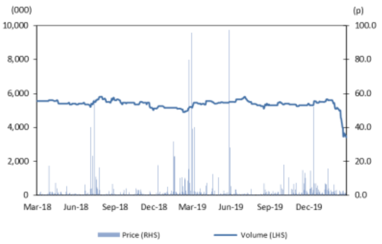
Buy

Current price	35.5p
Sector	Real Estate REIT
Code	RLE.L
AIM	AIM

Share Performance



	1m	3m	12m
RLE.L	-37.6%	-37.0%	-34.6%

Source: Thomson Reuters, Allenby Capital

Share Data		
Market Cap (£m)		66.2
Shares in issue (m)		186.42
52 weeks	High	Low
	58.0	39.0
Financial year end		December

Source: Company Data, Allenby Capital

Key Shareholders	
Invesco	16.96%
Premier Miton Group	11.31%
Ruffer Investment Mgt	8.21%
JO Hambro	8.20%
Directors & Employees	6.77%

Source: Company Data, Allenby Capital

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Equity Research

Real Estate Investors plc (RLE.L)

Defensively positioned commercial REIT

This update reviews a solid FY19 i.e. results in line with forecasts and growth in line with the core strategy. That now looks historic, since the COVID-19 virus and government response have added huge unknowns to the outlook, but we review the underlying resilience of RLE business model. Despite so many variables outside of the group's control, broad tenant and sector diversification and focus on strong covenants, underpinned by government measures to support UK business, should help defend the bottom line.

Severe corrections are certainly not unfamiliar to longer term investors in cyclical industries, such as UK property. The latest trigger is new but, as ever, the worst hit will be entities most exposed to vulnerable sectors and regions, especially, those highly indebted or engaged in speculative development. ***RLE doesn't fall into these categories.***

- **FY19 results; another solid performance in line with forecasts.** Finances are in robust shape. Contracted rent meets operating expenses, debt service costs and a dividend now equivalent to a fully covered prospective 11.2%. Debt levels are comfortably within covenants, with £7.5m cash available to conceivably finance growth.

- **Portfolio strategy focused on safe and steady growth.** RLE's strategy avoids the most volatile activities, such as speculative development, and maintains relatively conservative debt levels. Its motivation is quite deliberately to ensure that whenever the next market downturn arrives, it won't be over-exposed. Its defensive characteristics include continued focus on Birmingham and the West Midlands, its home territory and the UK's strongest regional economy.

- **Management has successfully steered RLE through previous crises relatively intact.** A highly committed, hands-on executive team is **totally aligned with shareholders**, having invested £10m of its own wealth (and never sold any shares). It has navigated the sector's last four decades and expects to be able to capitalise on the kind of rare opportunities that present themselves at these points in the cycle**.**

- **Valuation:** As a UK-REIT, RLE must distribute at least 90% of its recurring net income. The current 10.7% yield based upon the FY19 dividend (the seventh consecutive annual increase), implies a fall in portfolio rents much larger than that triggered by the financial crisis. We don't doubt that gaps will appear but as a more pragmatic view of RLE's prospects emerges, we feel that this rating will look very generous.

Year End: December

(£'000)	2016	2017	2018	2019
REVENUE	13,453	14,880	15,642	16,596
ADJ. PBT	4,672	6,167	7,160	8,045
EPRA EPS (p)	2.80	3.31	3.85	4.32
DIVIDEND/SHARE (P)	2.625	3.130	3.560	3.813
DIVIDEND YIELD (%)	7.4	8.8	10.0	10.7
EPRA NAV/SHARE (P)	66.2	68.9	69.3	67.4
DISCOUNT TO NAV (%)	46%	48%	49%	47%

Allenby Capital acts as Joint Broker to Real Estate Investors plc (RLE.L).

Investment case and FY19 results recap

We review the FY19 results below and highlight those aspects that underline the group's inherent strengths and resilience. We have endeavoured to remain factual and anticipate that we will produce a more forward-looking update as some of the dust settles on the impact of measures to tackle the virus and condition of the UK's businesses. That note could also model the impact of various scenarios on group finances, NAV etc.

