5th February 2018

Schroder European REIT

5.5% prospective dividend yield, triple underpinned

The focused SERE commercial property portfolio is 80% located in the fastest-growing western European cities (e.g. Berlin, Paris, Hamburg, Frankfurt). Assets generate robust yields. Further, they offer value-enhancement opportunities. Broader European market economic fundamentals remain positive, driving employment growth, investment, office take-up and reduced vacancy, against a modest supply pipeline. Market-wide, yields do, however, reflect both the strong market fundamentals and modest long-term debt yields. SERE has assembled good-quality, well-located and reversionary assets, acquired on 6.3% yield.

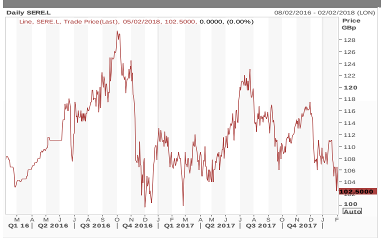
- **Commercial asset strategy:** Good-quality and well-located assets (in premium-growth cities) will generate sustainable income, with capital growth potential. Urbanisation and infrastructure improvement themes support this, particularly in mixed-use, supply-constrained locations with sustainable rental levels.
- **Asset management:** With voids low, this is about progressive enhancement of both rent and prospects. Each asset has a business plan. SERE is one of few UK-listed real estate companies offering sole access to a spread of western continental European regions, backing its long-term growth prospects.
- **Capital deployment:** Since the IPO (Dec-15), SERE has acquired investments of €212m, in nine assets (last year-end). As we go to press, a disposal in France has been announced, at a 10% premium to valuation, leaving SERE with equity and debt 'capacity' of a further €70m. It is in exclusive purchase talks on assets.
- **Risks:** Estimates assume progressive (strongly earnings-accretive) investment. SERE faces no currency risk (€ assets, debt) but has a sterling quote. Leases average 6.8 years to final expiry (4.4 to break), and the portfolio is virtually 100% occupied. Only from circa 2024 will certain finding material lines expire.
- **Investment summary:** SERE generates strong income and cash from a portfolio of assets located in European growth cities. Annual CPI rent rises and growth in market rents support most of the income. We model full deployment by end-calendar 2018. Given vendor-discussion progression, this is largely de-risked. Further equity might, judiciously, be raised to enlarge the portfolio and grow returns.

Financial summary and valuation

Year-end Sep (€m)	2016	2017
Income	3.9	11.8
Total expenses	(2.4)	(3.5)
Finance cost	(0.2)	(0.7)
Declared profit	(3.4)	11.2
EPRA PBT (adj. pre-revaluation)	1.0	6.9
EPS reported (€ cents)	Na*	8.4
EPRA EPS (€ cents)	Na*	5.2
DPS (€ cents)	0.0	4.6
Net cash (debt)	Na	(30.3)
Dividend yield (%)	Na	3.8
EPRA NAV (€ cents)	130.1	133.3
Price/EPRA NAV (pence price)	0.93	0.91

** IPO December 2015 – first part year reflects initiation costs* *Source: Hardman & Co Research*

Real estate



Source: Eikon Thomson Reuters

Market data

EPIC/TKR	SERE
Price (p)	106
12m High (p)	122
12m Low (p)	101
Shares (m)	133.7
Mkt Cap (£m)	142
EV (£m)	147
Market	Main, LSE
Market: secondary listing	JSE

Description

SERE is an externally managed REIT, focused specifically on Western Europe, with a bias towards statistically fast-growing regions, purchasing commercial assets at yields 20% to over 50% above market yields. Assets and dividends are denominated in €.

Company information

Lead manager	Jeff O'Dwyer
Head of Finance	Andrew MacDonald
Chairman	Sir Julian Berney Bt.

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Key shareholders

Directors	0.0%
Schroders plc	18.0%
Truffle Asset Mgt	10.0%
Investec	10.0%
Eskom pension, provident	5.1%
Nedgroup investments	4.8%

Next events

February-18	AGM
May-18	Interim results

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Investment case

Premium-growth European cities and regions

SERE invests in premium-growth European cities and regions, through good-quality, income-producing commercial real estate. Asset locations include Berlin, Frankfurt, Hamburg and Paris, all cities that are mature and liquid, and have growth prospects exceeding those of their domestic economy. The average rental yield exceeds 6%.

