HARDMAN & CO.

REAL ESTATE CREDIT INVESTMENTS

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Capital Markets Day, 27 June

RECI benefits from deep expertise, not only in selecting assets but in having the capability to protect assets where positions need attention. As part of the larger Cheyne debt investor specialist – with over $11bn assets under management – RECI has top-tier expertise. The CM Day presentation, on 27 June, highlighted the scope for a modest progressive rise in loan returns, an already-anticipated move out of development loans into loans for yielding assets where their owners seek finance to improve them. RECI's portfolio is largely senior debt and it has almost entirely exited its market-traded bonds. Dividend payout seems secure.

- **An under-supplied market:** Supply of funds for senior debt continues to run well behind demand, which is driven by the plethora of ongoing projects, market conditions with rising cost of money, banks' preferences, and regulatory issues concerning capital adequacy requirements. This is reflected in attractive returns.
- ***May Factsheet*:** NAV rose in the month, although it is still 1.3% below the level 12 months ago. The prior fall principally reflected the now small exposure to market bonds – as opposed to loans – and a small December 2023 writedown of a Parisian prime office development, completed in 2023 and slow in letting.
- **Valuation:** RECI traded at premiums to NAV in the five-year, pre-pandemic era. The average discount to NAV in 2023/24 was 14.7%. The real estate debt sector traded at an average discount of 26.3% (ex-RECI) over those 12 months (*source: Liberum*). Higher rates should, in our view, be seen as positive.
- **Risks:** Any lender is exposed to credit risks. We believe RECI has appropriate policies to reduce default probability. Positions are illiquid. Its average entry LTV is 61%, and most loans (e.g. nine of the top 10) are senior-secured, providing a downside cushion. In the short term, investor sentiment remains an issue.
- **Investment summary:** RECI generates an above-average dividend yield from well-managed credit assets. Directors and management have demonstrated their confidence in its sustainability through share purchases. 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, to date, have injected further equity into deals. The initial £5m share buyback programme has now been completed. A new £10m one was announced on 28 March.

Financial summary and valuation

Year-end Mar (£m)	2022	2023	2024	2025E	2026E
Interest income	27.0	31.9	30.3	37.0	49.6
Operating income	32.4	30.7	31.4	37.0	49.6
Management fee	(4.4)	(4.3)	(4.2)	(4.1)	(4.0)
Performance fee	-	-	-	-	-
Operating expenses	(5.8)	(6.1)	(6.0)	(6.0)	(6.0)
Total comp. income	24.6	20.6	21.9	26.5	35.0
EPS (p)	10.7	9.0	9.6	11.7	12.1
NAV per share (p)	150.0	146.9	144.9	144.8	145.0
S/P prem./disc. (-) to NAV*	0.4%	-9.1%	-20.7%	-16.4%	-16.5%
Debt to equity	29%	24%	7%	31%	32%
Dividend (p)	12.0	12.0	12.0	12.0	12.0
Dividend yield	9.9%	9.9%	9.9%	9.9%	9.9%

**2022-24 s/p historical, 2025-26E NAV to current s/p. Source: Hardman & Co Research*

Diversified Financial Services

Source: LSEG, 2024

Market data

EPIC/TKR	**RECI**
Price (p)	**121**
12m high (p)	133.5
12m low (p)	109.5
Shares (m, Exc. Treasury)	225.24
Mkt cap (£m)	272.5
NAV p/sh (Jun.'24, p)	147.9
Disc. to NAV (%)	-18.2
Div. yield (FY'24)	9.9%
Country/Ccy of listing	UK/GBP
Market	Premium equity closed-ended inv. funds

Description

Real Estate Credit Investments (RECI) is a closed-ended investment company that originates and invests in real estate debt secured by commercial or residential properties in the United Kingdom and Western Europe.

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Key shareholders (Mar'24)

Close Bros.	9.35%
Bank Leumi	8.02%
Hargreaves Lansdown AM	6.42%
Canaccord Genuity	5.91%
Premier Miton (Jun'24)	5.52%
Evelyn Partners (May'24)	4.90%
FIL (Apr '24)	4.64%

Diary

Mid-Aug	Jul NAV

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Executive summary

Rich environment, especially at a time of raised interest rates

Income opportunities more attractive at times of higher interest rates

We see irony in the deterioration of market-wide sentiment as the interest rate environment turned to rate rises. Income opportunities are actually more attractive at times of higher interest rates, while demand from high-quality borrowers is raised. Banking regulators encourage this route to source fresh capital. In March 2022, the Federal Reserve raised rates for the first time since 2018 and indicated rises in each of the subsequent six meetings due that year. We explain why the big hole created for developers, in particular, has been attractive to RECI.

Why borrowers and regulators welcome RECI-style capital

Regulators control Capital Adequacy ratios and RECI fills this need from the banks, which it passes on to the real estate owners

We assess the wider view. RECI's capital addresses the needs of the real estate market. This document looks at this from the investors' point of view.

The RECI portfolio – overwhelmingly senior debt bilateral loans

The portfolio breakdown detail indicates RECI – Cheyne – is a competent, experienced allocator into attractive sectors. It shows it is a proactive, value-adding manager of each position, protecting, at times, its interest by drawing extra equity from sponsors (borrowers) where LTVs had been squeezed. It demonstrates ability to manage problems proactively, protecting the asset itself (e.g. hotels during the COVID-19 lockdowns). Senior debt lending is a very fleet-of-foot asset class, with high optionality held by the managers as the cashflow from maturing positions rolls in.

Should investors choose real estate equity or debt?

Senior debt is attractive, as equity does not provide as much inflation-protection as might appear. We quantify this.

We compare risks and quantify rewards from senior real estate debt vs. the actual equity. Real estate, as an asset class, holds attractions as a real asset in times of inflation. While we do not contend holding real estate equity is unattractive *per se*, we compare the quantified returns from the real estate equity with RECI's returns. There is no compelling upside for equity over RECI's debt returns, in our view. RECI's NAV performance, in recent years, evidences superior downside protection.