Securely financed with focus on UK's strongest regional economy

The investment case pivots on (a) a management team with considerable experience of its target local markets and a track record of building the portfolio across multiple sector cycles, (b) a well-diversified tenant base, located within a carefully selected portfolio that includes assets where RLE previously identified opportunities to grow rent and capital values via hands-on asset management and (c) a focus on the Birmingham and West Midlands region, a vibrant regional economy, prospects for which have recently been buoyed the decision to proceed with HS2, Coventry's status as the UK's 2021 City of Culture and Birmingham's role as host of the 2022 Commonwealth Games.

This has helped encourage investment in infrastructure, housing, education, innovation and culture, and occupational demand from both domestic and overseas businesses. In January 2020, Segro announced plans to invest in a £400m gateway scheme for Coventry expected to create over 7,000 jobs, and BT confirmed that it will relocate up to 4,000 employees in Three Snowhill, a 17-storey landmark building in central Birmingham in the city's largest ever single office letting.

Savills' Birmingham city centre year end take-up figures pointed to the city's strongest year on record.

Exhibit 1: RLE's property portfolio

31 December 2019	Value (£m)	Area Sq Ft	Contracted Rent (£)	ERV £	Net Initial Yield %	Reversionary Yield %	Occupancy %
Central Birmingham	30,975	114,049	1,568,835	2,046,836	5.06%	6.61%	82.85%
Other Birmingham	35,225	215,895	2,681,532	2,855,319	7.61%	8.11%	95.80%
West Midlands	82,375	647,387	6,450,533	7,200,236	7.83%	8.74%	95.65%
Other Midlands	73,730	586,347	6,679,172	7,021,069	9.06%	9.52%	99.96%
Other Locations	2,770	28,779	284,402	310,326	10.27%	11.25%	96.15%
Land	3,780	-	-	-	-	-	-
Total	228,855	1,592,457	17,664,474	19,433,786	7.85%	8.63 %	96.35%

Source: Company Note: Land holdings are excluded from the yield calculations

FY19 results

Underlying PBT was £8.0m (FY18: £7.2m), IFRS PBT £3.7m (FY18: £8.4m), including a £4.3m negative adjustment to the investment portfolio value (FY18: £0.58m positive), and a small £0.04m loss on interest rate hedges (FY18: £0.71m surplus).

Exhibit 2: Income Statement

Year end: December (£m)	**FY18**	**FY19**	
Revenue	**15.6**	**16.6**	**+6.1%**
Cost of sales	(1.5)	(1.5)	+0.5%
Admin expenses	(3.3)	(3.6)	+7.0%
Property revaluation and sales	0.6	(4.3)	
EBIT	**11.4**	**7.2**	**-36.9%**
Underlying profit before tax	7.2	8.0	+6.6%
PBT	**8.4**	**3.7**	**-56.0%**
Underlying EPRA EPS	3.85p	4.32p	+12.2%
Dividend per share	3.56p	3.81p	+7.0%

Source: Company

There was a 6.4% increase in rental income to £16.6m (FY18: £15.6m) on the back of portfolio growth and rent reviews. Interest costs fell to £3.6m (2018: £3.7m), the benefit of a fall in the weighted average debt cost to 3.4% (2018: 3.7%).

That £4.3m negative adjustment related mainly to a more pessimistic view on the outlook for retail generally. RLE's retail asset values fell by 6.2% in FY19 in line with deteriorating market sentiment towards the sector overall, rather than asset specific. Conversely, the group's office portfolio increased in value by 4.0%.

That negative sentiment towards retail will clearly remain an issue, but RLE had no exposure to high-profile insolvencies e.g. Debenhams, House of Fraser, ToysRUs, or recent casualties such as Laura Ashley, or Carphone Warehouse store closures. **Management would argue that this is no coincidence; it is the result of its strong attention to detail and understanding of local retail market dynamics.**

The figures included a £2m write down on a shopping centre in Crewe. RLE also absorbed £0.47m of acquisition costs on £9.3m of purchases (net of those costs). Its traditional retail assets performed very well during the period.

