but nonetheless illustrative figures.

### Commitment #2 in the tables above

#### *London mixed-use development*

This zone 4 long-term development features a mix of office, residential and leisure. The well-established strategic lead-developer, RECI's client, is creating a large new community here, on a large strategic site, well within the urban envelope, with good transport links. The main redevelopment progressed via a large student accommodation block opened in 2013. In the same year, a large public-sector anchor tenant moved offices to the strategic location, and mixed development has continued since. Thus, the strategic development is already well advanced, and we understand that sales rates over recent years have been good. As the strategic lead-developer's brochure states, it "has transformed assets across London into places



where people want to live, companies want to grow and neighbourhoods can come alive." A number of leading national housebuilders are involved in selling on the site.

With the loan being a senior charge and the client (and main contractor) well-established, we consider the relatively full LTV not to be an unwarranted risk for a development. The sum advanced is not a rising draw-down.

Commitment #3 in the tables above (£21m) and another just under £15m – so outside top 10

### *Regional UK housebuilders*

RECI has exposure by loans to two housebuilders, one of which is as per the summary description in the tables above. While the two are quite distinct businesses, with distinct risk and reward, both positions stem from the same investment principles. Cheyne's capabilities include the expertise within the team of specialists to intervene in running the clients' businesses. Both housebuilders are established businesses and have established management teams. Cheyne has – where it became appropriate – taken a seat on the board, as well as governance control. It also holds equity participation but, we understand, the valuation in RECI's accounts is conservatively stated at a modest level. RECI's two housebuilders are well-capitalised and expanding – conservatively – with their respective clearly-articulated policies.

One concentrates on products with selling prices of around £250,000, which is a large and affordable market to aim for. The core geography is Peterborough and the surrounding region, with an ancillary growth point south westward. Land cost tends to be similar to gross profit margin, providing significant financial resilience.

The other housebuilder operates profitably out of offices in Beaconsfield and Guildford. Much of the product is for sale, at £250,000 to £750,000 – virtually all houses, not apartments. New management was put in place in 2016, driven significantly by Cheyne. The sites pre-dating this have been worked through.

Let us turn to some general investment parameters for UK housebuilders, bearing in mind that RECI has a profit share exposure. First, how does the developer lower its financial risk? The decision to commit to work in progress is driven typically by the housebuilders managing building rates closely allied to ongoing new sales rates. Although we understand that this is not the case currently, here, the strategy of the housebuilder might or might not take it to a greater or lesser commitment of capital upfront.

Of course, holding land with planning provides significant security for lenders. Such a security type typically commands a ready market. If forced to sell – in a theoretical downturn where pre-sales were to dry up – the housebuilder might sell at a loss and would find it difficult to sell a "live" site without taking, possibly, a significant loss. Much more typically – and this is why so few housebuilders in past downturns have found it impossible to trade their way out of ultimate difficulty – the developer would stop buying land and would "cash-out" by selling houses at reduced prices to exit sites and wait before re-investing. The problem would be if the developer concentrated simply on very large sites where trading out would take an overly extended time period. It would also be a problem if too much work in progress were tied up before firm buyer commitment (as might be the case with apartment schemes). There is also the two-fold risk connected to elevated sales prices. Aiming for the upper-middle "trade-up" market might lead to buyers who are dependent on property "chains" selling their own homes prior to commitment. It should also be noted that Help to Buy has assisted certain purchasers significantly, enabling purchasers with restricted buyer-ability to self-finance a deposit.

## Commitment #4 in the tables above

*UK-wide care homes portfolio*

Some of the characteristics of this commitment are listed in the tables above. We consider it important that the family business is well-established and has succession planning. As is standard, there are covenants as to the cash invested into maintenance (and selective upgrade) capital expenditure. We are confident that Cheyne monitors this constantly progressing ratio tightly, as it does the large number of other operational issues, not least the crucial Care Quality Commission (CQC) rating evolution. We understand CQC rating is part of the covenant.

We understand that ca.50% of the rooms are currently private-pay and that this ratio is rising. The weekly fee exceeds £800 and, within that, private can be some 25% higher. We note this is a growing portfolio, and one that is being selectively modernised, typically some short time post-acquisition. We have confirmed that, across the portfolio, capital is ring-fenced for maintenance and selective upgrade. There are around 30 homes owned and, with acquisitions, this is expected to rise. The business plan is for ongoing conservative expansion, so – in the expansion phase – a proportion of the rooms will be off-rent, due to major upgrade or to physical expansion projects. We would anticipate that any slowing of expansion would, in due course, lead to an expansion in free cashflow within the portfolio. We believe the portfolio is approximately evenly balanced between residential elderly care and nursing care.

This type of asset is of high quality, while also requiring a high level of monitoring to calibrate the evolution of the cashflows and risks. Therefore, while it is an established asset class that is eminently eligible for bank debt, non-bank lending can aspire to higher multiples of EBITDA as a commitment – specifically because such advances call for more “hands-on” monitoring.

Further details can be found in the Cheyne press release <https://www.cheynecapital.com/media/2419/cheyne-capital-provides-funding-to-country-court-care.pdf>

## Commitment #6 in the tables above

*UK family-based leisure*

This asset has been described above. In summary, the owner is a major global real estate specialist, well-financed and maintaining a progressive programme of upgrade investment. By the nature of the asset, occupancy through the year is excellent, as is visibility of bookings. The asset is well-maintained. Indeed, 4Q'16 saw a significant rise in lodges “off-line” due to upgrades. We note, from previous investor presentations, that there is a covenanted level of maintenance capital expenditure, which has been running at just under 10% of EBITDA. Operating margins are typically 40%-50% of revenue, figures that are broadly consistent over each location. Occupancy is in the high-90% level. Forward bookings typically are robust: ca.80% of the following year is typically booked by the autumn of the previous year.

## Commitment #9 in the tables above

*London-based small chain of high-quality hotels*

This handful of London hotels was purchased this year by a large, global company (Queensgate Capital). This investment company – which is proactive in investment to ameliorate cashflows and asset quality – is based in London. In place from day one is a strong covenant (Fattal Group), which has entered into a 25-year inflation-linked lease. There is a Topco guarantee in place from the listed company, which strengthens the lease covenant. While we have provided a brief overview of the London hotel development market (in the section of this report above), we consider this a special situation, predicated on the expertise of the established global hotel-specialist owner. The owner is investing in order to hold the assets into a stabilised income phase. More details on the exposure can be found at <https://www.thecaterer.com/articles/548588/grange-hotels-sold-to-queensgate-in-1b-deal> and <https://www.cityam.com/queensgate-investments-buys-four-grange-hotels-central/>.

### *Italian exposure*

The Italian commitment assets are outside the top 10. Nonetheless, they are reasonably meaningful (7% portfolio end-July). A lot of the assets are either malls or family cinemas, with many, but not all, of the cinemas being co-located in the malls – a typical type of development – and the remaining assets are largely long-let to good-quality local and European retail covenants. We discussed the nature of the exposure and Cheyne’s early involvement in structuring deals above.