A prospective touch of the tiller

As market opportunities open up further, RECI begins a repositioning

Now that global cost of money seems to be stabilising, RECI may adjust its strategy, downplaying new developments and lending more to yielding assets. These bilateral loans are typically for five years as opposed to under two. This gives more visibility to RECI investors and is taking place post the yield shift in the market, capturing that higher-rate environment. During a rising rate environment, it helps that development lending rolls over rapidly, typically within two years, creating liquidity. The detailed expertise RECI deploys, and the focus on senior bilateral debt, remains.

Dividend

With RECI's modest gearing, and given the rising returns, we see dividends as sustainable

2023/24 net profit totalled £21.9m, up from £20.6m. £27.4m dividends were paid out during 2023/24. EPS was 9.6p, so the historical dividend was covered 0.80x. Let us look at the driver to EPS, the loan income itself. The 2023/24 £30.3m loan income was taken to £31.4m by modest disposal profits. Operating costs and fees took the income down to £25.4m, with the cost of interest reducing this to £21.9m net profit. Hardman & Co's 2024/25E model assumes a slight increase in debt from the low-end March 2024 levels and we assume nil disposal profits as bond holdings are *de minimis*. For a covered dividend, however, the loan (and bond) income would need to have risen from £30.3m to £35.8m. We estimate, however, a figure of £32.8m; so, for a covered dividend, loan income would need to have been 9% higher than our model. With modest gearing and given the rising returns, we see dividends as sustainable. Note that share buybacks reduce the cash dividend total payout.

Capital Markets "takeaways"

At a Capital Markets Day, on 27 June, RECI presented its current position and prospects. It also outlined the benefits to RECI of the wider Cheyne organisation.

Cheyne

RECI externally managed by Cheyne Capital Management

RECI is externally managed by Cheyne Capital Management (UK) LLP, a UK investment manager. Cheyne's 185-person team manages $11.6bn, slightly under half of which is in real estate, invested in a number of closed-ended funds. Cheyne also invests in strategic value credit outside real estate, for around half its assets. No operating functions are outsourced. RECI outsources some management of "back office" functions in order to provide visibility of the costs recharged to borrowers.

RECI does not share positions with any other investor, so has freedom of action if the need arises

Going forward, investment opportunities are screened as to whether they fit RECI's characteristics or not. If they do, there is then an assessment as to what if any funds RECI has available for investment. New positions are then shared between Cheyne funds and RECI on a *pro rata* basis of funds availability. RECI does not share positions with any other investor bar Cheyne. This gives RECI/Cheyne freedom of action.

2024/25 strategy

In capital commitment terms, RECI, last year, was focused on paying down debt, so few new investments have been entered into in recent months. No new information was given, but RECI confirmed our expectations as follows:

- New investments will be focused more on core and core+ and fewer on development bilateral loans.
- Core and core+ loans are longer to maturity than development loans; typically, in the two- to five-year range.
- New loans will be, more often, floating rate rather than the recent trend of shorter loans on fixed rates.
- New loans are likely to continue to be overwhelmingly senior debt.
- The market-traded bonds position is now *de minimis* and is very likely to remain so or to reduce further.
- Our model assumes a somewhat higher interest rate received, and indications are that this is a correct assumption. The typical cash on cash return is *up to* 15% p.a., RECI indicates.

How RECI fulfils several needs

RECI's value proposition to specific types of borrower

Financing during value-add projects

There is always a need and appetite for debt as part of real estate investment. Fundamentally, the price of the asset, typically, is bid up too far for rental return alone to exceed investors' cost of capital. Equity investors rely on a rise in the assets' values and also a gearing on income. RECI does not put in finance between the secured bank lenders and the equity of the real estate – mezzanine debt – in any but very few situations. What it does is lend to good assets that are in transition.

Sweet spot for RECI is yielding assets, which are being upgraded in environmental terms or to move to prime fitout

There is a large market of this type of asset, which seeks a hands-on lender in the interim period of a few years while the asset is improved. At times, this can be a whole new development. In most cases, it could be yielding assets, which are being upgraded in environmental terms or to move to prime fitout. For example, there is a major trend, in place before COVID-19 but accelerated by it, for rents in several sectors to show an ever-greater premium for high quality, especially in offices and retail, the two largest commercial asset classes. The legal requirement to raise EPC (the slight misnomer of Energy Performance Certificate) performs a directly similar function. To put it overly simply, RECI finances the asset during the transition.

Therefore, a *de minimis* part of the portfolio is mezzanine debt. It is senior debt, often the only debt, and certainly – with very few exceptions – giving RECI the ability to take control of the projects, if needs be, unencumbered by other lenders.

With senior debt yielding cash-on-cash up to 15%, RECI not needing to significantly gear up its own balance sheet

For this, RECI receives a higher coupon than the bank, sufficiently strong for it not to be tempted to take on material debt on its own balance sheet. RECI's financial gearing is only 1.7%, if all cash including collateral cash is taken into account. Balance sheet gross gearing is 7.4%. Despite this quality, the cash-on-cash returns on its successful projects are typically 15%. Very few projects have suffered writedowns.

RECI income and assets have a proven robustness

Rich environment, especially at a time of raised interest rates

The rationale for achieving real estate returns through secured senior-debt lending is that income opportunities are more attractive at times of higher interest rates, while demand from high-quality borrowers is raised and banking regulators encourage this route to source fresh capital.

As a lender, RECI benefits from higher interest rates…

Part of RECI's robustness is that it benefits from a higher-interest-rate environment. It would be logical to assume investor needs are for higher returns as global interest rates shift upwards, taking cost of equity with them. RECI invests in finite-life debt and so the returns reflect its expertise and value-add but also the progressive changes in the rates environment.

NAV is "real"

…meanwhile, its assets regularly turn back into cash

The RECI model is to pay high dividends from assets whose value is as near unimpeachable as possible. Currently, the loan book has an average life of 1.3 years to maturity. This may lengthen for reasons we outline later – the global interest rate hikes are over – but will remain relatively short. Each time the loan rolls over, it is repaid in cash and thereby the RECI NAV is continually being validated as cash.