The outlook is supported by a focus on more reliant components such as convenience, town centre and neighbourhood outlets.

Exhibit 3: Financial & Operating Results

Year end: December	FY2018	FY2019	
Gross Property Assets	£224.8m	£228.9m	+1.8%
Like for like rental income	£17.0m p.a.	£16.9m p.a	-0.6%
Contracted rental income	£17.0m p.a.	£17.7m p.a.	+4.1%
Underlying PBT	£7.2m	£8m	+11.1%
PBT	£8.4m	£3.7m	-56.0%
Revenue	£15.6m	£16.6m	+6.4%
EPRA EPS	3.9p	4.3p	+10.3%
EPRA NAV per share	69.3p	67.4p	-2.7%
EPRA NNNAV per share	67.9p	66.0p	-2.8%
Net Assets	£128.7m	£125.4m	-2.6%
Loan to Value	44.7%	46.7%	+4.5%
Loan to Value net of cash	39.8%	42.2%	+6.0%
Average cost of debt	3.7%	3.4%	-8.1%
Dividend per share	3.56p	3.81p	+7.0%
Like for like capital value per sq. ft	£143.74 sq. ft	£141.31 sq. ft	-1.7%
Like for like valuation	£222.8m	£219.1m	-1.7%

Source: Company; Allenby Capital

Finance and banking

There is £7.5m at hand and further access to undrawn debt if required. RLE still has plans to build its portfolio and continue to review its pipeline of new investment opportunities. It remains selective and well placed competitively due to its reputation, ready access to cash, strong network and local market knowledge.

Outstanding debt at end FY19 was £105m (FY18: £99m). That is equivalent to 42% loan to value, vs 60-65% maximum per loan covenants. A new £8.5m facility was agreed with Barclays Bank at the end of December at 1.90% over LIBOR, and earlier in the year RLE fixed a £10m Lloyds Banking Group facility at 3.2% including margin.

This reduced RLE’s weighted average cost of debt to 3.4% (2018: 3.7%). The weighted average maturity at the year-end was 3.25 years (FY18: 4.5 years); 72% at fixed rates, 28% variable. End FY19 LTV was 46.7% (FY18: 44.7%), 42.2% net of cash (FY18: 39.8%).

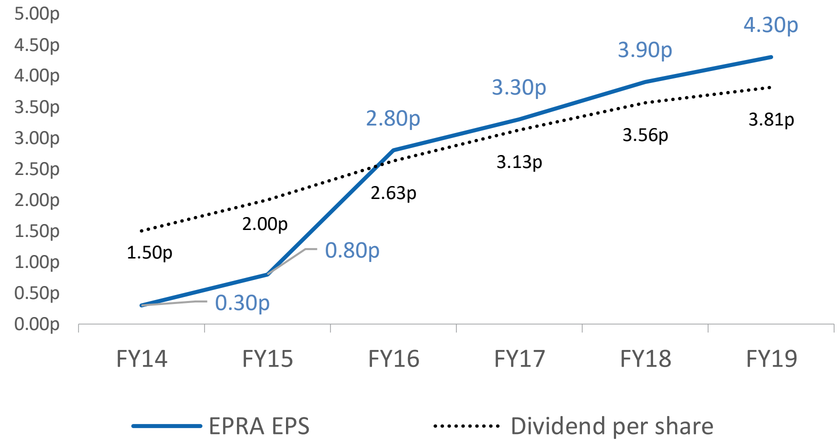
Valuation: 10.7% yield, 47% NAV discount

High yield discounts general market uncertainty regarding rents

The rationale for the current valuation would assume material declines in both rental income and external valuations. The former is, however, asset/tenant specific and expected to be cushioned by UK government initiatives to assist tenants and employees.

Beyond that, it is too early to extract much clarity on specific occupiers or potential rental shortfalls. We would note that RLE's focus on the strongest tenant covenants has been a core, consistent strand of its strategy since inception. That has enabled it to increase its dividend in each of the last seven financial years and build cover over the last four. In FY19 it its dividend was increased by 7% to 3.81p/share.