### *French exposure*

The French exposure is largely, but not exclusively, in central Paris, in hotels, offices and certain other assets, such as purpose-built student housing. Certain hotels are in well-established locations in the Alps or the south of the country. It should be noted that some of the hotel assets are not fully income-stabilised and some are in the process of re-branding (to Accor). Some were previously owned by investors who could not, or were not able to, optimise investment into the hotels. The important point is that, of course, each asset has an active asset-management plan and a well-equity-financed owner.

## Valuation

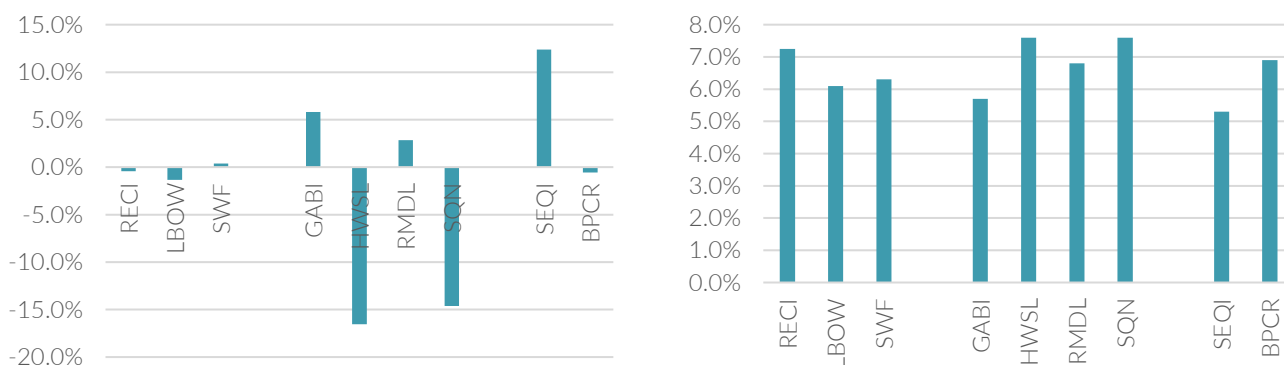
### Yield attractions above those of peers and NAV rating in line

We discussed the yield and its sustainability earlier in the report. We believe this is a key attraction for investors. In the charts below, we compare the premium/discount to NAV of RECI with its immediate peers (ICG-Longbow Senior Secured UK Property Debt Investments and Starwood European Real Estate), as well as a broader group of secured lender investment companies (GCP Asset Backed Income Fund, Hadrian’s Wall Secured Investments, RM Secured Direct Lending, SQN Asset Finance Income Fund). From the left-hand chart, we calculate that the average rating for the close peers is a 0.5% discount to NAV and, for the broader group, a 5.6% discount. RECI’s 0.4% discount is thus around the middle of the pack. The wider peers – not unsurprisingly, given their broad sensitivity, history and perceived risk – have a much broader range of valuations.

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

For illustration purposes, we have also included i) Sequoia Economic Infrastructure Income (SEQI), which has a diversified portfolio of senior and subordinated economic infrastructure debt investments, and which shows that specialist lenders can trade at a significant premium, noting the market’s current strong appetite for infrastructure funds (average premium to NAV for straight infrastructure funds ca.15%), and ii) BioPharma Credit (BPCR), which trades at a premium, despite a significant cash drag following a large loan repayment.

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



Source: Latest factsheets, priced at close 23 August 2019, Hardman & Co Research

### Upside from issuing shares above NAV

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

## Financials

The key driver to the absolute level of income, costs and profits is the extent to which incremental capital is raised and the timing of its deployment. We assume that FY'20 and FY'21 will see equity raises of £78m (raised 24 May 2019) and £86m, respectively, more in line with FY'18 (£83m) than FY'19 (£23m). We have not geared up on this equity growth. We assume a further increase in bonds as a proportion of the book (continuing the recent trend and reflecting increasing European penetration, which is more in bonds). In terms of revenue yield, we have assumed 6.5% for bonds and 9.5% on loans in FY'20, both up on the level reported in the latest monthly factsheet and reflecting the market uncertainty we expect over the coming months. Administration costs are forecast to be down on FY'19 but still well above the average of FY'16-18. For modelling purposes, we assume no change in forex, and we have built in some net gains on investments. With the returns above the hurdle rates, this triggers further performance fees.

Profit and Loss							
Year-end Mar (£m)	2015	2016	2017	2018	2019	2020E	2021E
Interest income bonds	6.4	4.7	2.6	5.4	6.9	12.6	17.1
Interest income loans	9.5	12.9	12.5	12.8	15.2	14.9	18.4
Other interest income	0.0	0.1	0.2	0.2	0.2	0.2	0.2
<b>Interest income</b>	<b>15.8</b>	<b>17.7</b>	<b>15.3</b>	<b>18.4</b>	<b>22.3</b>	<b>27.8</b>	<b>35.7</b>
Net (losses)/gains on investments	-0.1	4.7	4.6	2.8	-0.1	2.4	2.4
Net losses on options	3.2	-1.6	-2.4	-0.9	0.0	0.0	0.0
Net gains on foreign exchange instruments	2.6	-5.6	-1.8	0.2	3.1	0.0	0.0
Total net gains on fin. assets at FV through P&L	5.7	-2.6	0.5	2.2	3.0	2.4	2.4
<b>Operating income</b>	<b>21.6</b>	<b>15.1</b>	<b>15.7</b>	<b>20.6</b>	<b>25.3</b>	<b>30.2</b>	<b>38.1</b>
Management fee	0.0	-2.0	-2.0	-2.6	-3.0	-3.8	-5.0
Performance fee	0.0	-0.2	-0.1	-0.3	-0.7	-0.4	-0.6
Other operating expenses	-4.2	-0.9	-1.1	-0.8	-1.1	-1.0	-1.0
Operating expenses	-4.2	-3.1	-3.2	-3.7	-4.8	-5.1	-6.6
<b>Profit before finance costs</b>	<b>17.3</b>	<b>12.0</b>	<b>12.5</b>	<b>16.8</b>	<b>20.4</b>	<b>25.0</b>	<b>31.5</b>
Finance costs	-3.5	-3.5	-3.4	-1.9	-1.2	-1.2	-1.2
<b>Net profit</b>	<b>13.8</b>	<b>8.5</b>	<b>9.1</b>	<b>14.9</b>	<b>19.2</b>	<b>23.8</b>	<b>30.2</b>
Other comprehensive income	0.0	0.0	0.0	0.0	0.0	0.0	0.0
<b>Total comprehensive income</b>	<b>13.8</b>	<b>8.5</b>	<b>9.1</b>	<b>14.9</b>	<b>19.2</b>	<b>23.8</b>	<b>30.2</b>

Source: RECI Report and Accounts, Hardman & Co Research

In looking to clean earnings, our main adjustment is stripping out all capital gains to see the level of more predictable income. This may be unfair on RECI, for whom some capital gains are part of the core expected return. We also adjust the performance fee to reflect the lower return. It is worth noting that, if there were a forex move that generated a gain on the asset but a loss on the derivative, this would show in net gains on investments with an equal and exact offset in net losses on foreign exchange instruments. Not all the capital gains seen in the past are thus "real".