RECI fulfils a need from the real estate "improver", and, to its investors, to present a balance sheet regularly "proven" by loans maturing into cash.

RECI assists addressing of regulatory tensions

The real estate RECI lends on would raise banks' RWA

Risk-weighted assets affect banks' capital adequacy, so they tend to stand back from the market RECI fulfils

Risk-weighted assets, or RWA, are how the regulator calculates banks' capital requirement as a function of how risky the assets are deemed to be.

Why borrowers and regulators welcome RECI-style capital

We have illustrated how RECI capital addresses the needs of the real estate investor, either by creating new assets or refreshing and improving existing ones, possibly ones it has just acquired. RECI also performs an essential role for the real estate market as a whole.

Bank lenders benefit from RECI's existence and the regulator welcomes a wider spread of capital providers, such as RECI.

Risk-weighted assets

RWA are used to link the minimum amount of capital that a bank must have with the risk profile of the bank's lending activities (and other assets). The more risk a bank is taking, the more capital is needed to protect depositors. However, it is not that simple.

Why the regulator perceives RECI-style assets as riskier, even though they are not

Banks hold treasury loans, which are low risk. They also hold riskier positions, such as real estate. Not all real estate carries the same risk. The regulator does not have the mandate to comb through each position the bank holds. So, the type of asset RECI lends against usually comes out as risky in regulatory terms because the regulator is at "20,000 feet up".

Effectively, the regulator likes "plain vanilla" real estate, which means an asset that has high quality, right now, and yielding strong rent, right now. There are plenty of excellent assets that do not yield their optimum income immediately. This, not mezzanine tranches of risk, is where RECI comes in.

RECI's positions often require refurbishment or value-add from the real estate owner

RECI's positions often require refurbishment or value-add. At the moment, most are development loans. It is not hard to see that the regulator will not want to know the details of how low a level of risk each position actually represents. Banks calculate risk-weighted assets by multiplying the exposure amount by the relevant risk weight for the type of loan or asset. A bank repeats this calculation for all of its loans and assets, and adds them together to calculate total credit risk-weighted assets. Government debt carries a low ratio; real estate, any real estate, a higher one.

Non-yielding real estate is not favoured by the ratios. The bank may have to raise capital in order to maintain its regulatory capital adequacy ratio if it holds too much real estate debt. This is especially true if the real estate is not a "stabilised" yielding asset.

Portfolio breakdowns

As we go to press, RECI, on 16 July, announced a transaction, an £18.5m (net of leverage) senior refinancing of a portfolio of 4-star upscale hotels in central London.

Asset type – currently, mostly to developers

Asset type – currently, development loans predominate

RECI's portfolio comprises, predominantly, loans to development projects. It is expected this will soon begin to shift towards longer-dated core and core+ positions.

Note that exposure to market traded bonds is now minimal and will remain so

Core loans to yielding assets are longer-term positions. Locking in to these at a time of rising interest rates would not have been the best strategy. The cycle has now changed. RECI can be extremely selective within a large market. RECI has a number of high-quality partners that it has worked with in the past and continues to work with, financing developments through senior debt. These are partners who have good projects and track records, and the ability to entertain financial and operational paths to rectify any "mid-course" problems as they might occur.

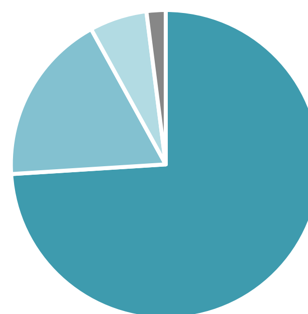
More strategically, in a cycle of rising interest rates, there have been benefits attached to going down the developer funding route, if done properly. By "done properly", we include:

Strong partners are a major strategic fact for the whole portfolio

- strong partners with good projects in good locations;
- senior debt finance;
- sensible LTV (loan-to-value) ratios both on cost and on ultimate GDV (gross development value); and
- an asset class well-understood by RECI (e.g. it has particular expertise in hotels but also other sectors).

There is a further set of benefits specific to a period of rising interest rates. Development finance, typically, will be of shorter – one- or two-year – duration than the more usual three- to five-year time horizon for mature (core), yielding assets. This means that RECI assets are regularly rolled over into rising rates, awaiting the time when longer-term debt funding horizons would suit RECI. We appear, now, to be in a cycle of falling interest rates both long and short. Therefore, we are more than comfortable with the RECI rationale, which appears to be shifting the portfolio into longer-term core bilateral loans (or core+, with a bit of value-adding counterpart refurbishment).

Portfolio, by asset type



Note: all charts are PRE 16 July transaction. *Source: RECI Monthly Factsheet, May 2024*

Asset classes

Asset class – various residential and hotels are a large portion

The primary consideration RECI has is "does this project make sense and is the rate offered an attractive one, adjusting risk for depth of knowledge of the partner and for jurisdiction?" Asset class is the secondary consideration. The pie chart, overleaf, clearly indicates the preponderance to residential (living assets), which comprise senior age, student, upper-mid range, built to rent and, in one case, housebuilding.

There is an acute shortage of residential assets in cities in most jurisdictions and exposure is strong, including student accommodation.

Higher-end tourist hotels are not higher-risk assets, quite the reverse

The exposure to hotels is also high. Hotels are lower-risk assets. Average London room rates, at the quality end, have risen some 20% since pre COVID-19; typically, to ca.£220 per night. Having coped well through COVID-19 – there were some positions where RECI worked with the developer, who injected more equity – we are now in a strong upswing. Returns from redeveloping tired assets into high-quality assets are high. Some RECI positions are just that, some new build too.

But the case of France is also instructive on risk. RECI has several French hotel exposures, in Paris and on the south coast. In the current political turmoil, the demand for offices, even housing, as an investor class may be impacted. By contrast, hotels are highly unlikely to see a reduction in demand. Now, there is an argument that the yield basis for all French investments may have widened; however, as the hotel exposure is to development assets and these are on decent LTVs based on cost rather than exit values, this yield shift is of minor consequence.