Local Schroder teams

Local Schroder teams ensure sourcing and asset management is 'bottom-up'. These, totalling nearly 100, identify sustainable rent, supply constraints, competing-use demands and infrastructure changes. These teams are directly responsible for actively managing all assets to grow rents, extend leases and improve buildings to add value, resulting in an improved and sustainable income profile.

Through choice, some leases have two or three years left to expiry

Leasing risk is entertained, as some leases have two or three years left to expiry, but this will be only after extensive due diligence and will be confined to sub- markets and localities of strong demand and limited supply. St Cloud is a good example where short WAULTs have been extended as leases are re-geared.

European backdrop

Office vacancy fell in most European cities in 1H'17 and prime office rents rose

Important for SERE is the continued recovery of the Eurozone. Office vacancy fell in most European cities in the first half of 2017 and prime office rents rose. In the logistics sector, the increase in prime rents in the Eurozone had grown to 2%-3% p.a. by mid-2017 (source Schroders, CBRE). Schroders research quotes an interesting analysis, namely that each extra €bn of online retail sales generates demand for around an additional 100,000 sq. m. of warehouse space.

Europe market-wide transactions fell

Continental European transactions weakened 8% to €89bn in 1H'17. French elections may have been an issue. This adds up to a market that should not derail a portfolio specifically constructed on the sub-regions with current stronger-looking prospects.

Asset management

Each asset has its own business plan

Each asset has its own business plan. This potential NAV-accruing 'alpha' may yield opportunities to recycle capital. This would be likely only post the execution of the asset-specific business plan. A number of assets have short-term upgrades, namely light refurbishment or tactical tenant mix enhancement. Examples include adding the leisure anchor in the Metromar retail centre complex in Seville. SERE had stated that a leisure-based offering would enhance the whole centre. A lease re-gearing was secured at St Cloud, extending income maturity.

Progress to date within the REIT

December 2015 IPO

In December 2015, the company raised £108m via an IPO (at 100p) in the UK and South Africa to invest in commercial real estate in continental Europe. A further £13.8m was raised in February 2016 at 104p. £15m was raised by new shares issued at 120p in October 2016. Since the December 2015 launch, the portfolio has increased in value by over 7% compared with the (€) purchase price.

€14.3m rent run rate pre the French disposal announced on 1st February 2018

As at 30 September 2017, SERE's nine assets in France, Germany and Spain were valued at €212m. It is actively pursuing a €30m pipeline (in exclusive discussions). Current contracted rent is €14.3m, with good prospects on top of the immediate pipeline. Since these figures, the two French retail assets have been disposed of (on 1st February 2018) for €44.8m to the JV partner, who exercised its option to buy. This generated a 10% price uplift.

Portfolio loan to value is 25%, but the disposal just announced extinguishes net debt

Note our estimates for re-investment timing

The portfolio loan to value is 25% (capped at 35%) but SERE goes cash-positive post the French disposal. Note that the average cost of debt is 1.3%. Lenders principally comprise leading German domiciled banks. Income (net initial yield or NIY) from the portfolio (at book cost) is 6.3%. Costs as a proportion reduce as the REIT invests. Full deployment is estimated by end-2018, leading to a 5.5% dividend yield (based on IPO issue price), equating to €0.074 DPS. It has indicated its desire to grow beyond this level (issuing equity) provided shareholder value is maintained.

Asset management underpinned by market intelligence

Tenant mix may be improved – assisted by the strength of locations selected

SERE is comfortable to own assets, which, under previous ownership, had lost some momentum regarding tenant attractiveness. Indeed, tenant mix may have become sub-optimal – but in strong locations. SERE is targeting markets where rents are largely at the mid/more affordable end of the spectrum, but growing. Further factors underpinning the income stream growth prospects are that assets are selected for:

Rental levels are 'affordable'

- their affordable and sustainable rental characteristics, particularly relative to prime rents in the respective cities (e.g. Boulogne Billancourt rents ca.€300/sq. m. ,vs. prime Paris at €800/sq. m.);
- the ability to add value, through executing tailored business plans for each asset – Frankfurt, for example, has seen a rapid fall in vacancy rates, driven by take-up and the conversion of obsolete offices to alternative uses (residential/ hotel).

Risk profiles and mitigations

Execution risk in investing funds remains

Execution risk for full investment does remain.