Hardman & Co adjusted Profit & Loss							
Year-end Mar (£m)	2015	2016	2017	2018	2019	2020E	2021E
Statutory profit	13.8	8.5	9.1	14.9	19.2	23.8	30.3
Capital gains & FX movements	5.7	-2.6	0.5	2.2	3.0	2.4	2.4
<b>Profit excluding capital gains &amp; FX movements</b>	<b>8.1</b>	<b>11.1</b>	<b>8.6</b>	<b>12.8</b>	<b>16.3</b>	<b>21.4</b>	<b>27.9</b>
Adjustment to performance fee	0.0	0.2	0.1	0.3	0.1	0.2	0.0
<b>Adjusted profit</b>	<b>8.1</b>	<b>11.3</b>	<b>8.7</b>	<b>13.1</b>	<b>16.3</b>	<b>21.6</b>	<b>27.9</b>
Cost of dividend	-7.9	-7.9	-8.4	-13.7	-17.6	-23.9	-29.9
Statutory cover	1.8	1.1	1.1	1.1	1.1	1.0	1.0
Excluding capital gains cover	1.0	1.4	1.0	0.9	0.9	0.9	0.9

Source: RECI Report and Accounts, Hardman & Co Research

We have included our best estimates for capital raises in FY'20 and FY'21. The sensitivity of per share measures (and the dividend) is modest – marginal investments are earning similar returns to the book, most costs are variable, and, with the use of Repos financing, the cash drag effect is modest. One material profit share realisation is likely to be much more significant to per share estimates than the level of equity raised.

Balance sheet							
@ 31 Mar (£m)	2015	2016	2017	2018	2019	2020E	2021E
Bonds	59.4	39.6	49.8	97.3	163.1	225.0	300.0
Loans	87.1	113.2	109.3	148.1	139.4	175.0	200.0
Financial assets at FV through P&L	146.5	152.8	159.0	245.4	302.5	400.0	500.0
Cash and cash equivalents	8.1	5.3	24.9	7.2	38.6	19.0	2.9
Cash collateral at broker	0.0	0.0	0.0	2.4	1.4	1.4	1.4
Derivatives	4.8	3.2	0.9	0.2	0.7	0.7	0.7
Other assets	3.5	2.5	4.4	4.9	12.0	12.0	12.0
Receivable for investments sold	0.0	0.0	0.0	48.1	0.0	0.0	0.0
Total current assets	16.4	11.0	30.2	62.8	52.7	33.1	16.9
Total assets	162.9	163.8	189.3	308.2	355.2	433.1	516.9
Current liabilities							
Derivatives	0.5	0.5	0.0	0.0	0.0	0.0	0.0
Financing	0.0	0.0	0.0	78.3	100.1	100.1	100.1
Cash collateral due to broker	0.0	0.0	0.4	0.0	0.1	0.1	0.1
Preference shares	41.7	41.8	41.9	0.0	0.0	0.0	0.0
Other liabilities	2.6	2.7	2.7	1.3	1.7	1.7	1.7
Total liabilities	44.8	45.0	45.0	79.6	102.0	102.0	102.0
Net assets	118.1	118.8	144.3	228.5	253.2	331.1	415.0
% of fin. asset at FV in bonds	41%	26%	31%	40%	54%	56%	60%
Debt as a percentage of equity	35%	35%	29%	34%	40%	30%	24%

Source: RECI Report and Accounts, Hardman & Co Research

Cashflow							
Year-end Mar (£m)	2015	2016	2017	2018	2019	2020E	2021E
Profit before tax	17.3	12.0	12.5	16.8	20.4	25.0	31.5
Movement in investments and liabilities at FV in P&L	-13.0	-6.3	-0.5	-0.2	0.1	0.0	0.0
Net purchases of investments	0.0	0.0	-5.7	-134.5	-9.1	-97.5	-100.0
Movement in derivative financial assets	-3.0	1.7	1.8	0.7	-0.5	0.0	0.0
Operating cashflows before movement in working capital	1.3	7.4	8.1	-117.1	11.0	-72.5	-68.5
Increase in other assets	-0.2	1.0	-1.9	-0.5	-7.1	0.0	0.0
Increase/(decrease) in other liabilities	-0.1	0.1	0.0	-1.4	0.4	0.0	0.0
Movement in cash held by/due to broker	0.0	0.0	0.4	-2.8	1.1	0.0	0.0
Net cash inflow/(outflow) from operating activities	1.0	8.5	6.6	-121.8	5.4	-72.5	-68.5
Cashflows from financing activities							
Net sales of shares	0.0	0.0	24.8	83.1	23.0	78.0	86.0
Dividends	-7.9	-7.9	-8.4	-13.7	-17.6	-23.9	-29.9
Preference coupon paid	-3.4	-3.4	-3.4	-1.6	0.0	0.0	0.0
Redemption of preference shares	0.0	0.0	0.0	-41.9	0.0	0.0	0.0
New drawings under finance agreement	0.0	0.0	0.0	78.6	21.8	0.0	0.0
Net cost of financing agreement	0.0	0.0	0.0	-0.4	-1.2	-1.2	-1.2
Net cash inflow from financing activities	-11.2	-11.2	13.0	104.1	26.0	52.9	54.9
Net increase in cash and cash equivalents	-10.3	-2.7	19.6	-17.7	31.4	-19.6	-16.1
Opening cash and cash equivalents	18.3	8.1	5.3	24.9	7.2	38.6	19.0
Closing cash and cash equivalents	8.1	5.3	24.9	7.2	38.6	19.0	2.9

Source: RECI Report and Accounts, Hardman & Co Research

# Appendix: state of the markets

## Introduction and methodology

The methods and structure behind RECI's origination are the most important

Earlier in this report, we assessed the all-important structures and philosophy behind RECI's origination policies. This is the driver to delivering a resilient business – because, from it, stems the positioning of the portfolio. RECI's matrix includes its own depth of local knowledge and its assessment of each commitment: principally, the cashflows, the local “micro” market, the covenant and the macro asset-class risk. However, it also must act on a view on the broader real estate dynamics to which it is exposing shareholder money.

The asset-class exposure is important too – we analyse UK commercial real estate, UK residential and Continental European commercial

## Assessment of trends in RECI's principal markets

We analyse rental and valuation trends in key asset classes: i) UK commercial real estate; ii) UK residential development; and iii) Continental European commercial real estate in the sectors most relevant to RECI's book.