Modest office exposure; two French developments have caused issues, one fully covered off by the partner injecting equity

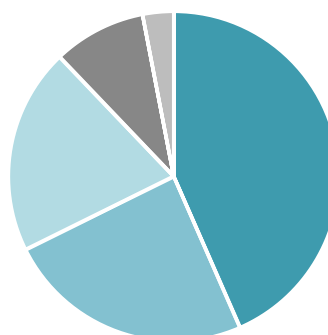
There is some office exposure, overwhelmingly development assets, of which many are complete or nearing completion. Many are in France. One has benefitted from further equity being provided by the well-capitalised sponsor (borrower), the other is more exposed. This has been part written down.

There is no NAV exposure to shopping centres. One small UK historical position was written off many years ago. There is no meaningful exposure to logistics, although this sector may be showing signs of becoming an attractive future opportunity.

No homeowner loans, no shopping malls

Note "living assets", which comprises residential, is not investment into home owner loans or these types of mortgage securities.

Portfolio, by asset class



Source: RECI Monthly Factsheet, May 2024

UK will always be highest but not 100%. Cheyne has pan-European networks and expertise.

Geography

Geographically, the exposure to the UK is the highest and will remain so. For many years, Cheyne has had a strong series of continental European teams, in particular France but also covering Italy, Spain and Scandinavia, which is the predominant jurisdiction in "other", in the chart overleaf. The exposure to Germany is now, and has been for some time, *de minimis*. Yields in the German market reflected an assumption on the high-quality nature of German assets as a whole, but this raised Germany particularly to the risk of rising global interest rates. That, of course, is exactly what happened and RECI has suffered an approximate sub 1% hit to its NAV in recent months through historical German exposure, an exposure now effectively non-existent.

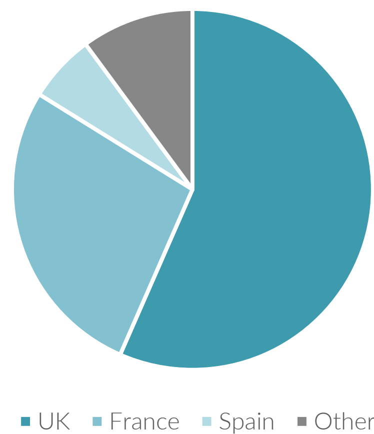
The exposure to France comprises predominantly a selection of hotel development positions, over which we would be very relaxed. It does also comprise one French regional housebuilder. This is more of an issue. However, the bilateral senior loan was to facilitate the acquisition and revitalisation of the developer a couple of years ago and it has been operationally successful since. Politically, clearly, there is an issue. But the LTV is under 40%; so, even were the value of the equity to halve, there would be ample cushion for senior debt. By the nature of housebuilding, the developer is regularly selling its product, even if and when the market slows. This means that there is a regular stream of cash – sometimes a torrent, sometimes a lesser flow – and this is prioritised to servicing the senior debt advance. *In extremis*, land purchased would be reined back, assisting cashflow further.

Spain comprises residential and there is some exposure to Scandinavia and Italy. There is no exposure to some of the lower-yielding but more highly financially geared regions and assets in Sweden.

Foreign currency exposure is hedged.

Germany – a difficult market – has *de minimis* exposure

Portfolio, by geography



Source: RECI Monthly Factsheet, May 2024

LTV (loan to value) and duration of the RECI loans

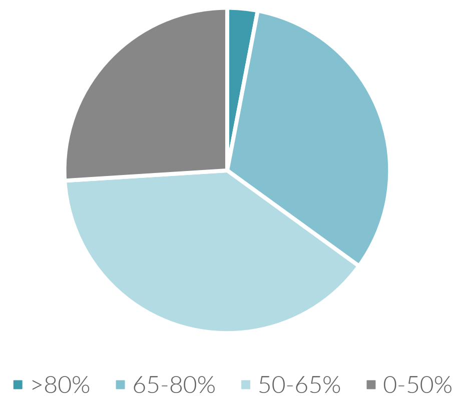
We have referred to the LTVs in passing, above. The importance of LTVs is high, even though the bilateral loan portfolio is almost exclusively senior debt. LTVs are not everything. They are not everything, even after taking into account the partner, the asset type and the jurisdiction. RECI is operating in a very large market, so can choose project and partner and usually – not exclusively and things can change – RECI's partners could, if needs be, invest more equity if LTVs were affected by some

event. Many, but not all, partners – borrowers – can "repair" breaches in LTV. But RECI proceeds on the basis that this is a bonus, not a "get out of jail" card.

There is a balance. Hypothetically, were RECI to select only projects with cast-iron LTVs, say below 40%, it would need to take on riskier counterparts, or riskier projects, or accept a lower return. Such a lower return would tempt RECI to gear up its own balance sheet and we emphasise that RECI's balance sheet holds minimal levels of debt. In our view, the range of LTVs is important but not the primary consideration, as it is only one element in this basket of risks. We gave the French housebuilder as an example. It is, by design, that this always had a low LTV.

Some LTVs are reasonably high – the quality of the borrower and the project are the risk drivers, the LTV can be the reward

Portfolio, by entry LTV

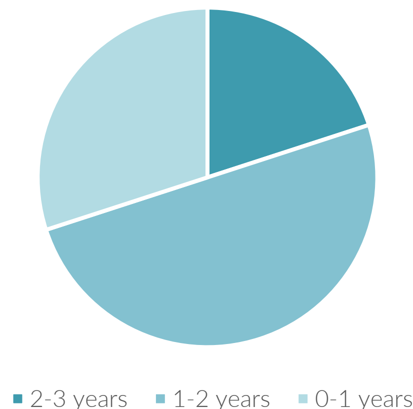


Source: RECI Monthly Factsheet, May 2024

The portfolio has an average term of only 1.3 years. We have, above, listed the rationale for greater exposure to development finance, which is, by its nature, shorter term. We would anticipate the average term gradually to lengthen, maybe double.

