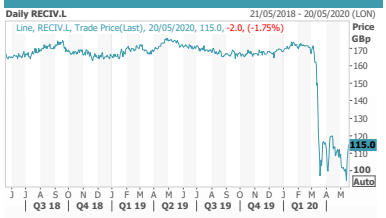
Diversified Financial Services



Source: Refinitiv

Market data

EPIC/TKR	**RECI**
Price (p)	**116**
12m High (p)	175.5
12m Low (p)	94.4
Shares (m)	229.3
Mkt Cap (£m)	266
NAV p/sh (p)	147
Discount to NAV	21%
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
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Key shareholders (19/02/20)

Close Asset Mgt.	8.46%
Bank Leumi	7.82%
Canaccord Genuity Group	7.55%
Fidelity	7.41%
Premier AM	7.21%
Smith & Williamson	6.60%

Diary

Early Jun	May Factsheet
End-Jun	Results to Mar'20

Analysts

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REAL ESTATE CREDIT INVESTMENTS

Getting a balanced view on outlook

We believe RECI's 21% discount to NAV reflects a reduction in investors' confidence, reflecting the uncertain outlook, security values and potential impairments. When considering if this discount is excessive, we note i) a relatively low-risk profile, ii) strong liquidity means RECI can optimise recovery returns, iii) restructuring is a core competency, iv) realised losses to date are just 2.1p, v) bond valuations are expected by RECI to be repaid at par, but priced at 17% below par, and vi) borrowers have been injecting equity into their deals. The stable 3p 4Q dividend and unchanged policy show confidence and re-investment returns rising.

- **Relatively low-risk profile:** Like-for-like, senior secured lending (76% NAV), especially when backed by property, should be a lower-risk profile than most lending. Borrowers have injected equity, and governments' support for borrowers is unprecedented. RECI's liquidity risk is low (net debt just 6% of NAV).
- **Recovery potential:** Realised losses to date have been just 2.1p. RECI believes its bonds will be repaid at par over the next couple of years, and their discount is a temporary sentiment issue, unjustified by fundamentals. For loans, having expertise, and working over time with borrowers, significantly reduces final losses.
- **Valuation:** RECI trades at a large discount to NAV, in line with secured lending peers. Its yield, at 10.3%, is the highest of its immediate peers and above wider peer averages. RECI showed its confidence with an accelerated dividend declaration (3p unchanged on prior quarter) and "stable" dividends going forward.
- **Risks:** Any lender is exposed to the credit cycle and individual loans going wrong. Security is currently hard to value and to crystallise. We believe RECI has appropriate policies to reduce the probability of default and the loss in the event of default. Some assets are illiquid, and Repos financing has a short duration.
- **Investment summary:** RECI generates an above-average dividend yield from well-managed credit assets. Management has confirmed no change to dividend policy, showing its confidence in its sustainability. Bond pricing includes a discount, reflecting uncertainty, which should unwind when conditions normalise. Market-wide credit risk is currently above-average, but RECI's strong liquidity and debt restructuring expertise should allow it time to manage problem accounts. Borrowers have, to date, injected further equity into deals.

Financial summary and valuation

Year-end Mar (£m)	2016	2017	2018	2019	2020E	2021E	2022E
Interest income	17.7	15.3	18.4	22.3	28.6	34.7	37.7
Operating income	15.1	15.7	20.6	25.3	-11.4	36.2	42.2
Management fee	-2.0	-2.0	-2.6	-3.0	-4.0	-4.4	-4.6
Performance fee	-0.2	-0.1	-0.3	-0.7	0.0	0.0	0.0
Operating expenses	-3.1	-3.2	-3.7	-4.8	-5.0	-5.4	-5.6
Total comp. income	8.5	9.1	14.9	19.2	-17.6	30.2	36.0
EPS (p)	11.7	12.4	13.0	13.1	-8.9	13.6	13.1
NAV per share (p)	163.2	163.2	164.0	165.1	147.0	148.2	150.7
S/P premium to NAV	3%	3%	2%	2%	-24%	-24%	-26%
Debt to equity	35%	29%	34%	40%	24%	14%	11%
Dividend (p)	11.6	11.1	12.0	12.0	12.0	12.0	12.0
Dividend yield	6.9%	6.6%	7.1%	7.1%	10.7%	10.7%	10.7%

Source: Hardman & Co Research

COVID-19

May update – key issues

Market-wide uncertainty

RECI issued an updated presentation for its 1Q'20 performance. Unsurprisingly, there was a considerable focus on COVID-19 exposures from here. Quite clearly, there are material risks in a highly uncertain economic outlook, but, from the information available to date, we believe the key issues are:

Stable divided, declared early, shows management confidence

- The acceleration of the declaration of the dividend shows great confidence in the portfolio, future cashflows and liquidity. It was a clear signal to the market that the Board believes the position is robust.

Quality of counterparties – still injecting equity

- To date, the borrowers on the loan book have continued to inject liquidity, where needed, towards their assets and debt service.

Interest payments made when due

- All loans (including hotels), which have a requirement for cash payments, remain compliant with their obligations to pay the interest.

No senior loan impairment

- No senior loans required impairment, and these account for 76% of the NAV.

Lessons learned from two mezzanine impairments

- Losses to date have been from two mezzanine exposures, which were originated around seven years ago. RECI has been focused on senior loan positions since 2016.

Bonds – management expects full repayment at par over time

- Market prices of bonds have fallen, reflecting likely losses, but also sentiment effects, which may be expected to recover in due course. Management comments that it expects full recovery at par over time on the existing positions.

- We understand that, on properties with tenants, all three of the largest loans have tenants who are currently on schedule (including from a guarantor on a hotel), and, in the bond portfolio, 70%-100% of rents billed have been collected. It is clearly still early in the crisis, but this level of rent received is encouraging.

Recessionary environment likely to increase losses but RECI's exposures appear manageable, especially as its strong liquidity and core re-structuring competency mean it can optimise returns over time

Further potential losses will be driven by the macro-economic outlook. A hard recession appears likely despite the unprecedented levels of government support. If there is visibility on an economic recovery, losses from commercial real estate lending are likely to be lower than they otherwise would be. In addition, to the macro-outlook, the company specific impairments will be driven by historic risk appetite, sectoral concentrations and recovery processes and expertise. RECI cannot be immune from the macro exposures, and it does have some areas of concern, but as we detail below these appear manageable, especially over the medium term. RECI can afford to take time to work with borrowers and has considerable restructuring skill where situations fall into difficulties.

Challenges

Customer cashflows and behaviour are uncertain. Historically some sectors which were economically insensitive may now prove cyclical.

We expect the COVID-19 pandemic to present a number of challenges, including operational cashflows, especially in certain countries and sectors, and an uncertain behaviour of current and potential borrowers. We expect a number of borrowers across the market to defer interest and capital payments, especially when, as in the case of hotels, they have been closed and so are seeing zero revenue. These disruptions will evolve at different times for different countries, and across different sectors. Exposures that, in the past, may have been relatively resilient to economic conditions, because they have had a low dependence on discretionary spending, and often had public money behind them, may now be at risk – for example, care homes and student accommodation. Such uncertainty makes the quality of the borrowers,

the depth of their pockets, their professionalism and willingness to work with a lender, as well as the lender's own procedures and culture, all the more important.