25% LTV pre the recent sale, 35% LTV management target

Lease to first break of 4.4 years compares with a weighted average unexpired lease term of 6.8 years. A 28% fall is due by end-2019, a further 4% in 2020, and 25% in 2021. In our view, this is not at all unusual for continental Europe (which tends to have shorter leases). Typically, the French market does often have three-year breaks. Metromar (Spain) has some key tenant breaks, but these have been tenants for some time, and are trading well. Rents related to turnover are de minimis. There are modest caps on service charge recovery, again, for example, at the Metromar asset.

An element of refurbishment

Assets may be bought that can be enhanced through an element of refurbishment. This is light work, rather than substantial capex. One of the greatest quanta is the ca.€1m earmarked for the Metromar investment.

Spain comprises 12% of assets (France 55%, Germany 33%). The Seville asset, Spanish macroeconomic weakness notwithstanding, is in a robust micro-location (and already, recently, enhancing the leisure offering, thus attracting shoppers). Its average lease expires in only 2.7 years (with 4% currently void).

Strong tenant spread

Robust mitigations to risk are, and will remain, in place. There are approximately 200 tenants, the top 10 comprising 68% of the total – well spread (again, these figures are before the €44m disposal to the French JV partner). Many assets, for various reasons, need refurbishment or re-configuring, and maybe lease lengths need to be extended. Often these issues would be related less to the asset and more to the vendors' capability or perceptions. Therefore, the purchase NIY is attractive – on assets that are not 'trophy' valuations – and may also hold medium- term scope to achieve better rents. A minority of acquisitions have been off-market. Advantage is taken of opportunities to achieve new lettings. Some (but certainly not all) of the assets will have been bought (always in strong sub-regions/cities) at well below replacement cost.

Financial summary; assets

Purchases have been at NIY of between 5.0% and 9.5%, averaging 6.3%

Purchases have been at NIY of between 5.0% and 9.5%, averaging 6.3%. Assessing the real estate market in western Europe in its entirety, Hardman & Co considers that the driver derives more from rental growth than further yield compression. A starting point of 6.3% therefore strongly drives SERE's prospective returns. Further, the opportunity to enhance rental income, even in higher-yielding assets, appears good.

£212m valuation pre the €44m disposal announced. The disposal takes SERE to a modest net cash-positive balance sheet.

Biarritz and Rennes selling for €45m

Current portfolio (by date of acquisition)

Asset	€m cost	NIY at cost	€m rent at purchase	Value rise	€m September 2017 valuation
Paris office	37.5	5.7%	2.1	10.7%	41.5
Berlin retail warehouse	24.3	6.2%	1.5	6.2%	25.7
Hamburg office	14.4	6.9%	1.0	16.0%	16.7
Stuttgart office	14.4	5.0%	0.7	5.6%	15.2
Frankfurt retail centre	11.0	5.6%	0.6	4.5%	11.5
Biarritz & Rennes hypermarkets*	39.9	5.0%	2.0	2.3%	40.8
Paris (Saint Cloud) office complex	30.0	9.5%	2.9	13.0%	33.9
Seville retail centre	26.3	6.2%	1.6	0.8%	26.5
Total	**197.8**	**6.3%**	**12.4**	**7.1%**	**211.8**

** sold 1/2/2018 to JV partner for €44.8m. Bought off-market in a 70% JV as a pair* *Source: SERE*

The first two assets acquired typify the approach, so we add some detail below. In addition, the St Cloud office complex (a different one from the first asset acquired) is worth touching on, particularly as the pipeline includes the potential addition of a further two floors (c.€6m at NIY of 8.5%) in the complex. A Paris office investment of €37.5m was made at March 2016. The area is mixed-use with generally 'affordable' rents and a supply-constrained location. There is scope to optimise future redevelopment values by discussion (which is now ongoing) with the owner of the adjoining site. The second purchase, a Berlin retail warehouse, has risen in value by 6.2% (to the end-September 2017 results). This cost was €24.3m in March 2016. In this supply-constrained location, the large four-hectare site offers medium-term development upside. Other enhancements include the potential to add 'fast food' retail or the acquisition of neighbouring units.

In February 2017, a western Paris (St Cloud) office was bought for €30.0m. This comprised two 1970s blocks in a larger 1970s office complex. This is in a fragmented co-ownership register. The investment has a strong occupancy track record, with the majority of tenants SME-related entities. Asset management opportunity exists. The average lease is only 2.3 years, but demand is strong.

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The fact that we are commissioned to write the research is disclosed in the disclaimer, and the research is widely available.

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

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