Loan terms pretty short but set to rise now that the cost of money has stabilised

Portfolio, by loan term

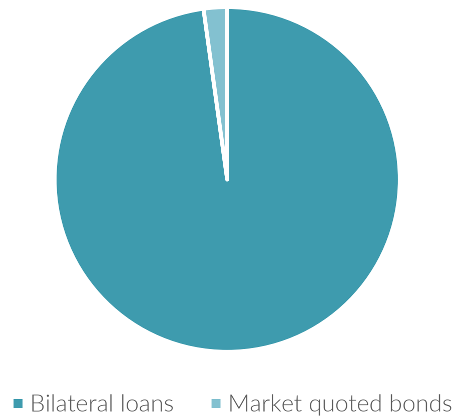


Source: RECI Monthly Factsheet, May 2024

The market-traded real estate bonds have provided RECI with superior coupons – or rather coupon yields at the acquisition process – but they have also provided headaches. Never a dominant element of the portfolio, they have, nevertheless, dominated the NAV impacts from their re-pricing and occasional collapse.

It is important to emphasise that, on all RECI bilateral loans, RECI controls the position and can, for example, require more borrower equity and also can – under default – step in and totally control the project. By definition, this cannot be the case on market-traded bonds. For this reason, RECI concludes, many of its layers of expertise – the ability to "set-in", the ability to work with borrowers to avoid getting close to needing to step in – are simply absent. Market-traded bonds were never more than a small minority of the portfolio. They are now *de minimis*.

Bilateral vs. traded bonds



Source: RECI Monthly Factsheet, May 2024

Conclusions

Bilateral, senior, no joint lenders to confuse tactics of loan management

- Nearly all bilateral loans are senior debt.
- As a lender, RECI has no exposure to rising rents, but it is important to aim for these sectors in order to underpin collateral value and ultimate rentability.
- RECI has a good strategy as to allocation of bilateral loan capital between development versus yielding asset ("core").
- Exposure to hotels is high and this has worked in the past, with all likelihood that clear trends in strong demand for international tourism will continue. The hotels are oriented to middle-upper tourist trade, not budget or business.
- Exposure to residential – including students in capital cities – is high. This chimes with the strong rising rents in cities.
- Exposure to offices is riskier and Paris has proven a more difficult market than West End London. RECI has done well to exclude London City (bar one position, exited successfully) and Docklands, but it has two Paris projects, which have not worked as well as hoped. In one of these, the sponsor put in more equity. The other has required a writedown and is completed, looking to be let.
- Information flow is strong, with a monthly update to investors on the top 10 positions and quarterly on the top 25.
- It is likely that interest rates received will rise in 2024/25, yet more than one future year of uncovered dividends is the likely outcome.

Exposure to France

A small writedown in one completed office development

Exposure to the positions RECI has selected in France does not, through the cycle, raise the overall risk. It has provided diversity and several successful exits. Clearly, the political situation warrants attention. There has already been one writedown with the December 2023 factsheet report of an unrealised hit of 1.6p to the NAV. See also our note, French and German exposures in perspective, published 27 February 2024. We conclude this is the only troublesome position across the entire French exposure. We have outlined, above, how the quality tourist hotel sector is strong.

The hotel sector is robust, vibrant

We first reviewed RECI's operations in France explicitly in our note, Vive la difference, published 15 February 2022. This showed how French exposure had peaked at 38% of the portfolio in December 2021, up from 11% three years previously. Since that point, several commitments have been successfully paid back, including the largest one, a super-prime residential/retail building in the heart of Paris. This has taken French exposure down to 25%. Excluding this large position, which has been exited, 32% of the remainder of the French exposure was to three offices in Paris, as of our February 2022 assessment. The supply trends into the French office market were high in 2021, encouraged by post-Brexit conditions. Then, with the COVID-19 era, commencement of new developments was well down. Since then, there has been a further rise in supply, and Knight Frank estimated, in 2023, that 900,000 sq. m. of newly developed office space will be delivered this year to Greater Paris. This high number was considered likely to result in all-time high Parisian vacancy rates in 2024, reaching 8.2%, which compares to 7.5% at end-2022, the recent low. UK investors should bear in mind that, for more than two decades, Parisian office vacancy rates have been between 2ppts and 4ppts higher than London rates.

The largest exposure is to a refurbishment/extension of a Paris (Saint Ouen) office building, which is a senior loan type, on an entry LTV of 58%. In such a modest LTV situation, there has always been a useful "cushion", and, furthermore, the sponsor (borrower) has been amenable to putting more equity into the position.

Always outside Top 10, a Grade A office in eastern Paris is slow to let

However, there is a Grade A office position in the eastern quarter of Paris, which is now completed and slow to let. This is a £10.3m senior loan made to two, credible sponsors. The development was concluded in 2022, on time and to budget. The sponsors, nonetheless, have been unwilling to inject more equity. Taking a view on a lower-than-originally-expected rent roll and also lower capitalisation rates, an unrealised 1.6p hit was taken to NAV, more than 40% of the entry value. The strategy is to let progressively rather than dispose of the problem quickly.

Importantly, the asset is now controlled by Cheyne, free from interference by the sponsor and an initial very small letting has occurred.

Conclusion

We are confident on the other Paris office position, and French office exposure, while a negative, not material in a group context. The risk might be 1% of NAV.

We consider the 1.6p NAV hit taken, at the end of 2023, on this one office development was a conservative figure at the time. Matters have worsened with the political situation likely to affect letting demand and capitalisation rates further. We are not making a forecast, but we consider that, worst case, if there were a further writedown, it would be ca.1% of RECI NAV, taking the position to a *de minimis* level. Given its senior status, we consider this downside as not the most likely scenario.

Hotels thriving and housebuilder LTV very conservative

Turning to hotels, the hospitality sector is thriving, 2023 RevPAR across Europe increased by 20% and continues to rise this year. The sponsors are strong, the assets robust and high-quality, tourist-driven. We have no concerns on these. The housebuilder position has entry-level LTV of 36%, so we are not concerned, especially as house developers have various ways of generating cash from sales.

Senior debt beats equity

Why should investors prioritise senior debt over holding tangible real estate?

In this segment, we turn to the wider point of how RECI fits into investor portfolios. How do they choose between buying into the real estate asset itself versus the senior debt route, which RECI offers. We do not digress into REITs analysis – this is simply comparing tangible real estate trends and senior debt returns, their risks and rewards.