Security hard to value and realise

The current conditions bring market-wide uncertainty in security values. We understand, from our bank contacts, that some professional valuers have refused to offer them opinions for security purposes, because they simply do not know what is a realistic price. Existing potential buyers may try to re-negotiate better terms, and, even if they want to complete the deal, may not be able to get finance (RECI itself has stopped its existing pipeline discussions). In such conditions, not being a forced seller is hugely important, and we detail in the section on liquidity below why RECI should not be in that position. We understand that, for its recent publications, the valuations used in the loan value calculations are the latest external ones available, and so are typically pre-COVID-19.

Our opinion is consistent with RECI's market-wide view: "Forced selling of real estate assets to be relatively muted in Europe compared to the US (due to a lower leverage point and more concentrated lender groups), and the stress from current loan expiries and lack of new lending will curtail capital values for some time. However, we do believe that income generating and prime real assets will find eventual valuation support from a search for yield in a world where interest rates are set to be held low for a long period of time."

Company response to crisis

As to be expected, RECI working closely with borrowers. Has also improved own liquidity positions and stopped existing discussions on new lending, but started new ones (at higher returns).

"Since the onset of this crisis and the resultant market turbulence, RECI has moved to take the following measures:

- An evaluation of each of its positions in light of the likely long-term impact of the crisis on operating models and valuations and hence recovery prospects for the individual positions. The output of this analysis was to write down the value of just two of its mezzanine positions. These impairments are not realised losses, but provisions for potential losses recognised today.
- Engaged positively with every one of its borrower counterparts to put in place mitigation and de-risking strategies for the long term.
- Improved the resilience and flexibility of the company by increasing its cash balances and reducing its net leverage to just 1.06x as at 30 April 2020. This was achieved by a combination of repayments of loans as well as sales of select liquid bonds, raising £24.3m. The net realised loss from the latter was limited to 2.1 pence per Ordinary Share.
- Performed a granular analysis of the future liquidity profile of the company. A detailed cashflow profile of each investment was completed, incorporating the probability of likely delays to repayments (and additional cash needs).
- Withdrawn from progressing on its significant pipeline of senior loans to refocus on new investment targets with more attractive risk and return characteristics."

Hardman & Co comment: The measures taken are what we would expect – a detailed interaction with existing clients to establish their risk profile, and stress-testing their cashflow assumptions, actively managing liquidity (the implied price for the bonds sold was ca.84% of cost) and stopping the pipeline, as new lending opportunities are much better priced than existing ones.

Forbearance

To date, only small part of loan book, and none of the bond borrowers have requested forbearance

Looking at the loan book, there have been four loans seeking forbearance, representing 4% of gross assets, and management is expecting a further six loans (19% GAV) to ask for forbearance in due course. The relatively low number is partially because development loans typically look for extension, rather than forbearance as such. On the public market bonds, there have been no requests for forbearance, but RECI is expecting the majority of borrowers to make requests in due course.

RECI notes that its borrowers could ask for one of three things – less cash interest/principal repayments, temporary suspension of covenants, or simply an extension to the loan. In its development exposures (where RECI typically has monthly covenant requirements), there have been some delays and cost over-runs, and RECI has typically agreed to a delay in repayments, with more cash being injected into the project by the borrower. Some income-earning assets would have seen breaches of their income covenants and, again, RECI has typically agreed to this, where the discussions with management have indicated clear mitigation action.

Markdowns/recovery potential

Realised loss 2.1p per share, and unrealised loss of 16.0p

Since the end of February, RECI has taken a number of unrealised losses, including two fair value adjustments against mezzanine loans (UK housebuilder £12.6m, 5.5p per share hit, taking value to £9.1m, and UK retail £3.7m, 1.6p per share hit, taking value to zero), and also taken a £20.4m, 8.9p per share, mark-to-market (MTM) reduction in the value of bond holdings. There has been a crystallised loss of £4.8m, 2.1p per share, on bond sales.

Unrealised losses can be managed over medium term to maximise recoveries and limit realised losses. RECI not in position of being forced seller at distressed prices.

We discuss in detail below how the unrealised loss exposures will be managed to minimise actual losses over the coming years. A key aspect of this is that RECI is liquid, and so will not be a forced seller at distressed prices, and it has a team that is highly experienced in debt restructuring to optimise returns over time. How the economy develops will be important in the quantum and timing of unrealised losses converting into recoveries or actual losses. As we note in the section below, up until now, RECI has shown remarkable resilience.

Loans

Mezzanine loan to UK housebuilder: £12.6m, 5.5p per share hit, taking value to £9.1m. RECI has been focused on senior loan positions since 2016, so this type of exposure would not be originated at present.

We understand that the biggest loan writedown was to a mezzanine finance exposure to a housebuilder focused on mid-market and affordable homes in the South East. This is a long-standing exposure, and RECI took equity in a previous restructuring, which saw a fundamental change in strategy, inventory and personnel. The business had been demonstrating a significant improvement in performance (profitability, volume and growing land bank) since the post-Brexit slowdown, but RECI has now written down the likely sale values (of the RECI asset) by 60%, reflecting current market conditions. The revised carrying value recognises the relatively high look-through LTV (ca.80%). We note that quoted housebuilders have seen a material fall in their share prices since mid-February (e.g. Barratt Developments 880p to 483p, Crest Nicholson 524p to 239p, Bellway 4,315p to 2,442p), and this markdown appears reasonable for current market prices. We understand that part of the impairment reflects a land bank that is considered to be far from ideal. The potential for recovery here will be driven by how the UK housing market evolves and, in particular, the extent to which government stimulus is focused in this area. The fact that estate agents have re-opened early suggests that the housing market is likely to be an above-average beneficiary of stimulus. Even before the formal re-opening, and despite the negative outlook, the UK housebuilder has sold homes at a rate of around 70% of its normal run rate. After the March writedown, this exposure represents 2.3% of gross assets.

Lesson learned: The position was originated in 2013, when RECI's risk appetite included mezzanine finance. Since 2016, its focus has been on senior loan positions, and we would not expect a new position of this type to be originated now.

Mezzanine loan to UK retail: £3.7m, 1.6p per share hit, taking value to zero

The second exposure requiring impairment was, again, mezzanine finance, and was to an out-of-town retail warehouse in Essex. Again, this is a long-standing exposure, where RECI had been working through a restructuring programme, which would have enhanced its security position. The collateralised out-of-town warehouse retail site benefits from long leases to national tenant covenants. The borrower has repaid 70% of the outstanding accrued loan balance, and continues to work with the company in improving the asset pool, including working on planning gains to additional land held in the collateral package. However, the outlook for retail is challenging, and the fact that RECI has been restructuring this exposure for some time, and now feels the need to write it down to zero, does not bode well for potential recoveries. Equally, the downside from here is now zero.