Exhibit 4: Dividend and EPS cover



Source: Company; Allenby Capital

The high prospective yield appears to reflect perceived risks that rent shortfalls will necessitate a cut in distributions. That is less of an elective decision than for many UK listed companies. The group's UK-REIT status obliges RLE to distribute 90% of recurring net income to its shareholders. That provides some underpinning, as does the absence of any speculative development (or unlet space held for that purpose), and minimal vacancies.

Sector valuations will come under pressure, but individual assets will still perform

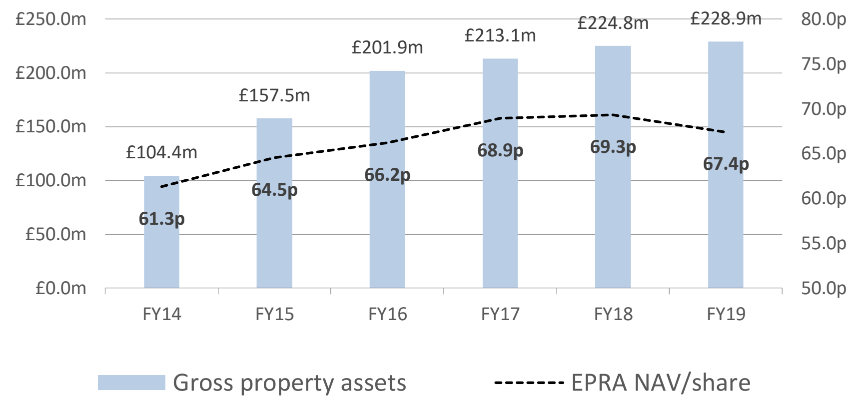
With respect to capital values, it is logical to assume sharp corrections across the sector overall, but again, the impact will be specific to individual assets.

At the extreme end of each property sector cycle headline valuation shifts for the market overall can be sobering. There is often, however, a big difference between the external, 3rd party appraised views of property values, and the price at which any assets actually change hands. As in previous market troughs, RLE would look to add to its portfolio.

The current valuation reflects extreme pessimism. The perceived risk is on the downside and pending actual evidence of transactions, reviews, lettings etc., that's probably legitimate.

We'd make one observation derived from experience of previous sector troughs however. Unless large investors decide to hoard cash for an extended period, the best quality well-let assets will still attract buyers. They did post the banking crisis. The rental yields implied by a 50% discount to NAV will look very attractive in a near zero interest rate environment.

Exhibit 5: Gross portfolio & NAV/share



Source: Company; Allenby Capital

Any adjustment to externally appraised valuations would nonetheless impact the calculation of outstanding loan-to-value, limits to which are set out in covenants related to each facility. These typically set maximum LTV at 60-65% but different ratios may apply in each case. All are however, well above the average portfolio LTV of 42% at end FY19.

Portfolio: steady progress

RLE very deliberately built its portfolio to outperform across the cycle. It is diversified by sector and there is no material reliance on a single asset or occupier.

- The value of the office portfolio (37.7% of rent) was up by 4% in FY19. Some 6.4% of total portfolio rent is derived from government tenants.
- The FY19 year-end portfolio comprised 280 assets and 53 tenants with 7.85% net initial yield, 8.63% reversionary yield. Occupancy was above 96% and management refers to opportunities for further capital and rental growth.
- The portfolio was valued at £228.9m (2018: £224.8m), at end FY19, 1.8% y-o-y growth. Contracted annualised rent roll was £17.7m (2018: £17.0m).

The portfolio is mostly located out-of-town, in vibrant markets where rents and capital values have benefited from both strong demand and all-time-low space availability.