Long-term rents in top-quality assets just match CPI

Tangible assets' protection against real value erosion is distinctly mixed…

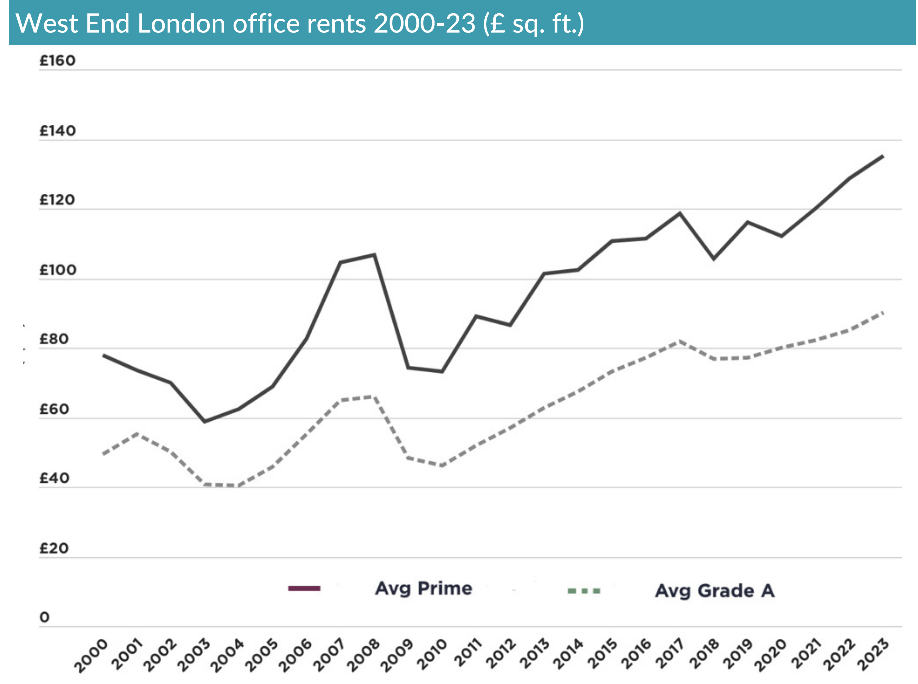
Rents for the best long-term quality asset class, prime West End London offices, have just about kept pace with CPI but significantly lagged RPI since the start of the century. There have been wide fluctuations, fluctuations that have been correlated with wider downturns; i.e., the 2000 dot-com collapse and the 2008 financial crisis.

Our thesis is that, even taking this superior asset category, the hedge against inflation has been there but has been modest. Indeed, additionally, it should be highlighted that the price for this is both volatility and also a low rental yield, between 3.0% and 4.0% (*source: JLL and others*).

RECI invests in senior debt, so misses out on the inflation of the assets it invests in. The foregone return is not particularly attractive, from the data above and below.

…for example, in West End London offices, one of the best asset classes

West End London office rents 2000-23 (£ sq. ft.)



Source: RECI, Savills

The Savills data show West End rents in prime office space rising from £78 to £135 sq. ft., a 73% rise over 23 years. Over the same period, UK CPI rose from 73.2 to 131.4, a rise of 80%. Over the same period RPI registered a rise of 124%. These data are for year-end figures.

It is interesting to note the rental return and inflation from the other UK asset class that is in continuous strong demand, residential. ONS data show how rents prior to 2021 tracked 1% either side of CPI inflation, while subsequent rises have been largely in line with the significantly rising inflation rate. There is some evidence that, in a recent short number of months, rental inflation has remained high and thus

outperformed the CPI figure, which fell back sharply in recent months. Our contention is that, in this asset class, which is in particularly short supply, rents have kept pace with inflation, not outpaced it. Recent months may indicate a firmer trend, though. Again, as with prime offices, initial yields are well below other forms of commercial property. Residential yields offer a wide spread, given locality and quality, but prime residential yields are in line with the low figures on prime West End London offices.

UK residential rent inflation 2016-24 (annual %)

Source: ONS

The contention remains that, even in these two specially selected, most attractive UK asset classes (RECI's focus is UK), there is scant evidence of consistently beating CPI. In this context, it is worth reminding ourselves of the 2% CPI target the Bank of England has set, and the net initial yields of these assets of 4% or less.

Long term, rents and asset values in other classes have not kept pace with inflation

Other real estate asset classes may frequently offer net initial yields higher than these two asset classes we have detailed. However, long term, the rents and asset values in other classes have not kept pace with inflation.

How this CPI-matching tangible asset return compares to RECI

So, with a covered 8.2% dividend yield on NAV, RECI's returns offer a competitive return versus the underlying real estate assets. It would seem that there is an appropriate, sustainable return for the value-adding role RECI capital plays, both for the market as a whole (i.e. the structure encouraged by the regulator) and for its individual borrowers.

By their nature, RECI positions have a finite life, turning to cash

Senior debt returns appear to beat most tangible asset returns and in addition regularly "prove" the asset valuation

When the transition ends, the owner of the asset might wish to refinance with a bank or it might sell. Either way, the RECI role has matured and ripened when that happens and the RECI coupon can be replaced by a lower interest cost from a different lender, which is watching its capital adequacy ratio. This suits RECI. It recycles the capital. Each time the loan is repaid, it "proves" its NAV. RECI's asset value is regularly being validated as cash.

RECI in an era of raised finance cost

RECI in a time of rising interest rates

In March 2022, the Federal Reserve raised rates for the first time since 2018 and indicated rises in each of the subsequent six meetings due that year. Debt costs have risen fast. This research looks at how this affects demand and returns for RECI's capital. We explain why the big hole created for developers, in particular, has been attractive to RECI. It is best to finance fresh proactive projects rather than possibly stale investments with a financing problem. Furthermore, development lending rolls over rapidly, typically within two years, attractive in a period of rising money rates.