Lesson learned: Again, there is limited appetite for new mezzanine finance positions, and the appetite for retail-related exposure is low.

Bonds

February bonds £99m, yield 3.2%

At the end of February 2020, the bond portfolio consisted of 28 positions, with a fair value of £99m, an average LTV of 60.4% and a weighted average life of 1.4 years. The unlevered yield was 3.2%, which is indicative of the perceived quality of the book at the time. Geographically, the book was ca.65% UK and 35% European (with 20% of this in Italy – value £20m – and under 10% in Finland). We have previously highlighted the risk in Italy, where the security backing the portfolio was primarily in cinemas and malls in northern Italy.

March bonds £86.5m, yield 10.6%

By the end of March 2020, the portfolio was still 28 positions, with the fair value down to £86.5m, and with MTM losses equivalent to 10p per share. The unlevered yield had risen to 10.6%, on average LTVs of 57.3%, and a weighted average life of 2.2 years. In summary, there had been a fall in fair value, a near trebling of the yield and a material extension in the duration. Italy was just under 20% of the book (value ca.£17m). The driver to the rise in the yield reflects the short-term nature of the bonds, where the market price fall effectively gives a return over just over a year (assuming repaid at par).

April bonds £70m, yield 14.8%

By the end of April 2020, the number of positions had fallen to 26 (fair value £70m), with an average unlevered yield of 14.8%, LTV of 56.1% and a weighted average life of 1.7 years. 2.1p of the losses were realised on sale, as three public market bonds were sold in the period, generating cash receipts of £24.3m, which were used towards a reduction of leverage and strengthening the company's liquidity position. Italian exposure rose to 24% of the bonds (value £15m), and Finland's exposure was 7%. We understand that the bonds chosen for sale to enhance RECI's liquidity were corporate ones, which have seen an early bounce-back in value, and where the bid/offer spread meant the sale was at an acceptable price.

Management comment: "The bonds have been impacted by unrealised MTM movements due to the volatile market. The bond book has a strong credit profile and we expect a par recovery on the book over time. Market volatility has subsided in the last couple of weeks, but we cannot assume volatility may not return."

Bonds Level 2 accounted => based on observable inputs and valued by external party => reported NAV may be considered "real"

Hardman & Co comment: It is worth bearing in mind the valuations come from independent third-party pricing, based on observable market trading levels (bid/offer). As disclosed most recently in its interim report, these bonds are on a Level 2 accounting basis (valuation techniques are based on observable inputs; this category includes instruments valued using quoted market prices in active markets for similar instruments, quoted prices for similar instruments in markets that are considered less than active, or other valuation techniques, where all significant inputs are directly or indirectly observable from market data). We take comfort, therefore, that the reported NAV is realistic. We believe trading volumes will be mixed for a while to come, but that RECI has now achieved a strong liquidity position, and is not a forced seller from here.

Recovery expected by company to be at par value but may take some time

In terms of making a full recovery to par over time, we believe the critical part of this is time. The table below shows the top five bonds with a range of MTM prices. The UK hotel, at 75.5% of par, is likely to be one of the later beneficiaries of the lockdown unwinding, and so will take time. Management is confident of a recovery at par because of a strong backer, which had recently injected £100m to buy the business, and is also confident that the price reflects market sentiment to the hotel sector, rather than exposure specific issues. Northern Italian cinema and mall exposures (where we understand the marks are typically 75%-85% of par) may also take some time to recover but, again, we note that there are strong tenants (e.g. Telecom Italia), niche markets (so attracting customers who may not be going to the high street) and strong backers. The weighted average life of 1.7 years could see some extension if bond holders believe it will see better recoveries over time. The key point is that RECI has liquidity to manage its exposures to optimise returns.

Top five public market bonds held at 30 April 2020

(£m)	LTV (%)	Notional (£m)	MTM price (% par)	Value	% GAV	Yield to worst*
UK leisure parks	65	16.5	89.1	14.8	3.8	9.7
UK mid-market housebuilder	65	7.8	93.0	7.2	1.8	8.0
UK hotel	37	6.6	83.9	5.6	1.4	6.5
UK hotel	46	7.3	75.5	5.5	1.4	9.5
Italian long lease	38	5.1	93.6	4.8	1.2	6.1
Weighted average	55		87.7			8.4

** "Worst" assumes the bond is given the maximum extension RECI believes probable. Source: RECI Report and Accounts, Hardman & Co Research*

Collection/recovery process

RECI's procedures

Collection process hugely important. RECI will work with borrowers to restructure facilities. Most deals have "make good" clauses, which will protect RECI's profitability if loans are extended. RECI will earn higher returns where there is higher risk.

In assessing ultimate loss (and so near-term impairments), the collection process is hugely important. It is worth emphasising that RECI will, wherever optimal, work with the existing borrowers, so that they complete any development/sale work. RECI believes it has strong sponsors, who are best-positioned to optimise the value of the projects that have been worked on. RECI comments that all of its private loan borrowers are working constructively with the company to de-risk their loans, in exchange for additional time to come through the crisis. We believe this will involve a combination of restructuring, rescheduling and forbearance, all of which are detrimental to near-term cashflow. However, during this process, RECI is also looking to re-price upwards to reflect the higher risk. Most of its facilities have a "make-good" clause, which means that, if a deal is extended, the borrower has to make good the IRR that RECI would have achieved had the deal completed as scheduled. This provides profitability protection.

No impairments to date on senior loans

A critical part of this assessment is the realistic value of security. RECI notes that, with senior positions secured on real estate, the quality of security is relatively high and, on the types of loan to value, it has not taken any impairments against its senior loan book.

RECI very different from bank lenders, and we would not expect their historical loss rates

We note that, historically, commercial real estate lending was a high-loss area for banks, and it is important to note that RECI's assessment, monitoring and collection procedures are very different from such lenders. We went into some detail on this in our initiation report, and we would summarise the situation by saying that, in RECI's case, each loan is "owned" by the individual lender. It is not the loan of the "banks", and this difference in culture impacts every aspect of risk management.

Nature of borrowers

Quality of borrowers will be especially important. Significant proportion have deep pockets and expertise to manage complex restructuring discussions.

In its May 2020 presentation, one of the striking features in the COVID-19 sector update was the nature of the borrowers.

- Nearly a quarter of gross assets are backed by private equity sponsors. Investors will note from our reports on Pantheon (a closed-ended private equity investment company) that, through downturns, private equity-backed vehicles typically outperform their quoted peers. They benefit from more certain access to equity capital, and so debt financing too. The expertise available to a private equity-backed business is much greater than would normally be seen at a company of that size, and so complex restructurings are much more likely to be completed. These more than outweigh the impact of incremental gearing.

- Another quarter of gross assets is where the counterparty is a large corporate – with the diversification benefits that may result from this. 16% of this is in the form of senior loans and 8% in mezzanine finance, including 6% in student loans.

- A further 15% is where the borrowers are high-net-worth individuals/families.