We look first at UK commercial real estate and then at UK residential, and we summarise our answer to the question, “How does this UK positioning affect RECI?” We then provide a brief overview on French offices. This is used also as a proxy for broad confidence trends in hotels (a sector with direct relevance to RECI). We touch on the market conditions for Italian offices (also used as a proxy for broader confidence trends) and shopping centres, to reflect some of the Italian asset-class exposure for RECI, and we also comment on Germany.

RECI has exposure to regional UK housebuilders through various instruments, including mezzanine debt. We provide an overview of the current and strategic positioning of the UK housing market and the housebuilders.

*These form the basis for then drilling down to RECI's commitments*

This assessment of these components of RECI's real estate opportunity by asset class puts into context RECI's top 10 commitments that we discussed earlier.

## UK commercial market

### An overview of price forecasts

First, we assess UK commercial assets' rental and valuation trends

The rental and valuation outlook for the UK market as a whole, on average, is weak. Growth prospects for rents have been downgraded over the past two years, particularly over the past year. Indeed, retail property rents are seen as falling slightly in absolute terms this year and also over the next two, according to most commentators. For the total market, there is a minimal rental reduction anticipated this year, and then a minimal rise next, followed by a small rise in 2021. We quantify this in the tables below.

For a broad-based analysis of projected rent and valuation trends, we draw data from the official survey collations published by the Investment Property Forum (IPF).

Our summary of what forecasts tell us is as follows:

Trends are weak

- ▶ The outlook is for weak rental growth in some sectors and an ongoing, more significant, fall in all forms of retail.
- ▶ Risk appears to be on the downside – even without the additional negatives of the outlook on Brexit and the global economy's effect on the UK – as evidenced by the August downgrade in UK GDP growth forecasts from the Bank of England.

Downgrades modest and progressive

A 2.6% shortfall in rents versus spring 2018 forecasts – noticeable but not overly disruptive to lenders

Valuations are relatively robust, with some risk on the downside

- ▶ But none of this caution is new – optimism over the recovery from the global financial crisis peaked in the UK early in 2018. It was at that point that rent and capital value forecasts on UK commercial real estate started to see downgrades.
- ▶ The past year’s downgrades are relatively modest (in both rental and capital value outlook). For instance, the cumulative shortfall in “All-property” rents for the three years of 2019, 2020 and 2021 in the most recent estimates, versus those of spring 2018, is 2.6% – this is a noticeable figure, and the trend may extend further, but it is not a dramatic worsening.
- ▶ There is an anticipated rise in capitalisation rates (net initial yields, or NIY) evidenced by the forecasts that capital values will perform worse than rents, but this deterioration in the NIY is, like the downgrades themselves, modest in nature.

So, it would be an ill-judged policy that would have led any professional lender into difficulties under this macro scenario. We now turn in a little more detail to the forecasts as published by a recognised consensus of commentators and analysts.

## The detailed data on UK rent and valuation trends

For the broadest input on projected trends in rent and valuation, we draw data from across the IPF survey.

We reference the IPF survey, which takes in a broad range of inputs

The IPF surveys a wide variety of market participants: the 27 contributors to the most recent quarterly forecasts comprise 13 property advisors and research consultancies, 12 fund managers and two others. Rental growth in retail is negative. In other sectors, the prognosis is positive, but, in most cases, the rise is weak – so average rents across all UK commercial real estate fall this year and witness small rises in the following two years.

Retail is bad...

...and weakness in office sector still leaves rents forecast to grow

The IPF survey estimates of both rental growth and capital values have been revised downwards across the board, as we have alluded to. Here we provide a little more detail. Deterioration compared with spring 2018 is evident for most asset classes within UK commercial real estate and for all three forecast years. Indeed, IPF notes a deterioration in all sectors, apart from Industrial (which is broadly unchanged). By far the greatest reductions are in all sub-categories of retail, with the reduction in rent estimates (i.e. the change in forecast spring 2019 vs. spring 2018) in the offices sector being 1.2% in the current year and 2.1% in 2020. There are a number of possible drivers, but, clearly, some of the deterioration must be a reflection of the extension to the Brexit timetable.

Rental value growth forecasts, %			
Segment	2019E	2020E	2021E
Offices	0.4	0.3	1.1
Industrial	3.0	2.2	1.8
Standard retail	-2.8	-1.7	-0.6
Shopping centres	-3.9	-2.6	-1.3
Retail warehouses	-3.1	-2.1	-0.9
All property	-0.2	0.1	0.6

Source: IPF spring 2019 survey

After valuation growth in 2018, small falls are projected in coming years

The IPF UK consensus forecast as of spring 2018 for All property rental value growth in 2019 was 0.6%, which the table above shows as then falling to a negative figure of 0.2%. While 2018’s actual outcome of a small rise was in line with IPF consensus early estimates, 2019, 2020 and 2021 have all seen consistent, if undramatic, reductions in estimates. For example, the cumulative shortfall in rents for those three years in the most recent estimates vs. those of spring 2018 is 2.6%.



Capital value growth forecasts, %			
Segment	2019E	2020E	2021E
Offices	-1.7	-1.3	-0.1
Industrial	2.6	1.0	0.5
Standard retail	-7.4	-4.5	-1.3
Shopping centres	-10.7	-6.2	-3.1
Retail warehouses	-8.9	-4.9	-2.0
All property	-2.8	-1.7	-0.5

Source: IPF spring 2019 survey

**2019: All property values set to fall 2.8% – downgrade from 1.4% fall projected a year ago**

**Minor change – not significant inflection point**

**This assessment is pre potential “no-deal” exit from EU**

**Under negative scenarios, important that supply pipelines are generally modest**

**Important to note RECI’s minimal exposure to retail**

Turning to the capital value estimate, as of spring 2018, for All property, the fall was -1.4%. As the table above shows, the most recent forecast shows a downgrade to a 2.8% capital value fall. This reduction in value of 1.4% is more than the 0.8% reduction in rent growth estimates (the new estimate of a 0.2% fall vs. the estimate a year earlier of a 0.6% increase). However, we consider it worth noting that the estimated trimming of capital value is only somewhat worse than the cut in rent forecasts. This points to a reasonably resilient valuation basis (NIY). Our overall view is that this reasonably resilient position is not unwarranted at all. The valuation basis for commercial real estate is made up of a large number of variables, but one in particular provides robust and significant support. This is the risk-free return available on long-term government debt, which has seen ongoing falls in the past year.

Turning to 2020 and 2021 IPF consensus forecasts for capital values, the figures a year ago (the spring 2018 survey) stood at -0.7% and +0.3%, respectively, whereas now the figures are -1.7% and -0.5% – again, a deterioration, but a steady and – as yet – not large deterioration.