Exhibit 6: Rental income by sector

	Rent (£)	31 Dec 19 % Income	31 Dec 18 % Income
Office	6,659,625	37.70%	37.86%
Traditional Retail	3,785,116	21.43%	19.60%
Discount Retail - Poundland/B&M etc	1,650,902	9.35%	10.07%
Medical and Pharmaceutical – Boots etc	1,135,300	6.43%	6.69%
Food Stores - Sainsburys, Lidl etc	1,011,150	5.72%	5.94%
Restaurant/Bar/Coffee – Costa Coffee etc	1,035,150	5.86%	6.12%
Financial/Licences/Agency - Ladbrokes etc	845,002	4.78%	4.62%
Leisure - The Gym Group etc	537,596	3.04%	3.16%
Hotel	511,000	2.89%	3.00%
Car Park	424,613	2.40%	2.50%
Industrial	52,500	0.30%	0.34%
Assured Shorthold Tenancy	16,520	0.09%	0.10%
Total	17,664,474	100.00%	100.00%

Source: RLE FY19 results

The West Midlands office market is materially undersupplied with offices, a situation exacerbated by limited new build over the last decade, and conversion of office space to residential under permitted development rights. This is reflected in rental growth across this component of RLE's portfolio, notably within its non-city centre stock across the Midlands.

Acquisitions

The group's investment objectives were illustrated by the £9.25m of mixed-use properties acquired during FY19. All located in Royal Leamington Spa, Warwickshire, the price paid was equivalent to an average 8.13% net initial rental yield, derived from tenants including O2, Toni & Guy, McDonald's, Tiger UK, Moss Bros and Timpson.

Lease events already secured since acquisition have captured some of the significant potential rental and capital value growth identified by RLE prior to purchase. It expects to materially extend the average unexpired lease term.

Sales

RLE didn't actively seek asset sales in FY19 but identified properties most suitable for disposal. It still anticipates that these will achieve at least end FY19 book values.

Its plan remains, subject to current market turmoil, to acquire another £10m of assets during H1 2020. It will continue to leverage an established network of regional contacts and its market reputation to identify opportunities to build income, maintain low gearing.

Outlook

A period of extreme and unprecedented political and economic turmoil creates an opaque outlook, and we must assume substantial challenges lie ahead. RLE confirmed that it is closely monitoring the situation, but that it is too early to quantify the future impact. It does not anticipate major disruption due to the need to work remotely to protect its staff.

Nonetheless, it fully expects to be able to navigate the turmoil ahead.

- Its resilient business model is designed to be suitable for all points in a traditional sector or economic cycle and has to date performed in line with expectations.

- It has an experienced management team with a substantial stake in the group, three decades' experience of its specific target markets, and a proven track record of performance during uncertain periods.

- Its approach is risk averse. The portfolio combines revenue diversity and resilience, derived from a focus exclusively on locations well known to the team, and the strongest tenant covenants in each niche, diversified across multiple sectors. There is no material exposure to any single asset, sector or occupier.

- Some 6.4% of group rent is secured from government tenants. The office portfolio (37.7% of the total by value) is the largest component. In FY19 occupier demand, occupancy levels and capital values (4% up y-o-y) held up well, mainly due to asset management initiatives.

It has maintained high portfolio occupancy levels and overheads are tightly controlled. At the end of 2019 the portfolio consisted of 280 occupiers within 53 assets. The period under review saw 53 lease events completed, and occupancy was 96.3% at the year end.

Office occupier demand was particularly strong. Values have benefited from relatively limited new build in recent years, plus conversion of existing stock to residential under permitted development rights. These have been contributors to strong rental increases, such as the 18.6% increase at Topaz Business Park, Bromsgrove. A positive start to 2020 included completion of new lettings and lease renewals totalling £0.73m pa.

There was, conversely, some downward pressure on retail properties valuations due to negative sentiment towards the retail sector generally. RLE has no exposure to department stores, indoor shopping centres or out-of-town stand-alone retail. It maintained its long-term track record of outperformance versus the MSCI IPD Quarterly Property Index.

Management still plans to enlarge its portfolio and reports a pipeline of acquisition opportunities. It has £7.5m in cash available, but remains cautious and extremely selective, and committed to maintenance of modest gearing.