RECI – comments on major exposures and the nature of their backers

Sector exposure	% gross assets	Manager commentary
Private equity		
Hotels	4.0	"**Mezzanine loan** (50%-75% LTV) to a private equity borrower, representing 4.0% of GAV, backed by a portfolio of well-located and established core income London hotels that have the additional benefit of an FRI lease. The lease income (rent) is guaranteed for the long term by a well-capitalised operator. The guaranteed lease income is sufficient to keep the lenders' coupon paid for the term of the loan, as well as to cater for operating costs while the hotels are shut down."
Hotels	2.1	"A **mezzanine loan** (37%-52% LTV) to a private equity borrower, representing 2.1% of GAV, backed by a portfolio of five core income-producing 4-star and 5-star hotels in Paris and one in Nice. The hotels are centrally located in prime locations. The sale of one asset (in May 2020) was achieved for substantially above the allocated loan amount and above the pre-COVID-19 valuation, resulting in a further de-levering of the loan and providing for sufficient liquidity to meet lender interest and operating costs for 2020."
Retail	2.4	"A **subordinate loan** (74%-89% LTV) to a private equity sponsor, representing 2.4% of GAV, secured by a period Haussmannian mixed-use office and retail building in prime central Paris. The business plan is to seek the eviction of the current tenants, followed by a refurbishment and release of the asset. The loan to gross exit valuations under this business plan are estimated to be 64%. The loan benefits from significant headroom to current market rents and a widening of cap rates from current levels."
Serviced apartments	3.7	"Two senior loans (65% LTV and 58% LTV) to the same large global private equity sponsor, representing 3.7% of GAV. The loans are secured on development projects, one in central Lisbon, Portugal (2.3% of GAV) and one in Cambridge, UK (1.3% of GAV). The developments are progressing to budget and time."
Leisure	3.8	"Senior loan (65% LTV) to a private equity borrower, representing 3.8% of GAV. This is backed by the operations and assets of the largest UK leisure parks operator. There is sufficient cash coverage to see the operations through a long period of lockdown (we estimate to summer 2021). We believe that the asset will benefit from a move to holidays at home. The private equity sponsor has substantial investments in the portfolio and, we believe, is likely to remedy any shortfall, should it arise, on cashflows in the period to an easing of restrictions. The carrying value of the bond equates to a 9.2% yield to a worst-case repayment scenario."

RECI – comments on major exposures and the nature of their backers – continued

Sector exposure	% gross assets	Manager commentary
Mixed use	6.2	A senior loan (64% LTV) to a large private equity sponsor, representing 6.2% of GAV, secured by the development of a residential apartment block (for rent) and an office building in Wembley Park, London, as part of the larger ongoing regeneration project in the area carried out by the sponsor. Practical completion has been achieved: the office building completed in December 2019 and the residential building achieved practical completion on 31 March 2020. The office building is >50% pre -let. The lockdown has slowed the residential leasing, and we expect the loan to repay in full, but with a delay to the scheduled repayment date."
Major corporate		
Hotels	1.9	"A **mezzanine loan** (30%-51% LTV) to a large conglomerate, representing 1.9% of GAV, backed by a collection of high-end luxury leisure hotels in France. The hotels have performed above-budget in the winter season, producing sufficient income to cover the lenders' coupon for 2020."
Student accommodation	5.8	"A **mezzanine loan** (55%-78% LTV) to a large student housing operator in the UK, representing 5.8% of GAV. The loan is secured by income-producing core assets, well-located in two university towns (one of which is a Russel Group university). The occupancy levels for 2019 have been >95%, and bookings for the coming year are close to targets. We are in constant dialogue with the borrower regarding visibility on future cash shortfalls that need to be catered for by equity injections."
Mixed use	8.5	"A senior loan (58% LTV) to a large established UK operator, representing 8.5% of GAV, secured by an income- producing, well-diversified and relatively liquid portfolio, comprising 17 assets across the UK (81% in affordable residential, office and development, 19% in light industrial and retail). A number of assets in the portfolio have already been exchanged for sale, and we expect to see a rapid de-risking and repayment from this loan over the next two quarters."
Mixed use	7.5	"A senior loan (45% LTV) to a large UK developer, representing 7.5% of GAV, secured by the development of a mixed-use office and residential scheme located in central London. The loan represents a conservative 55% LTC and 45% LTGDV. There has been minimal impact from COVID-19, as the site has continued to run through lockdown, with practical completion expected on time in June 2020. A number of the apartments have been exchanged. We expect a repayment of roughly half the loan to be effected in September this year, de-risking the position further."
Other corporate		
Housebuilding	4.8	"A **mezzanine loan** (30%- 5% LTV) to an established SME housebuilder, representing 4.8% of GAV. The builder has performed well in terms of operations, land bank under control and sales. The average house price is in the region of £250,000. Given the stable operations, margins and large land bank, we expect this position to be repaid in full through home sales proceeds or a sale of the company."
Housebuilding	2.3	"A **mezzanine loan** (60%-82% LTV) to an established SME housebuilder, representing 2.3% of GAV. This loan was made prior to Brexit, and did suffer from the combination of a slow house market and falling valuations post that event. While the builder has performed well in the period since (operations, margins and sales have all posted significant improvements), the high LTV going into the present crisis, combined with the lack of land under control, gave us cause to revalue the assets and operations, resulting in a fair value revision of 5.5p to the company. Home sales at the builder have been reasonable (30% lower than normal) in the lockdown period. The reopening of sales and marketing suites and work on construction sites are positive recent announcements from the government. We will continue to work with the builder for the long-term success of the business and its assets, and the recovery of the mezzanine loan."
High-net-worth family		
Retail	10.2	"A senior loan (67% LTV) to a high-net-worth family, representing 10.2% of GAV, secured by an income-producing prestigious freehold retail and residential building, located in the 8th arrondissement of Paris, at the heart of the Golden Triangle."
Care Home	5.2	"Senior loan (73% LTV) to a long-established family-owned care home business in the UK, representing 5.2% of GAV. We are in weekly contact with the operator, who provides us with complete updates on all of the key metrics (occupancy, weekly fees, infection numbers, staff hours) and numerous measures being put in place, especially to source protective clothing and equipment. The operator has a very strong rating from the CQC across all of its homes, and has a very low agency staff usage rate. It is heavily dependent on local authorities taking on patients discharged from hospitals. Consequently, the occupancy rates at the homes have remained stable through the crisis (>90%)."

Note: non-senior loan highlighting by Hardman & Co. Source: RECI Factsheet, Hardman & Co Research

Re-investment opportunity

Re-investment at 2%-3% higher returns for same risk profile

RECI has previously significantly benefited from the prior dislocations in the CMBS markets brought about by stress in the financial markets (2009, 2011, 2016), and will look to do so again, gradually, in this crisis. We understand that, currently, new propositions are yielding 2%-3% more than pre-crisis levels for the same level of risk. We expect this to reduce over time, as conditions normalise, but higher returns appear probable.