It is noteworthy that macroeconomic factors, such as unemployment and earnings growth, have remained benign. Consumer spending is not under particular negative pressure. In a “no-deal” Brexit scenario, the Bank of England suggests rising inflation and a reduction in both supply-side inputs and demand. The risks are on the downside. This would seem to be particularly evident in retail.

So perhaps a “no-deal” Brexit scenario would test market trends. An important factor to be clear about is that, currently, supply/demand is not being distorted by significant rises in supply. This supply scenario is best analysed in detail asset class by asset class and, particularly, location by location, but developers are remaining generally more disciplined (nine years into the upturn) than in most previous cycles. The potential negative scenarios are dependent on a significant weakening of occupier demand and are not set to be exacerbated (other than very specific isolated instances) by the supply of new commercial real estate developments.

## UK commercial sectors of relevance to RECI

An earlier segment of this report assesses RECI’s top 10 commitments (by quantum), but some of the larger asset-class sector exposures comprise London mixed-use sites, UK-wide care homes, London hotels and UK leisure parks. There is also exposure to regional (south-west Midlands – west country) housebuilders.

### *Retail – minimal and only in mixed-use schemes*

The generally negative forecast UK commercial real estate trend seems relatively gentle, indicating that – unless matters change markedly for the worse – a reasonably conservative and professional lender should find an environment that is relatively safe, in which borrowers can service their commitments. Retail is a structurally difficult environment. We note that RECI’s exposure to retail – apart from modest exposure through mixed-use schemes – is minimal.

### Offices – mixed-use schemes

For offices – an asset class that sees exposure for RECI through its London mixed-use schemes – the outlook in the coming couple of years has deteriorated, but rents are still forecast to rise, whereas small reductions in valuations are estimated by the consensus of forecasters. We consider this to be an unexciting but resilient-enough environment for lenders. Pockets such as the most expensive London areas, like Mayfair St. James, may be at some risk as a result of high pricing – as regards offices, not retail. New supply is not taxing the rates of take-up in the large majority of the areas in the UK.

Care homes an asset class into which RECI has made a commitment

### Care homes

Within commercial real estate, RECI has care home exposure that is supported by strong covenants. However, it is always best to challenge the asset class itself, setting aside the covenant.

Care homes are affected by a disparate variety of factors. There is a widening differentiation of NIY valuation basis regarding prime and sub-prime segments. Valuation is usually on the basis of EBITDA of the homes. These are treated as operating companies. Again, on EBITDA, the spread of valuations in the market is high, with higher-quality, more expensive occupancy cost assets tending to lead to higher EBITDA multiple valuations. Valuations also vary between care homes relying on public funding and those where the service on offer attracts private-pay clients on higher rates.

People are living longer, and the number aged over 85 is set to double by 2040 to 3.2 million. Capacity is well below its 1994 peak, having fallen some 20% between then and 2004, and remaining stable since, despite the rising demographic demand. Effective demand is another matter. In 1985, NHS and local authority homes comprised 70% of the total, but this figure is now around 3%. 45% of funding is private, 44% pure public sector, and 11% is public funding with a private top-up (Source: Laing Buisson). This last segment is growing rapidly – so there is a transfer in funding to the types of establishments where occupants and families are prepared to pay all or some of the cost. This places significant funding pressure on the portion of the independent care sector that is designed to suit publicly-funded occupants. Nonetheless, since 2005, revenues for private operators have grown 4.2% p.a. (Source: Impact Healthcare REIT). This is a growth sector, but one where different assets face very different investment outcomes.

RECI has taken on exposure to London hotels

### Hotels

Within commercial real estate, RECI has hotel exposure in London. For the detail of RECI exposure risk, it is essential to note that the exposure to hotels is supported by strong covenants. However, we also consider it prudent to look at the asset class itself.

Hotel exposure within RECI is based in London, which is by far the largest institutional hotel market in the UK. In 2017 and 2018, London development exceeded long-term supply growth trends, according to Knight Frank's (KF) survey. In 2017, the latest KF data, on new rooms, brought the London total offering to 160,000 rooms, and grew 4%, with further growth of a similar nature in 2018. London accounts for ca.40% of the UK development pipeline. KF, using Glenigan data, states London's pipeline at 11% of existing supply, a significantly greater percentage than any other area nationally (most UK regions see 4% to 6%). This is quite normal, given the size and, principally, the complexity of the market in London. Brexit uncertainty may cut both ways, with a falling currency a significant compensatory factor.

Looking more closely at central London hotel developments, new rooms totalled 1,500 in 2014, 5,600 in 2015, 3,500 in 2016 and 5,000 in 2017. We have no data currently for 2018. Of the 16 cities (plus Heathrow and Stansted) identified in the KF sector report, the London stock growth rate average since 2010 stands at 1.2% p.a., which ranks only above two other cities in the UK. London's growth has been modest; yet the pipeline under construction or with detailed planning (typically a near-three-year delivery window) stands at some 15,000 rooms in London.

UK-wide, in the past couple of years, over 15,000 new rooms have entered the UK market each year. Two-thirds are in the budget sector and two-thirds are new build (Source: Knight Frank). Some commentators see regional cities as more attractive to developers than London; indeed, KF, just as one example, does not place London in the top five.

### *Family leisure parks*

#### UK family leisure exposure

In leisure, the RECI exposure is to sites that offer family lodge accommodation, allied to central facilities and outdoor, as well as indoor, experiences. These assets benefit from significant rolling maintenance capital expenditure upgrading the quality of the assets. Commentary suggests that such expenditure has expanded in the past three years, under new ownership.

## UK residential trends

#### Some background to RECI's UK residential developer exposure

### UK housing market

In this segment, we note the long-term structural issues that principally comprise the growing population, ongoing moderate reductions in household size and the supply shortfall that was particularly evident between 2010 and 2017. The annual deficit is now some way below its 2014 peak. The overarching point is that there was a demonstrable undersupply of housing before 2010 (evidenced by rising prices for purchase and rent and by public sector waiting lists) and that, since the 2014 peak, the cumulative deficit has risen by some 800,000 units (Source: Construction Products Association and Forterra).

#### London has seen slowdown from 2014, with pricing now entering negative YoY territory

Regionally, the Scottish and Welsh nations are seeing price rises some 1.5% to 2.0% above UK national averages, as are the Midlands and Yorkshire. The north-west of England is seeing prices rising slightly above UK levels elsewhere, and other regions in line with or below. Prices in London, south-east England and north-east England are falling, although only modestly, at ca.2% or less. Again, looking at trends of the past few years, comparing with the current position, it is noteworthy that house prices compared with average household earnings stand at 5.0 times, compared with 5.1 times at end- 2014. Only five out of 13 regions identified by Arbutnot Group (28 May 2019 "Perspectives") see this ratio down versus 2015, while the UK-wide figure is marginally down. Large regions, such as London and various categories of the rest of the south east, have cheapened on this measure, but a number of regions where the ratio is lower than the UK average have nonetheless seen the ratio rise (marginally) since 2015. This has to be a slight concern for outer regions.