We published research on this specific topic on 8 November 2021, *Why rising rates should not hurt RECI.*

A prospective touch of the tiller

Now that the global cost of money seems to be stabilising, RECI may be adjusting its strategy, downplaying new developments and lending more to yielding, matured assets. Here, the bilateral loan demand may be for five years, as opposed to under two. This gives more visibility to RECI investors and is taking place post the yield shift in the market, capturing that higher-rate environment.

Valuation

Dividend yield – summary

12p annual dividend expected

Any valuation must take into consideration the stable and uninterrupted dividends delivered consistently since 2012, with a dividend history pre-dating 2013. The 3.0p quarterly dividend is an all-time high, having reached this level in June 2017.

During the COVID-19 crisis, when RECI took large, early mark-to-market (MTM) hits in 2020, and then steadily released them throughout the rest of the year, it maintained a consistent 3p quarterly dividend. The trust appears very committed to this dividend, and the noise from MTM losses and gains will reduce with a smaller bond portfolio. A path towards better cover is visible.

Dividends and dividend cover

EPS was ahead of the 12p dividend payment in 2020/21, but that was from writeback of COVID-19 writedowns. If foreign exchange gains and revaluations are excluded, the latest covered dividend was 2016/17, when EPS was 12.3p, ahead of the 12.0p dividend paid. It should be noted the number of shares was significantly lower at 73.4m.

While we model only the next two years, we point to the following matters regarding future dividends:

- RECI has maintained its dividends at somewhat uncovered levels for the past seven years, excluding revaluations and foreign exchange.
- With low balance sheet gearing, even after share buybacks, RECI has the cashflow potential to sustain further years of uncovered dividends.
- In this document – see later segment, page 20 – we illustrate what returns would be needed on the loan book in order to generate enough to achieve a covered dividend.
- Our 2024/25E numbers estimate a significant rise in the percentage profit return on the loan book.

NAV, absolute

Current NAV likely to be on conservative side

The total NAV return over the past five years has a modest standard deviation and has averaged 5.4% p.a., including 6.2% in year-ended March 2023 and 7.0% year-ended March 2024.

We have, in previous reports, considered how the NAV is assessed (see pages 23-24 of our initiation report, *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 the independent checks and controls that are in place to review the process. As we noted in that report, RECI's approach to both issues appears to be in line with best practice.

RECI vs. peer group

RECI historical average 14.7% discount to NAV vs. 26.3% peer group

RECI shares traded at an average discount to NAV of 14.7% during the financial year-ended 31 March 2024. Reflecting market sentiment, the Real Estate Debt Sector traded at an average discount of 26.3% (excluding RECI) over the same 12 months (*source: RECI and Liberum*).

Previous research

Investment themes explored and revisited

This document updates a number of themes we have explored in previous research, namely: how RECI's offering adapts to changing market conditions; how its geographical diversification works; how accounting – and writedowns – are conservative; and how debt financing is attractive compared with tangible real estate investment. Our research documents are designed to provide an ongoing assessment rather than snapshot and the 27 June Capital Markets Day has put this into further context. An important aspect throughout has been the input from Cheyne, and examples were provided of current transactions being undertaken by Cheyne in the UK and western Europe.

What is driving rising returns?

The insight into the current market opportunities confirms to us the availability of senior debt returns of ca.15% cash-on-cash annually, a rate above the current weighted average on the book, which stands around 10% at the ungeared level. Our financial model assumes a modest rise this year and there is scope, we estimate, for progressive modest rises without raising risk profiles. Supply of funds for senior debt continues to run well behind demand, which is driven by:

- the plethora of ongoing projects;
- market conditions with rising cost of money;
- banks' preferences; and
- regulatory issues concerning capital adequacy requirements.

Previous Hardman & Co documents

Our recent research comprises:

- *Why rising rates should not hurt RECI* (8 November 2021).
- *Vive la difference* (15 February 2022).
- *New faces, same resilience* (20 May 2022).
- *Marks taken in uncertainty, released thereafter* (5 August 2022).
- *Positioned for the current crisis* (17 November 2022).
- *Looking at the current opportunities* (9 February 2023).
- *Double tangible security* (13 June 2023).
- *Why CRE equity worries should not apply to RECI* (30 August 2023).
- *Portfolio management to optimise risk/reward* (16 November 2023).
- *French and German exposures in perspective* (27 February 2024).

Fiscal 2024 highlights

Results and share buybacks

The annual report and accounts for the period to end-March 2024 was published 20 June.

86% of RECI's positions at end-March 2024 comprised of senior assets. Holding of market bonds had reduced to 2.2% of the portfolio.

NAV per share fell to 145p from 147p.

Net profit was £21.9m, up from £20.6m.

£27.4m dividends were paid out during 2023/24.

Leverage (excluding cash held as collateral) ended the year at 7.4%, down from 23.8% in the prior year, average cost of debt being 7.0%.

Total NAV return rose to 7.0% from 6.2% in the prior year. This figure is the NAV/share change plus dividend.

At end-March 2024, the portfolio had a 10.2% weighted leveraged yield and an LTV of 64.9%.

The portfolio yield remains consistently above 9%.

The RECI board launched an initial buyback programme in August 2023 and a successor buyback programme in March 2024. Separately, directors and Cheyne employees have acquired a total 1.24m shares in the past fiscal year.

Much reduced exposure to bonds

Exposure to market-quoted real estate bonds has raised the overall risk of the vehicle and has resulted in some NAV mark-downs as well as providing a strong running yield.

At end-March 2024, the holding of market bonds had reduced to 2.2% of the portfolio, mostly through disposals, but also positions have been written down. Transparency is not high, so we do not feel able to comment on valuation other than to say the written-down value has a very high notion running yield.

Dividend prospects

Dividend cover

2023/24 dividend cover was 80%

The 2023/24 dividend cover was 80%.

We estimate 2024/25 dividend cover to increase significantly, to 98%. The rapid rise stems in part from an increase in the interest yield, largely from a prompt reversal in the trend of balance sheet de-gearing, which took place in 2023/24.

We model 98% dividend cover this year and 101% 2025/26

We estimate 2025/26 dividend cover to rise further, exceeding 100%. This is modelled on an equity raise at the commencement of that fiscal period, but in the absence of such an event, we also model 2025/26 dividend being fully covered by earnings. Note that our model does not assume capital profits within these prospective calculations.