Buy-backs offer very attractive option but, for now, focus on building balance sheet strength

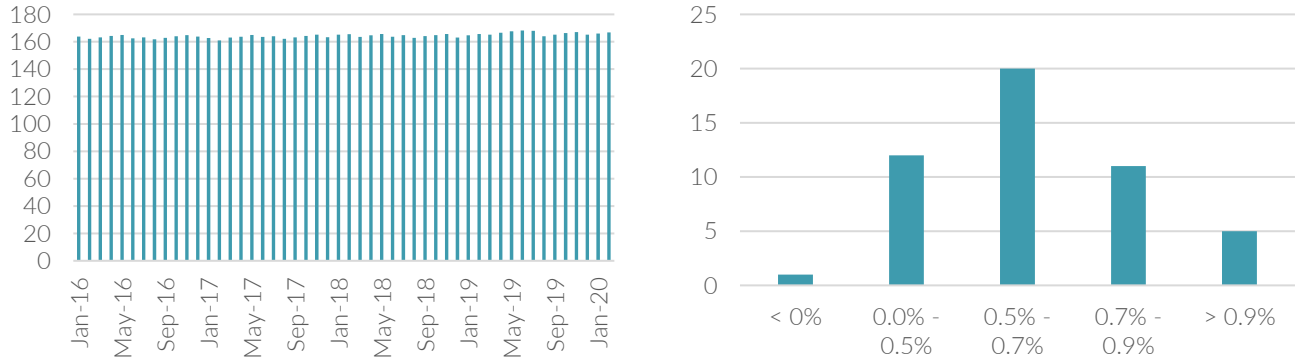
With the share price currently at 116p and the NAV at 147p, there is an immediate significant upside from buying back shares. We understand that this is kept under regular review by the Board, and the value created by this option will be considered against re-investing in new loans. At present, re-investment in loans would earn 10%-11% p.a., which is much lower than the return from buying back shares but, clearly, this may change over time. There are implications for liquidity and expense ratios but, should the discount continue, buy-backs would have a lot of appeal. In the short term, with continued uncertainty, we would expect RECI to continue to focus on strengthening its financial position, with the decision on buy-backs being taken in due course.

Previous resilience of the portfolio

Portfolio returns driven by predictable cashflow, supporting incredibly stable NAV

As can be seen in the updated charts below, consistency of performance has continued to be delivered, with sustained stability in NAV (left-hand chart), and two thirds of the monthly performance since January 2016 has been between 0.5% and 0.9% (all five of the past five months have been in the most frequent 0.5%-0.7% monthly NAV accretion bucket). RECI has continued to pay a 3p quarterly dividend, as it has every quarter since 3Q'17.

Monthly NAV (p, LHS) and number of months, Jan'16–Feb'20, by monthly return (RHS), both dividend-adjusted



Source: RECI factsheets, Hardman & Co Research

Resilience does not come about by accident. Reflects culture, benefit of hard security, diversification, resource committed to ongoing monitoring and market knowledge.

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

- The manager's (Cheyne's) lending culture is hugely important.
- There is clear independence between risk-sanctioning and deal-origination.
- The Board is strong, independent and experienced.
- Property security reduces both the probability of default and the loss in the event of default. The weighted average LTV is 65%. Under 5% of loans are at 80%+ LTV.
- The portfolio is diversified (now 53 positions). Italy now represents 4.9% of the portfolio, down from 7.1% six months ago.
- Positions appear to be closely monitored once committed.
- Cheyne gives i) economies of scale, ii) specialist credit and structuring skills, iii) access to new deal flow, and iv) market knowledge and relationships.
- The mix of bonds and loans is likely to provide greater liquidity than a book of loans alone.

Liquidity

Short-term debt been repaid, even though facility providers continue to offer it

RECI has been conservative in managing its overall gearing levels, and has used Repos financing against bonds, which, at least in theory, were relatively liquid assets. However, in previous reports, we have noted the risk from having this short-term debt. There is the additional uncertainty in this type of finance, where bonds are marked to market, and additional security may be required if the bonds see a fall in value. RECI has been using Repos finance from four different bank counterparties to leverage up the returns on its bond portfolio and, while all counterparties have continued their facilities, RECI has chosen to pay down debt. RECI notes that central banks' injections of liquidity into the market have seen a much-improved market, with new banks approaching RECI to offer Repos facilities.

Confidence in liquidity shown by continued dividend payments and FX hedging

We note that, in March, RECI maintained its FX hedges (net cash outflow for margin calls £9m) and paid a dividend (cash outflow £7m). The facts that both are discretionary and that RECI chose to continue the payments are indicative of the confidence it has in own liquidity. The acceleration of declaring the fourth interim dividend (see announcement of 15 May 2020) at a further cost of £7m is further evidence of the company's confidence in its cashflow.

Bonds sold, generating £24m (crystallising loss of £4.8m that had already been recognised)

In April, three public market bonds were sold in the period, generating cash receipts of £24.3m, which were used towards a reduction of leverage and strengthening the company's liquidity position. This reduced the gross leverage to £50.5m (15% of NAV) and net debt to £19m (6% of NAV). The fact that these assets could be sold validates RECI's approach that its short-term funding is backed by liquid assets.

Outflows limited, as talks on existing pipeline stopped. New commitments unlikely to see drawdowns until 3Q at earliest.

The main outflows of cash in normal conditions are the drawdown of loans. As noted above, given the economic uncertainty caused by the impact of COVID-19, the manager ceased all discussions on its pre-March 2020 pipeline of uncommitted investments, and has commenced the origination of a new pipeline of senior loans that reflect the manager's revised risk assessment. Existing commitments have been drawing down at £2m-£3m per month. The pipeline of senior loans will demonstrate a lower risk point (lower LTC and LTV) and a higher margin compared with the period before this crisis. Any drawdowns on these lines are unlikely to take place before 3Q'20 at the earliest.

All interest payments made as due. Active engagement with borrowers – likely to see repayments over longer time period, but RECI documentation has make-good clauses.

The usual source of liquidity is, of course, repayments of principal and interest on the bonds and loans. All loans (including hotels), which have a requirement for cash payments, remain compliant with their obligations to pay the interest. As is expected, Cheyne is getting regular updates from borrowers to understand the impact of the crisis on delays to repayment and programme timing (for development assets), and RECI has reflected the likely need for interest forbearance where necessary. For its own internal forecasts, it has assumed repayments only from "highly certain" sources (typically where assets are already exchanged for sale), and the indication of a stable dividend going forward is based off these forecasts. We understand that RECI's base-case modelling assumes three loan principal repayments totalling £24m in 2020.

Longer-term finance under discussion

We also understand that RECI is in advanced discussions to get long-term, non-recourse financing secured against specific loan assets. Additionally, it is looking to extend the duration of its Repos from three months to six months.