RECI's exposure is to East Midlands, Oxfordshire and Home Counties

We understand that RECI's exposure to regional housebuilders is through two, which are located broadly in the East Midlands, Oxfordshire and the Home Counties..

Lender trends remain robust

From a lender's point of view, one of the prime issues is that overall market lending is stable. There are no material signs that loans for residential properties are growing above trend, and the same can be said for transactions. Since 2013, residential transactions have been remarkably steady, at 260,000 to 320,000 p.a. (bar a spike upwards at the time of a change in Stamp Duty Land Tax – SDLT). From 2008 to 2012, the number ranged between 160,000 and 250,000, but, in 2007, the market was much larger, at around 400,000 and more. Loan approvals show a very similar trend, although at lower levels, as some homes are bought without a loan.

New housing supply is rising..

### *Cumulative undersupply, but a softening market*

...but 800,000 unit cumulative shortfall has built up since 2010 alone

The Bank of England May Inflationary Report commented that “in addition to reduced demand, an increase in housing supply may also have weighed on prices”. We see this as a potential warning sign, but the extent of the risk should prove low. We reiterate the broad picture painted at the start of this segment of this section, namely the 800,000 unit shortfall just since 2010.

Nonetheless, it is clear that the housing market is slowing, particularly housing for sale and particularly within and near the M25. Annual national price growth is barely over 1%, which is the lowest since early 2013. In autumn 2014, average price rises of 9.5% were registered across the UK. The 2014 Autumn Statement announced higher rates of SDLT and, since then, trends across the market (starting in London) have been progressively weaker.

Weakening market but mortgage finance available at competitive rates..

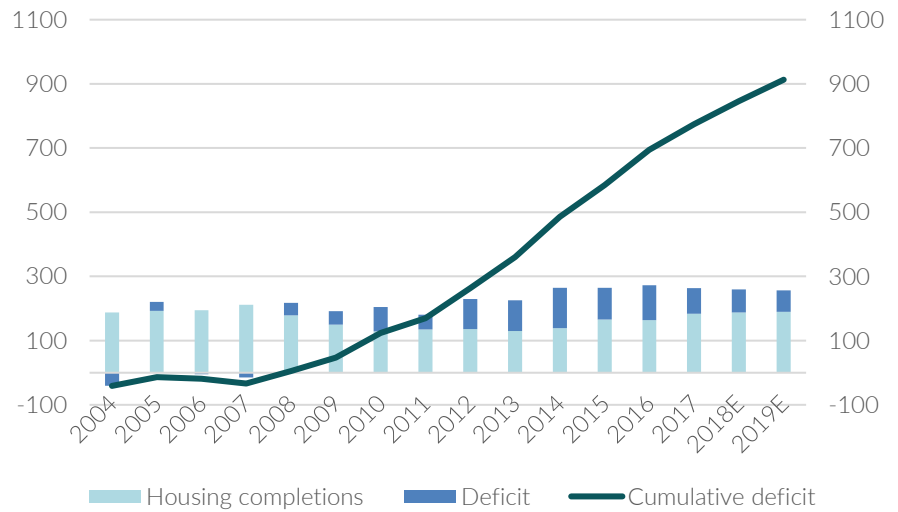
What might be dragging down the market? It is neither absolute nor real wages rises, where the situation is improving after a particularly weak patch pre the EU Referendum. Nor is it worries about the cost of borrowing. The mainstream prime mortgage market is very competitive, and market-wide rates for risk-free interest rates are falling at all maturities over one year. Fixed-rate 75% LTV two-year mortgages cost 6.0% in 2007, 3.8% in 2012, 1.7% in 2017 (Source Arbutnot Group) and a similar rate in 2019. UK population growth is still positive, at ca.1% p.a., but growth, still positive, is just starting to reduce, with a slightly smaller net immigration to the UK. Brexit uncertainty hit a peak in February and March 2019, and this impacted both the sales and rental markets (this effect is blurred, however).

The rental market was subdued in the run-up to the ban on agents' fees to tenants, which caused tenants to hold off moving until March; since then, there has been an upward spike. For transactions, the May and June completion falls are the lag from March's uncertainty. There are signs of a pick-up in agreed transactions, but uncertainty remains.

...and volumes to date holding up

Before we turn to the developer market (as opposed to the underlying housing market), we emphasise again the supply/demand imbalance. The chart below is put together from data provided by the Construction Products Association and the Department of Communities and Local Government. It shows annually the units of housing completed in each year. This is then allied to annual household formation. If, for example, the household formation were 200,000 and the annual housing completed in that year were 170,000, then the “deficit” shown in the chart would be 30,000. These annual deficits (note that some years, such as the very first, 2004, show a surplus built that year) are then cumulated to provide the line on the chart. That line – the cumulative shortfall from an (arbitrary) starting point in 2004 – clearly shows that the market just about kept pace with household formation demand until 2008. Since 2008, the market has significantly under-delivered.

UK housing units – completions vs. household formation (000s)



Source: Forterra (Construction Products Association (CPA) Construction Industry Forecasts – spring 2018 – and Department of Communities and Local Government), Hardman & Co estimates.

A market failure – and RECI is here to help

This under-delivery is an important component to RECI in two ways:

- ▶ The financial crisis led to a lack of financing – particularly for medium-sized developers. This contributed significantly to the deficit shown above.
- ▶ This major shortfall in funding for medium-sized residential developers plays into the hands of institutions – such as RECI – which have an appetite to address this market.

In our analysis on UK commercial real estate, we looked at the positions on both rents and valuations. The equivalent for UK housebuilders is to look at housing completions and prices, but then to look at the market prices for quoted housebuilders.

While housebuilding has some clouds appearing, market pricing shows strong demand for the asset class, with most quoted housebuilders trading above NAV

It is reassuring that many quoted housebuilders trade at a premium to NAV, but most have low debt, which must assist this resilience of the rating. Trading at a premium to NAV implies that the stock market considers that those assets are either undervalued (i.e. development land values are rising) or that there is some barrier to competition, which means an established developer has value simply as a result of its market position. We consider both factors are at play. Either way, lending to an established developer would be supported by this stock market sentiment. Sentiment and – broadly – stock market-announced results have been resilient, even since the EU Referendum vote.

## European commercial market

Continental Europe presents some core markets for RECI

The largest non-UK position for RECI is France, followed by Italy. While Germany is a more modest position, the German economy is a European leader of relevance. We outline RECI exposure in more detail, below, but offices are a key driver, and thus important in assessing the general “tone” of the commercial real estate market. The assessment below is based on Cushman & Wakefield analysis.

RECI's positioning is weighted towards France, with a Paris weighting dominating there. The Italian exposure is predominantly in northern Italy – a stronger region within the nation. Overall, RECI's European exposure to retail is stated as 5%. A

significant proportion of this is within Italy, typically malls and long-let retail to good-quality tenants. Italian exposure also includes cinemas, some stand-alone, some within malls. No Continental European assets feature in the top 10 RECI commitments.

