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Schroder Real Estate Inv Trst Ld
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Schroder Real Estate (SREI)

12/06/2024

Results analysis from Kepler Trust Intelligence

Schroder Real Estate's (SREI) final results to 31/03/2024 saw a positive NAV total return of 1.1%. The components of this positive total return were an increased 3.34pps dividend (+4%) and NAV decline of 2.7p (-4.4%) to 58.8p. SREI has outperformed the benchmark on a rolling three-year basis with a 5.5% per annum total return compared to the benchmark's 0.8% per annum.

Schroder Real Estate (SREI) and its closest peers continue to trade on wide discounts to NAV, in SREI's case c. 26%, which may be a signal that investors are happy to sit on the fence until a rate cut actually comes, unsure of whether property assets really are at attractive valuations. Two things strike us, the first is that SREI's net initial yield is about 200bp higher than 10-year gilts, and the estimated rental value (ERV), 8.4%, is clearly much higher than that. The spread between property yields and the 10-year gilt is an age-old rule of thumb for property investors, with 200bps often seen as the 'right' number. Earlier on in the interest rate cycle, our analysis suggested that UK REITs share prices were actually at about the right level, as opposed to being undervalued, compared to gilts at the time, but this calculation has shifted now, with SREI's yield at NAV now being at the 'right' level, and therefore one can suggest, based on long-established convention, that the share price, a discount of 26% to the NAV, and the dividend yield of over 8%, undervalues the portfolio. The second thing that strikes us is that SREI's portfolio valuation levelled off in the final quarter of the year, and while one must of course treat this as just one small datapoint, it's interesting that it occurred just as the net initial yield reached our so-called 'right' level.

SREI's adoption of specific sustainability criteria, overwhelmingly approved by shareholders in December 2023, is based on a pragmatic assessment that buildings that can demonstrate higher sustainability performance are very likely to generate higher rent, and thus higher returns for shareholders. The team has already completed a number of asset management initiatives where capital expenditure on upgrades has been exceeded by increases in rental income, and by adopting a strategy of improving existing assets rather than simply purchasing a portfolio of sustainable buildings, the trust's entry price is likely to be much lower. While ESG mandates more widely, for example ESG equity funds, remain somewhat polarizing, within real estate the focus on the sustainability performance of buildings is far more mainstream even among investors that haven't adopted formal targets such as SREI, so in our view the adoption of the formal policy should widen the appeal of SREI rather than restrict it to investors with their own specific ESG goals.

Overall, SREI has generated further rental growth, has an attractive net initial and reversionary yield compared to government bonds, more so when measured at the share price discount of 26% and a strategy of adopting sustainability performance as a key part of asset management, ahead of the peer group, at a point when in our view such a strategy will only become more mainstream over the next few years.

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