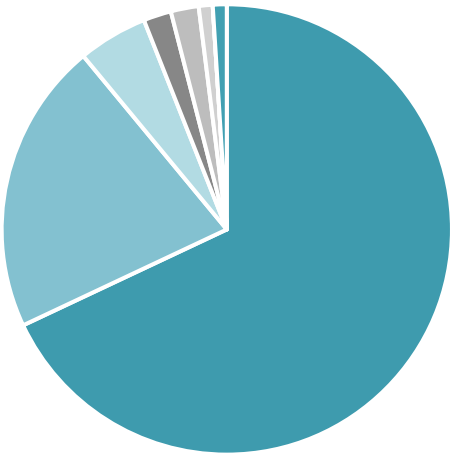
Latest portfolio

Key messages of good diversity, strong asset backing, balanced geographical mix and robust yields all remain unchanged

The overall key messages of good diversity, strong asset backing, a balanced geographical mix and robust yields all remain unchanged. The bond portfolio risk has reduced. In terms of some more specific trends over the past six months, we note:

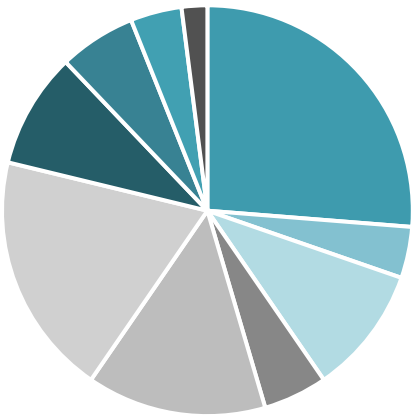
- The number of positions is 49, with 23 loans and 26 bonds. The top 10 are £288m of commitments (£211m drawn), and represent 85% of NAV.
- The weighted yield has risen sharply (April 2020 11.3%), with a stable weighted LTV (64.1%). Of note, the average unlevered yield on the bond portfolio is 14.8%, against a low of 3.2% in February 2020.
- The loan book average life has been gently declining (now 1.1 years), while the life of bonds is 1.7 years.
- The UK remains the main exposure.

Portfolio concentration by geography (%)



UK, France, Italy, Germany, Portugal, Finland, Ireland, Netherlands, Pan European

Portfolio concentration by asset type (%)



Mixed use, Serviced apartments, Housebuilder, Residential, Hotel, Retail, Student Accom, Healthcare, Lesiure, Office

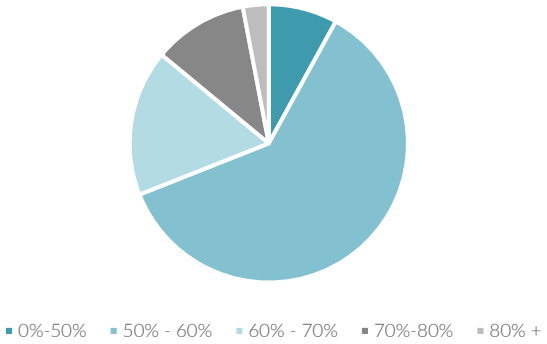
Source: RECI factsheets, Hardman & Co Research

Loan portfolio

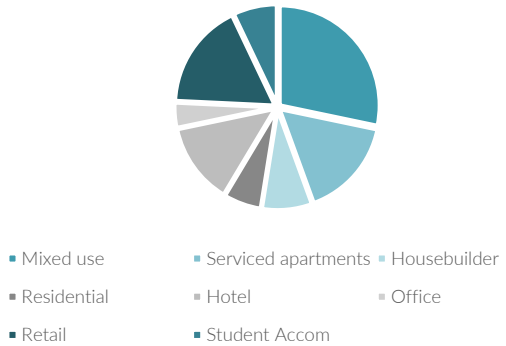
	End-Aug'19	End-Feb'20	End-Apr'20
Number of assets	17	25	23
Drawn value (£m)	163.7	311.8	282.0
Undrawn commitments (£m)	60.1	62.7	59.6
Weighted average yield (%)	9.2	8.3	10.2
Weighted average LTV (%)	66	66	66
Weighted average life (years)	1.6	1.3	1.1

Source: RECI Factsheets, Hardman & Co Research

Loan book LTV breakdown (%)



Loan book sector breakdown (%)



Source: RECI factsheets, Hardman & Co Research

Investors should note that RECI re-categorised some self-originated bonds into loans in 2020 to improve the transparency of self-originated against third-party. This has seen the growth in retail in loans to around a sixth of the loan book, having been around 5% at end-February. There is no change in RECI's exposure – just a classification issue.

Public market bond portfolio

Bonds invested are typically senior-secured (1st lien) credits, with conservative LTV collateralised by core and core+ assets owned by large institutional borrowers. RECI actively trades its bond book for relative value, and also for the efficient management of liquidity in the company overall.

Bond portfolio

	End-Aug'19	End-Feb'20	End-Apr'20
Number of assets	33	28	26
Fair value (£m)	168.2	99.2	70.3
Weighted average unlevered yield (%)	6.1	3.2	14.8
Weighted average levered yield (%)	8.3	8.5	21.0
Weighted average LTV (%)	61.8	60.4	56.1
Weighted average life (years)	2.4	1.4	1.7

Note: The slide above differs from slide 27 of the May presentation, as there has been a reclassification of some self-originated bonds into loans. Source: RECI Factsheets, Hardman & Co Research

In its quarterly presentation, RECI gave some incremental data on the bond portfolio:

- The carry value at the end of February was 100.2% of the notional value. This had fallen to 82.7% at end-April.
  - We understand that the marks on the Italian bonds (which are primarily malls and cinemas in Northern Italy) are in the range of 75% to 85%. It is worth bearing in mind that the valuations come from independent third-party pricing, based on observable market trading levels (bid/offer). As disclosed most recently in its interim report, these bonds are on a Level 2 accounting basis (valuation techniques are based on observable inputs). This category includes instruments valued using quoted market prices in active markets for similar instruments, quoted prices for similar instruments in markets that are considered less than active, or other valuation techniques where all significant inputs are directly or indirectly observable from market data). While the pricing may appear surprisingly high, given the Italian market, we understand that it reflects the market's perception of the value of security implied from loan to values.

Italian bonds 75%-85% of par. Values taken from observable data by third-party valuers, and reflect market's perception of underlying security.

- The ungeared weighted average yield to worst of 8.9% and life to worst of 2.9 years (the "worst"-case extension dates are based on Cheyne's assumptions of the maximum extensions that will be granted to borrowers by the servicers in the current environment).

In the bond portfolio, 65% is to the UK, 24% to Italy, 7% to Finland and 4% to conduits.

Top 10 exposures

The top 10 positions are detailed below. Seven of the top 10 are senior loans, one is a senior bond, and two are mezzanine loans (numbers 8 and 10). The lower risk profile of senior loans is evidenced by the fact there were no write-downs of senior positions in March.