Super-strong in 2017 and 2018 – slight slowing of growth rates now

## France

Prime office rents are mainly stable, but areas with very tight supply have started to see sustained upward pressure on rents. Supply is stable, due to high absorption levels and the large amount of development pre-let. Demand is also broadly robust. We say “broadly”, as 1H’19 saw a 19% reduction in Greater Paris transactions (a total of just over 1m m<sup>2</sup>). The average between 2009 and 2018 was 1.1m. Taking Paris City as a barometer, as of 2Q’19 (with 3Q’18 as a comparator), built stock totalled 17.216m m<sup>2</sup> (17.125m), with vacancy of 2.3% (2.2%) and availability at 0.388m m<sup>2</sup> (0.375m). Take-up in 1H was 0.480m m<sup>2</sup> (0.48m in 2Q’18 and 3Q’18), and under-construction was 0.465m m<sup>2</sup> (0.619m). Prime rents for the Paris Central Business District (CBD) stand at €850 m<sup>2</sup> per year, +3.0% YoY. It is worth noting that, in 3Q’18, rents were stable, but had risen 6.3% over the previous year. After a very encouraging 2016 and 2017, 2H’18 remained strong, but there has been no growth since.

Macroeconomic annual growth should reach 1.3% in 2019, representing a 40bp decrease compared with 2018 and a 110bp fall compared with the exceptional results seen in 2017. These estimates place France slightly higher than the wider Eurozone, at +1.2%.

Firm tone – despite lacklustre Italian GDP growth

## Italy

Prime office rents in Rome stand at €420 m<sup>2</sup>, up 5.0% YoY (Source: Cushman & Wakefield). Regarding 2019, Cushman & Wakefield states: “The office market in both Milan and Rome is off to a good start, with Milan increasing its figures by 30% compared to the same period of 2018, with one single pre-let accounting for 25% of the overall take up. Levels of demand for grade A space continue to be at an all-time high, as quality real estate is increasingly recognized as a key element for corporate success. Although future pipeline is positive, the shortage of immediate grade A supply is putting upward pressure on prime headline rents, also sustained by tenant incentives. Rome registered a particularly active beginning of the year with tripled take up figures compared to the same period of 2018 including two transactions above 10,000 m<sup>2</sup> and several medium surfaces. As a number of international corporate companies are looking to upgrade their spaces, similar transactions are expected by year end.”

RECI’s main exposure in Italy is to shopping centres and cinemas...

RECI’s main exposure in Italy is to shopping centres, long-let retail and cinemas (the latter often located in shopping centres). Regarding malls, a mid-2018 JLL report states that 43 new projects are to be opened by 2021, for a total surface of 1.3m m<sup>2</sup>. The new openings are concentrated in Milan (70%). For example, Westfield in Milan will be the biggest shopping centre in Europe, at 185,000 m<sup>2</sup>. This is due to open in 2020. The Italian market as a whole has a lower gross leasable area of retail per inhabitant than the European average (Source: Duff & Phelps 2019 Real Estate Market Study on Italy’s Retail Sector). Duff & Phelps states that “Retail parks are only 16% of the national retail offer, with an average size of 12,000 m<sup>2</sup> of GLA, with high potential for growth, considering last available figures produced by CNCC as of 31/12/2018.” The Duff & Phelps study quantifies a low number of large existing schemes and a wide spread of NIY between prime and secondary. Prime high street is illustrated in the report at ca.2.8% to 4.0%. From a UK-based analyst point of view, this level of under-supply of larger assets and the low NIYs are both quite alien. Prime shopping centres are stated at NIYs typically of 5.0% to 6.0%. The high street is typical of established Italian cities, but RECI exposure is to large modern outlet malls, at less “rarefied” valuations. It is worth noting that the Cushman & Wakefield 2Q’19 retail report on Italy points to a severe fall in investment into this

...Italian retail not like UK

retail segment in 1H'19.

RECI has some German office exposure –  
generally a well-bid market

### Germany

In the first half of 2019, office take-up volume of 1,642,500 m<sup>2</sup> was registered in the top-five German markets. Compared with the previous year's equivalent figure, this is an increase of 6% (Source: Cushman & Wakefield). 2018 and 2017 were particularly strong years too. Berlin continues to see strong rental growth, but the rent figure is still significantly below that in Frankfurt and similar to Rome. Berlin CBD stands at €440 m<sup>2</sup>, up 17.5% YoY; Frankfurt is at €540 m<sup>2</sup>, up 7.1% YoY. Berlin's vacancy rate is 1.4%, but 1.4m m<sup>2</sup> is under construction – a high figure in a market with a built stock of 18.7m m<sup>2</sup>. Under-construction is around two years the current rate of take-up. Frankfurt has 11.7m m<sup>2</sup> stock and 0.5m m<sup>2</sup> under construction, but a vacancy figure of 7.1%. Take-up is good. The German manufacturing economy seems to be slowing fast.

## Company matters

### Registration

Real Estate Credit Investments Limited (“RECI” or the “Company”) is a non-cellular company incorporated in Guernsey and governed by the Companies (Guernsey) Law, 2008 (the “Companies Law”). The Company is regulated as an authorised closed-ended investment scheme by the Guernsey Financial Services Commission. At the AGM in September 2017, the continuation vote was passed, and a further continuation resolution will be proposed at the AGM, to be held in 2021.

### Board of Directors

#### *Bob Cowdell – Non-executive Chairman*

Bob Cowdell (UK resident) is an independent non-executive director who has focused on the financial sector throughout his career; initially as a solicitor and then as a corporate broker and adviser. He was previously co-founder and Head of the ABN AMRO Global Investment Funds Team and then Head of Financials at RBS Hoare Govett. He is currently chairman of Castel Underwriting Agencies Limited and a non-executive director of Thomas Miller Holdings Limited; and a former non-executive director of Baillie Gifford UK Growth Fund Plc, Catlin Underwriting Agencies Limited, Catlin Insurance Company (UK) Limited, XL London Market Limited and XL Insurance Company SE. A Freeman of the City of London, he is a member of the Institute of Directors and the Chartered Insurance Institute. He has been a member of the Board since June 2015.

#### *Susie Farnon – Chairman of the Audit Committee*

Susie Farnon (Guernsey resident). Mrs Farnon is a Fellow of the Institute of Chartered Accountants in England and Wales and qualified as an accountant in 1983. She is a former Banking and Finance partner of KPMG Channel Islands from 1990 until 2001 and head of the Channel Island Audit Practice from 1999. She has served as President of the Guernsey Society of Chartered and Certified Accountants and as a member of the States of Guernsey Audit Commission and as Vice-Chairman of the Guernsey Financial Services Commission. Susie is a non-executive director of a number of property and investment companies listed on the London Stock Exchange or elsewhere and is a board member of the Association of Investment Companies. She has been a member of the Board since February 2018.