Exhibit 7: Income statement

Year end: December (£000s)	2017	2018	2019
Revenue	14,880	15,642	16,596
Cost of sales	(1,727)	(1,478)	(1,485)
Gross profit	13,153	14,164	15,111
Administrative expenses	(3,548)	(3,322)	(3,553)
(Loss)/surplus on sale of investment properties	176	(42)	8
Change in FV of investment properties	4,212	578	(4,349)
Profit from operations	13,993	11,378	7,217
Finance income	19	31	41
Finance costs	(3,457)	(3,713)	(3,554)
Surplus on financial liabilities at FV through P&L	725	706	(41)
Pre-tax profit	**11,280**	**8,402**	**3,663**
Adj. (underlying) PBT	**6,167**	**7,160**	**8,045**
Tax	(145)	(113)	0
Net profit	11,135	8,289	3,663
EPS			
Basic	5.97	4.45	1.96
EPRA EPS	3.31	3.85	4.32

Source: Company; Allenby Capital

Exhibit 8: Balance Sheet

Year end: December (£000s)	2017	2018	2019
Assets			
Non-current			
Intangible assets			
Investment properties	209,421	221,040	225,075
Property, plant and equipment	12	11	8
Deferred tax	540	405	405
	209,973	**221,456**	**225,488**
Current			
Inventories	3,708	3,764	3,780
Trade and other receivables	3,663	2,277	2,423
Cash and cash equivalents	4,339	10,843	10,092
	11,710	**16,884**	**16,295**
Total assets	**221,683**	**238,340**	**241,783**
Liabilities			
Current			
Bank loans	(20,378)	(364)	(7,368)
Provision for current taxation	(23)	(1)	(1)
Trade and other payables	(6,146)	(7,883)	(8,113)
	(26,547)	**(8,248)**	**(15,482)**
Non-current			
Bank loans	(64,213)	(98,411)	(97,807)
Financial liabilities	(3,869)	(3,010)	(3,051)
	(68,082)	(101,421)	(100,858)
Total liabilities	**(94,629)**	**(109,669)**	**(116,340)**
Net assets	**127,054**	**128,671**	**125,443**
NAV per share (p)	**67.1**	**67.9**	**66.0**

Source: Company; Allenby Capital

Exhibit 9: Cash flow

Year end: December (£000s)	2017	2018	2019
Cash flows from operating activities			
Profit after tax	11,135	8,289	3,663
Adjustments for:			
Depreciation	5	6	5
Net surplus on valuation of investment property	(4,212)	(578)	4,349
Loss/(surplus) on sale of investment property	(176)	42	(8)
Share-based payment	350	(148)	100
Finance income	(19)	(31)	(41)
Finance costs	3,457	3,713	3,554
Surplus on financial liabilities at FV through P&L	(725)	(706)	41
Tax charge	145	113	0
Increase in inventories	(13)	(56)	(16)
Decrease/(increase) in trade and other receivables	(738)	1,386	(146)
Increase/(decrease) in trade and other payables	(87)	1,504	113
	9,122	13,534	11,614
Cash flows from investing activities			
Purchase of investments properties	(20,353)	(16,744)	(10,384)
Purchase of property, plant and equipment	(3)	(5)	(2)
Proceeds from sale of investment properties	13,522	5,661	2,008
Interest received	19	31	41
	(6,815)	(11,057)	(8,337)
Cash flows from financing activities	**0**	**0**	**0**
Interest paid	(3,457)	(3,713)	(3,554)
Hedge payment	0	(153)	0
Equity dividends paid	(5,359)	(6,291)	(6,874)
Proceed from new bank loans	0	14,570	8,500
Payment of bank loans	(927)	(386)	(2,100)
	(9,743)	**4,027**	**(4,028)**
Net increase/(decrease) in cash and cash equivalents	(7,436)	6,504	(751)
Cash and cash equivalents at beginning of period	11,775	4,339	10,843
Cash and cash equivalents at end of period	4,339	10,843	10,092

Source: Company; Allenby Capital

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Roger LeBoff is the author of this research recommendation and is employed by Allenby Capital Limited as an Equity Analyst.

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