Loan income scenarios

Loan income yield in 2022/23 was 8.3%

The loan (not bond) income in 2022/23 yield was 8.3%. This is a simplistic calculation, taking the average loan value on the balance sheet and the total income registered from the loans during the year. The 2023/24 figure was 8.5%. With a rising interest rate environment, we estimate the rate rises to 9.7% for our current year 2024/25E estimate, a figure calculated simplistically on the presumption that average capital deployed in loans through 2024/25 is half the sum of the outstanding at the start and at the end of the fiscal period. Again, simplistically, our model assumes equity issuance from day one of the 2025/26 fiscal period and this money is deployed progressively through the period, the average deployed to loans being half way between period start and end. We assume a rising interest rate return environment and an average yield of 10.2% for 2025/26E. We believe this to be a conservative figure as cash-on-cash returns on loans are indicated by RECI to be ca.15% on typical new positions available. It is also conservative to assume, we believe, that any new equity raised early in the period is deployed progressively through the period.

We are confident that the interest from the ongoing loan portfolio is on a rising trend. This is as a function of the portfolio held, the fact that a large proportion rotates to new loans because the average term to maturity now stands at 1.3 years and the underlying global interest rate background has risen since the current loans were initiated.

DPS history

While EPS was ahead of the 12p dividend payment in 2020/21, this was the result of a writeback from negative revaluations in 2019/20. In 2018/19, EPS was 13.1p, the same as 2017/18. The 2018/19 figure, however, included foreign exchange gains, without which the EPS would have been 11.1p. The 2017/18 EPS benefits from fair value revaluation on investments, excluding which the dividend also was uncovered. 2016/17 EPS was 12.3p, ahead of the 12.0p dividend paid. Modest revaluation uplifts were registered, so 2016/17 was the last year that RECI's EPS, excluding revaluations and foreign exchange, exceeded the dividend payment. It should be noted that the number of shares was significantly lower, at 73.4m.

Financials

Profit and loss

Year-end Mar (£m)	2022	2023	2024	2025E	2026E
Interest income bonds	3.2	5.0	1.5	0.2	-
Interest income loans	23.7	26.7	28.4	36.3	49.1
Other interest income	0.0	0.2	0.4	0.4	0.4
Interest income	**27.0**	**31.9**	**30.3**	**37.0**	**49.6**
Net (losses)/gains on investments	5.4	0.8	0.6	-	-
Net losses on options	-	-	-	-	-
Net gains on foreign exchange instruments	0.0	(2.1)	0.4	-	-
Total net gains on fin. assets at FV through P&L	5.4	(1.3)	1.0	-	-
Operating income	**32.4**	**30.7**	**31.4**	**37.0**	**49.6**
Management fee	(4.4)	(4.3)	(4.2)	(4.1)	(4.0)
Performance fee	-	-	-	-	-
Other operating expenses	(1.5)	(1.8)	(1.8)	(1.9)	(2.1)
Operating expenses	(5.8)	(6.1)	(6.0)	(6.0)	(6.1)
Profit before finance costs	**26.5**	**24.5**	**25.4**	**31.0**	**43.5**
Finance costs	(2.0)	(4.0)	(3.5)	(4.5)	(8.5)
Net profit	**24.6**	**20.6**	**21.9**	**26.5**	**35.0**

Note: classification bonds and loans restated in 2021, Source: RECI Report and Accounts, Hardman & Co Research

Hardman & Co adjusted profit & loss

Year-end Mar (£m)	2022	2023	2024	2025E	2026E
Statutory profit	24.6	20.6	21.9	26.5	35.0
Capital gains & FX movements	5.4	(1.3)	1.0	-	-
Profit excl. capital gains & FX	**19.2**	**21.8**	**20.8**	**26.5**	**35.0**
Adjustment to management fee	1.0	0.4	0.5	-0.7	-1.8
Adjusted profit	**20.2**	**22.2**	**21.3**	**25.7**	**33.2**
Cost of dividend	(27.5)	(27.5)	(27.4)	(27.0)	(34.6)
Statutory cover	0.89	0.75	0.80	0.98	1.01
– excluding capital gains cover	0.73	0.81	0.78	0.95	0.96

Source: RECI Report and Accounts, Hardman & Co Research

Balance sheet

@ 31 Mar (£m)	2022	2023	2024	2025E	2026E
Bonds	98.5	49.2	7.9	0.0	0.0
Loans	295.9	351.5	321.5	419.4	544.4
Financial assets at FV through P&L	**394.3**	**400.7**	**329.4**	**419.4**	**544.4**
Cash and cash equivalents	47.4	14.1	18.3	1.7	6.2
Cash collateral at broker	5.2	2.4	4.5	4.5	4.5
Derivatives	0.0	1.8	0.0	0.0	0.0
Other assets	0.0	0.0	0.1	0.1	0.1
Receivables for investments sold	0.0	0.0	0.0	0.0	0.0
Total current assets	52.6	18.2	22.9	6.3	10.8
Total assets	**447.0**	**419.0**	**352.3**	**425.7**	**555.2**
Current liabilities					
Derivatives	1.1	0.0	0.0	0.0	0.0
Financing	100.4	80.2	23.8	100.0	135.0
Cash collateral due to broker	0.0	0.0	0.0	0.0	0.0
Preference shares	0.0	0.0	0.0	0.0	0.0
Other liabilities	1.6	1.9	2.1	2.1	2.1
Total liabilities	103.0	82.0	25.9	102.1	137.1
Net assets	**343.9**	**337.0**	**326.4**	**323.6**	**418.1**
No. shares (m)	229.3	229.3	225.2	223.4	288.4
NAV per share (p)	**150.0**	**146.9**	**144.9**	**144.8**	**145.0**

Source: RECI Report and Accounts, Hardman & Co Research

Our model assumes 65.0m new shares issued 1 April 2025. FY 2026, therefore, sees average shares in issue rising by 29%. Note the quantum of loans increases by 30% in FY 2026 and income from these loans rises 35%.

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