#### *John Hallam – Non-Executive Director*

John Hallam (Guernsey resident). Mr Hallam is a Fellow of the Institute of Chartered Accountants in England and Wales and qualified as an accountant in 1971. He is a former partner of PricewaterhouseCoopers having retired in 1999 after 27 years with the firm both in Guernsey and in other countries. He is the Chairman of NB Distressed Debt Investment Fund Ltd as well as being a director of a number of financial services companies, some of which are listed on the London Stock Exchange. He served for many years as a member of the Guernsey Financial Services Commission from which he retired in 2006 having been its Chairman for the previous three years. He has been a member of the Board since March 2016.

#### *Graham Harrison – Non-Executive Director*

Graham Harrison (Senior Independent Director) (Guernsey resident). Mr Harrison is co-founder and managing director of Asset Risk Consultants Limited, an investment consulting practice based in Guernsey. After obtaining a Masters in Economics from the London School of Economics, he began his career working in structured finance for Midland Montagu in London and then as a project economist for the Caribbean Development Bank in Barbados. In 1993, he moved back to Guernsey to help



develop investment-related business for the Bachmann Group and in 2002 he led a management buy-out which saw Asset Risk Consultants Limited become an independent business. A Chartered Fellow of the Chartered Institute for Securities and Investment, he has been on the Board of the Company since launch. He is also currently a non-executive director of a number of investment and asset management companies including BH Global Limited and Volta Finance Limited.

## Investment Managers

### *Ravi Stickney*

Ravi Stickney joined Cheyne in 2008 and is a partner and Head of Cheyne's real estate business. He has 16 years' experience in the real estate debt markets. Previously he was on ING Bank's proprietary investments desk (2005 to 2008), with sole responsibility for managing a €400 million long / short portfolio of European commercial real estate loans and CMBS. Prior to that, he was at Lehman Brothers (2002 to 2005), structuring and executing UK and European CMBS/RMBS and commercial real estate mezzanine loans. He began his career on the UK commercial real estate desk at Ernst & Young (1998 to 2002). Ravi is a qualified chartered accountant and holds a Masters in Engineering from Cambridge University.

### *Richard Lang*

Richard Lang is Business Manager of the real estate desk, and is a partner at Cheyne having joined in 2007. Before joining Cheyne, Mr Lang worked at Barclays Capital, and prior to that was at Deutsche Bank where he was responsible for the controlling of the Commercial Mortgage Backed Securities and Securitised Products businesses. Before that he worked in management roles within the fixed income areas of RBS and Paine Webber. He is a Fellow of the Institute of Chartered Accountants in England and Wales, having qualified as a chartered accountant in 1999.

### *Arron Taggart*

Arron Taggart has over 20 years' experience in the real estate markets. He joined Cheyne in August 2012 to originate real estate loans in the UK and Northern Europe. Prior to Cheyne, Arron was a Property Specialist and Partner at Clydesdale Bank responsible for the origination and execution of real estate loans in London and the South of England. He was also responsible for the management of the loan portfolio and setting regional strategy. Prior to Clydesdale Bank he was at Bank of Scotland and Hitachi Capital.

### *Daniel Schuldes*

Daniel Schuldes has over 10 years' experience in the European real estate debt and ABS markets. He joined Cheyne in 2007 and specialises in the origination, structuring, negotiation and execution of German real estate credit transactions. He was previously an associate on Credit Suisse's asset finance team in London, which was responsible for originating and structuring the bank's European securitisations. He focused on fundamental analysis of RMBS collateral.

### *Raphael Smadja*

Raphael Smadja joined Cheyne in January 2014 and has 10 years' experience. Prior to Cheyne, he was an Associate Director in Real Estate Finance at Deutsche Pfandbriefbank, responsible for sourcing and structuring commercial real estate loans across Europe. Prior to that, he held positions within the Real Estate Finance and CMBS space at Moody's, UBS and Morgan Stanley.

### *Sa'ad Malik*

Sa'ad Malik is Head of Structured Credit with the real estate team. Prior to Cheyne in 2016, he founded Rhino Investment Management LLP in 2011, an FCA-

authorised boutique investment and advisory firm, active in the European commercial real estate market. Among his responsibilities were strategy, origination, client management, structuring and execution. He previously worked for Lehman Brothers International (Europe) in 2004, and Credit Suisse Securities (Europe) Limited in 2005 where he was Director in their European Real Estate Finance & Securitisation area and had a central role in building the Titan Europe CMBS platform. Sa'ad started his career in 2000 with Commerzbank Securities in Asset Backed Finance.

### Investment policy

"To achieve the investment objective, the Company invests and will continue to invest in real estate credit secured by commercial or residential properties in the United Kingdom and Western Europe ("Real Estate Credit Investments"). The Real Estate Credit Investments may take different forms but are likely to be:

(i) secured real estate loans, debentures or any other forms of debt instruments (together "Secured Debt"). Secured real estate loans are typically secured by mortgages over the property or charges over the shares of the property-owning vehicle. Individual Secured Debt investments will have a weighted average life profile ranging from six months to 15 years. Investments in Secured Debt will also be directly or indirectly secured by one or more commercial or residential properties, and shall not exceed a loan to value ("LTV") of 85% at the time of investment;

(ii) listed debt securities and securitised tranches of real estate-related debt securities –for example, residential mortgage-backed securities and commercial mortgage-backed securities (together "MBS"); for the avoidance of doubt, this does not include equity residual positions in MBS;

(iii) other direct or indirect opportunities, including equity participations in real estate, save that no more than 20% of the total assets will be invested in positions with an LTV in excess of 85% or in equity positions that are uncollateralised. On certain transactions, the Company may be granted equity positions as part of its loan terms. These positions will come as part of the Company's overall return on its investments and may or may not provide extra profit to the Company, depending on market conditions and the performance of the loan. These positions are deemed collateralised equity positions. All other equity positions that the Company may invest in are deemed uncollateralised equity positions."

Glossary	
Asset types:	<p>Core – assets that benefit from having long-term income.</p> <p>Core + – assets that benefit from having strong current income, but do require some measure of asset management to optimise the income profile and term.</p> <p>Value-add/transitional – assets that require asset management (typically refurbishment) and re-letting to secure a core income profile.</p> <p>Development: Groundworks/Super-Structure – assets that are to be built from the ground up and are in the ground-works stage, or building the super-structure has commenced. These typically already benefit from the requisite consent to develop.</p> <p>Development: Fit-Out – assets that have either been built from the ground up and have reached the completion of the super-structure (“topped out”), or assets that are in need of substantial refurbishment works. These typically already benefit from the requisite consent to develop.</p> <p>Development: De-Risked – development assets that benefit from being substantially pre-sold or pre-let.</p> <p>Real Estate Op-Co/Prop-Co Loan – loan secured by both the operating company and all of the company’s real assets.</p>

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