Top 10 commitment (end-Apr'20)

	Commitment (£m)	Funded (£m)	LTV (%) **	Manager commentary
Paris prime resi/retail building	47.5	39.8	67	Income-producing prime central Paris retail and residential
UK mixed-use portfolio	38.0	33.1	58	Income-producing granular UK portfolio (mainly residential for rent and sale, offices, light industrial).
London mixed-use development	34.8	28.9	45	Substantially complete (completed delivery expected Sep'20). Offices fully pre-let. Residential substantially pre-sold.
Lisbon aparthotel	34.6	8.2	58	Development in progress. Expected completion early 2022.
London mixed-use development	27.2	21.8	64	Substantially complete (delivery scheduled for Dec'20), partially pre-let.
Cambridge serviced apartments	25.4	5.1	65	Development in progress. Expected completion Q4'21.
UK care homes	23.2	20.1	73	Stable, income-producing UK care homes.
UK student housing*	22.4	22.4	78	Stable income-producing UK student accommodation assets.
London office to residential	20.0	16.2	36	Development completed, Residential pre-sales at 20%. Commercial accommodation fully let.
London hotels*	15.0	15.7	75	Stable income-producing asset, benefiting from a long-term rental agreement.

*Note: *Mezzanine loans, **Most values based off pre-COVID-19 valuations. Source: RECI Factsheet, Hardman & Co Research*

We detailed in the section, *Nature of borrowers*, RECI's comments on most of these exposures. In terms of additional comment:

- **Paris prime residential/retail building:** This property is on one of Paris's premier roads (Avenue Montaigne), where RECI expects market values to be robust. It is partially subject to renovation, and some delays before it becomes fully income- generating are expected, but the documentation includes a make-good clause to ensure the IRR is maintained. We understand that RECI is exploring the opportunity to get long-term financing against this loan, which could see half of the outlay recouped in 2H. Once the improvements to the retail element of the property are concluded, we understand that it may be re-financed or sold, offering RECI an even greater cash inflow. We note that the backer is a high-net- worth family, which should be in position to inject further equity as required.

- **UK/London mixed-use portfolio:** We note the quality of borrowers above (large corporates), the low LTV for senior secured facilities and the mature state of assets.

- **Lisbon aparthotel:** We note that only £8m of the £35m commitment has currently been drawn. The residual amounts are likely to be taken only as the business plan progresses provided against "project monitor" reports. The potential cash calls have been fully built into projections in RECI's liquidity modelling.

- **London mixed-use development:** We note that the backer is private equity, with capacity to make further equity injections, as required, and that the development is close to completion.

- **Cambridge serviced apartments:** The development is still at an early stage (just £5m drawn down), with material borrower equity already injected. Delays to completion may be expected, but we understand that there are make-good clauses in the contract. We would expect Cambridge to be a relatively resilient location.

- **UK care homes:** It is currently unclear what the long-term financial dynamics for care homes in the UK will be. It is probable that costs will be higher, with a greater focus on hygiene, and the appetite over next few years for families to put elderly relatives into a home, given the recent death rates, is unknown. Additionally, there is the risk of litigation. There have been multiple press comments on care companies fearing bankruptcy (e.g. *BBC*). For RECI's specific exposure, we note RECI's comments about dependency on local authority payments, good-quality reviews and occupancy remaining over 90%.

- **UK student housing:** We note that the LTV is quite high (78%), and it is also a mezzanine loan. We believe there are uncertainties, both positive and negative, in the near term. Of note, it is unclear how many foreign students will be coming to the UK, how much rent will be paid when students are absent from college, whether students will take gap years and, as happened post the GFC, how many people will take up further education if there a fewer jobs available. We note that the quoted Unite (ticker UTG) has seen its share price fall from 1,342p in mid-February 2020 to 701p now. We also note the comment that September 2020 bookings are close to plan (albeit, market-wide, we believe only 50% of places have been booked by early May), and we believe the Russell university exposure is likely to be below-average risk for the sector. Management has also commented that its discussions with the borrower have included mitigating action, such as offering the accommodation on short-term lets, should there be a shortfall of foreign students. We understand that the borrower intends, and is currently able, to put in cash to ensure that the loan can be kept current through to the next academic year, if required.

- **London office to residential:** The low LTV should give some protection here.

- **London hotels:** While this is a mezzanine facility, we note that it is again a private equity backer, with additional protection from the lease income (rent) being "guaranteed" by a well-capitalised operator. The guarantee is sufficient to keep the lenders' coupon paid for the term of the loan, as well as to cater for operating costs while the hotels are shut down. RECI thus has protection from the guarantor and the private equity borrower and, ultimately, in the hotel itself, which should see it through to more normal trading conditions. The risk here appears relatively low.

Valuation

Absolute

Realised losses 2p, unrealised losses 16p, but share price fallen 55.5p

Against realised losses of 2.1p and unrealised losses of 16.0p, we note that RECI's share price has fallen by 55.5p (from 171.5p on 4 March to 116p now), ca. three times the reported losses. This suggests that either investors do not believe the current NAV or that they expect future losses, which have not yet been captured by the NAV assessment. We note that, with a number of other debt investment companies (e.g. Hadrian's Wall, SQN), an initial credit-related impairment can lead to a reduction in confidence. This leads to the share price falling well beyond the actual loss incurred, so creating a significant discount to NAV. Over time, delivery of returns should reverse any unjustified sentiment fall.

Current NAV likely to be realistic

We have, in previous reports, considered how the NAV is assessed (e.g. see pages 23-24 of our initiation, *7%+ yield from well-secured property debt portfolio,* published on 28 August 2019). The critical issues are how conservative the culture of the organisation is and what independent checks and controls are in place to review the process. As we noted in that report, RECI's approach to both appears in line with best practice. We have discussed throughout this report RECI's risk exposures, controls, collection processes and recovery potential.

Discount equivalent to 45% on every one of top 10 positions

To put the discount into perspective, it (£72m) represents a 34% loss on the drawn amount for every one of the top 10 exposures. We consider that such a loss rate would be extremely high, given security cover, and we would not expect all of the top 10 exposures to simultaneously default.

Yield

Company indicating stable 12p annual dividend

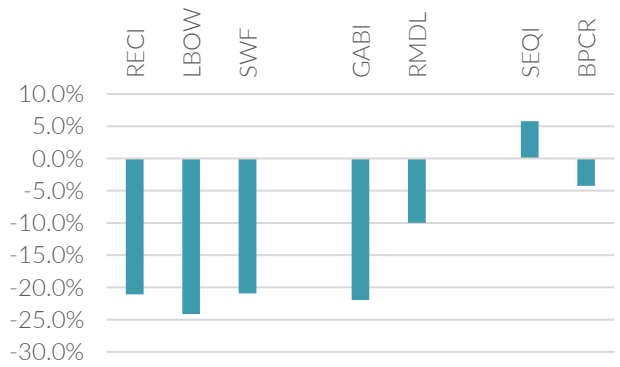
In its *15 May announcement,* RECI brought forward the date of declaration of the fourth interim dividend, declaring a 3p payment (in line with previous quarters). The Board confirmed that there will be no change to its dividend policy for the current financial year ending 31 March 2021, and that the company intends to continue to pay a stable quarterly dividend. This shows great confidence in its portfolio, cash generation and liquidity.

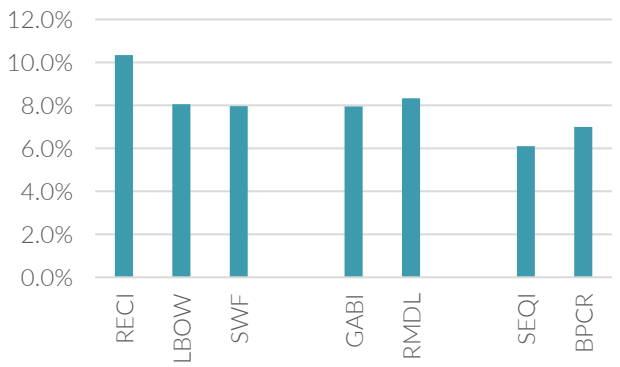
Relative

NAV discount and yield highest among peers

RECI comparisons with a close and a broad peer group are given below. The NAV discounts and dividend yield are the highest in the group. For investors viewing the risk controls and procedures in RECI as being robust, such a valuation would appear anomalous.

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





Source: Latest factsheets, priced at close 20 May 2020, Hardman & Co Research

Financials

Our profit and loss forecasts have seen a material change since our last report. As noted below, we have materially reduced both Repos financing and equity issuance, which, combined with writedowns, mean the balance sheet is much smaller. At this stage, we have not materially increased the yield, but this is a trend we expect to see on re-investment.

Profit and loss								
Year-end Mar (£m)	**2015**	**2016**	**2017**	**2018**	**2019**	**2020E**	**2021E**	**2022E**
Interest income bonds	6.4	4.7	2.6	5.4	6.9	8.1	4.4	3.3
Interest income loans	9.5	12.9	12.5	12.8	15.2	20.3	30.0	34.2
Other interest income	0.0	0.1	0.2	0.2	0.2	0.2	0.2	0.2
Interest income	**15.8**	**17.7**	**15.3**	**18.4**	**22.3**	**28.6**	**34.7**	**37.7**
Net (losses)/gains on investments	-0.1	4.7	4.6	2.8	-0.1	-40.0	1.5	4.5
Net losses on options	3.2	-1.6	-2.4	-0.9	0.0	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	0.0
Total net gains on fin. assets at FV through P&L	5.7	-2.6	0.5	2.2	3.0	-40.0	1.5	4.5
Operating income	**21.6**	**15.1**	**15.7**	**20.6**	**25.3**	**-11.4**	**36.2**	**42.2**
Management fee	0.0	-2.0	-2.0	-2.6	-3.0	-4.0	-4.4	-4.6
Performance fee	0.0	-0.2	-0.1	-0.3	-0.7	0.0	0.0	0.0
Other operating expenses	-4.2	-0.9	-1.1	-0.8	-1.1	-1.0	-1.0	-1.0
Operating expenses	-4.2	-3.1	-3.2	-3.7	-4.8	-5.0	-5.4	-5.6
Profit before finance costs	**17.3**	**12.0**	**12.5**	**16.8**	**20.4**	**-16.4**	**30.8**	**36.6**
Finance costs	-3.5	-3.5	-3.4	-1.9	-1.2	-1.2	-0.6	-0.6
Net profit	**13.8**	**8.5**	**9.1**	**14.9**	**19.2**	**-17.6**	**30.2**	**36.0**

Note: 2020 estimated, as awaiting annual results. Source: RECI Report and Accounts, Hardman & Co Research

Hardman & Co adjusted profit & loss								
Year-end Mar (£m)	**2015**	**2016**	**2017**	**2018**	**2019**	**2020E**	**2021E**	**2022E**
Statutory profit	13.8	8.5	9.1	14.9	19.2	-17.6	30.2	36.0
Capital gains & FX movements	5.7	-2.6	0.5	2.2	3.0	-40.0	1.5	4.5
Profit excluding capital gains & FX mvmts.	**8.1**	**11.1**	**8.6**	**12.8**	**16.3**	**22.4**	**28.7**	**31.5**
Adjustment to performance fee	0.0	0.2	0.1	0.3	0.1	-0.3	-0.8	-1.3
Adjusted profit	**8.1**	**11.3**	**8.7**	**13.1**	**16.3**	**22.1**	**27.9**	**30.2**
Cost of dividend	13.8	8.5	9.1	14.9	19.2	-27.5	-27.5	-28.7
Statutory cover	5.7	-2.6	0.5	2.2	3.0	-0.6	1.1	1.3
Excluding capital gains cover	8.1	11.1	8.6	12.8	16.3	0.8	1.0	1.0

Source: RECI Report and Accounts, Hardman & Co Research

Our balance sheet forecasts have seen a material change since our last report. We have reduced bonds and the associated repos financing materially, and we do not assume that RECI will rebuild these exposures in the next two years. In contrast, we do expect further loan growth. This is partially financed by new equity issues (£10m 1Q'21 and £50m through FY'22). We do not believe RECI will undertake such issues at a discount to NAV value. We would hope that the current level of uncertainty/lack of visibility may have reduced significantly over the next year, allowing the first tentative steps for an equity issuance.

Balance sheet								
@ 31 Mar (£m)	2015	2016	2017	2018	2019	2020E	2021E	2022E
Bonds	59.4	39.6	49.8	97.3	163.1	86.5	50.0	50.0
Loans	87.1	113.2	109.3	148.1	139.4	287.8	324.3	374.3
Financial assets at FV through P&L	**146.5**	**152.8**	**159.0**	**245.4**	**302.5**	**374.3**	**374.3**	**424.3**
Cash and cash equivalents	8.1	5.3	24.9	7.2	38.6	36.7	22.4	53.8
Cash collateral at broker	0.0	0.0	0.0	2.4	1.4	1.4	1.4	1.4
Derivatives	4.8	3.2	0.9	0.2	0.7	0.7	0.7	0.7
Other assets	3.5	2.5	4.4	4.9	12.0	7.6	7.6	7.6
Receivable for investments sold	0.0	0.0	0.0	48.1	0.0	0.0	0.0	0.0
Total current assets	16.4	11.0	30.2	62.8	52.7	46.4	32.1	63.5
Total assets	162.9	163.8	189.3	308.2	355.2	420.7	406.4	487.8
Current liabilities								
Derivatives	0.5	0.5	0.0	0.0	0.0	0.0	0.0	0.0
Financing	0.0	0.0	0.0	78.3	100.1	81.7	50.0	50.0
Cash collateral due to broker	0.0	0.0	0.4	0.0	0.1	0.1	0.1	0.1
Preference shares	41.7	41.8	41.9	0.0	0.0	0.0	0.0	0.0
Other liabilities	2.6	2.7	2.7	1.3	1.7	1.7	1.7	1.7
Total liabilities	44.8	45.0	45.0	79.6	102.0	83.5	51.8	51.8
Net assets	**118.1**	**118.8**	**144.3**	**228.5**	**253.2**	**337.2**	**354.6**	**435.9**
NAV per share	**162.3**	**163.2**	**163.2**	**164.0**	**165.1**	**147.0**	**148.2**	**150.7**

Source: RECI Report and Accounts, Hardman & Co Research

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