Schroders capital

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SCHRODER UK REAL ESTATE FUND (SREF)

Q4 2021

31 Dec 2021

Investment objective

SREF's performance objective is to outperform its benchmark by 0.5% per annum, net of fees, over rolling three year periods, although this is not guaranteed over this or any other period.

Key information

Fund net asset value	£2,512.3 million
Fund gross asset value	£2,529.6 million
Cash	£103.7 million
Number of holdings	52
Number of tenants	644
Void rate[1]	6.6%
Average unexpired lease term to break	8.7 years
Average unexpired lease term to expiry	9.9 years
Debt (% NAV)	0.2%
Net initial yield[1]	4.0%
Reversionary yield[1]	5.1%
Equivalent yield[1]	4.8%
Gross distribution yield[2]	2.8%
Investment parameters	Compliant

Source: Schroders, 31 December 2021.

[1]Includes all directly held properties joint ventures and indirect funds. Includes agreements for lease but excludes land and development.

[2]Distributions payable in the twelve months to 31 December 2021 as a percentage of the latest net asset value per share (NAV).

[3]Performance is calculated on a net asset value (NAV) to NAV price basis plus income distributed, compounded monthly, net of fees, gross of tax and based on an unrounded NAV per share.

Performance analysis

Performance (%)	3 months	12 months	3 yrs (p.a.)	5 yrs (p.a.)	10 yrs (p.a.)
SREF[3]	5.2	16.2	5.7	7.1	8.4
Benchmark[4]	7.5	19.1	6.2	7.0	7.6

Performance (%)	Q4 20 Q4 21	Q4 19 Q4 20	Q4 18 Q4 19	Q4 17 Q4 18	Q4 16 Q4 17
SREF[3]	16.2	-0.4	2.1	7.3	11.1
Benchmark[4]	19.1	-1.0	1.6	6.5	10.2

Past performance is not a guide to future performance and may not be repeated. The value of investments and the income from them may go down as well as up and investors may not get back the amount originally invested.

Source: MSCI.

[4]MSCI/AREF UK Quarterly All Balanced Property Fund Index Weighted Average.

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UK Core Property Manager of the Year

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Risk factors

- Property-based pooled vehicles, such as the Fund, invest in real property, the value of which is generally a matter of an independent valuer's opinion
- The price of shares and the income from them may fluctuate upwards or downwards and cannot be guaranteed
- It may be difficult to deal in the shares of the Fund or to sell them at a reasonable price because the underlying property may not be readily saleable, or because valuations may not be reliably determined in unusual market circumstances – thus creating liquidity risk. In addition, the payment of redemptions may be deferred for a maximum period of 24 months from the original Dealing Day for Redemption
- There is no recognised market for shares in the Fund and, as a result, reliable information about the value of shares in the Fund or the extent of the risks to which they are exposed may not be readily available
- A potential conflict with the Manager's duty to the shareholder may arise where an Associate of the Manager invests in shares in the Fund. The Manager will, however, ensure that such transactions are effected on terms which are not materially less favourable to the shareholder than if the potential conflict had not existed

Executive summary

Market summary

Schroders forecasts that GDP will grow by 5% in 2022, and by 3% in 2023. This growth will be primarily driven by sustained consumer spending from pent-up demand and investment. We expect inflation to slow over the second half of this year, resulting in small incremental rate increases by the Bank of England. While some polarisation in overall sector performance remains – especially between industrials peaking and retail acclimatising to structural change – this is tempered by pockets of opportunity in sub-sectors of the retail market and the forecast slow down in industrial rental growth. Meanwhile, take-up in office space recovered over the back half of 2021 and demand remains concentrated on the best-quality buildings with leading sustainability credentials.

Performance

For the quarter to 31 December 2021, SREF delivered a total return of 5.2%, versus the benchmark total return of 7.5%. SREF continues to outperform over 5 years and 10 years per annum. Please note that past performance is not a guide to future performance and may not be repeated.

SREF's performance during the quarter was derived principally from capital value growth of £117.7 million generated across the portfolio. The fund's high-quality industrial portfolio focused across London, the South East and the Midlands, saw strong performance driven by a combination of active management to achieve rental growth and further inward yield movement. SREF's prime, long-let office portfolio also saw capital growth over the quarter, driven by inward yield shift reflecting the strength of investor demand in the sector.

The fund's relative underperformance versus the benchmark is largely attributable to our underweight position to the industrial sector. SREF is progressing several industrial development sites within the existing portfolio and continues to consider selective investment opportunities within the sector.

The fund maintains a high-quality portfolio of assets which continues to offer defensive income characteristics, including a low void rate, affordable rents and a long unexpired lease term. SREF benefits from the UK government being the largest (and a growing) occupier in the portfolio. The portfolio is well hedged against inflation with 16.6% of contracted rent subject to index-linked rent reviews increasing to 24.7% on completion of 2 Ruskin Square, Croydon. SREF's office exposure is set to benefit from the polarisation between demand for prime offices and more secondary offices with 95.7% of SREF's offices located in winning cities, low office sector void at 7.7%, and 9.5 years unexpired to earliest termination. SREF has also proactively fitted-out space in four buildings to meet evolving tenant requirements and to provide greater flexibility in exchange for rent premiums and reduced incentives.

International marketing permissions

International capital has been a growing component of the Fund's investor base over recent years. SREF currently manages capital from the North American continent, Europe and Asia Pacific. Since the UK's exit from the EU at the start of 2021, SREF has successfully re-applied for select European marketing passports, with permissions granted in the Nordics, Netherlands and Germany. The Fund has on-going applications currently under review by local regulators in Asia.

UK real estate market commentary

While UK economic growth will vary from month to month as the government tightens and lifts Covid-19 restrictions, Schroders forecasts that GDP, on an annual basis, will grow by 5% in 2022 and 3% in 2023. The key drivers will be consumer spending and investment as businesses look to raise productivity, switch to more energy-efficient equipment and make use of the temporary increase in capital allowances. The main downside risk is that the jump in inflation and staff shortages in construction, care homes, road haulage and other sectors spill over into a general wage-price spiral. That would force the Bank of England to hike interest rates, which would hit consumption and house prices. However, our main scenario is that inflation will slow through the second half of 2022, as supply chains normalise and last year's surge in energy prices falls out of the annual comparison. Accordingly, Schroders expects the Bank of England to raise the base rate gradually to 0.5% by the end of this year and 1.0% by the end of 2023.

The arrival of Omicron during the all-important run up to Christmas capped off a difficult year for retailers already struggling with online competition, rising costs and interruptions to supply. We forecast that shop and shopping centre rents will fall by a further 10% over the next two years as weaker retailers fail and surviving retailers shift more of their business online and close stores. By contrast, supermarket and retail park rents will probably be stable. The greater bias of retail parks to bulky goods means they are more internet-immune than shopping centres and they have also benefited from being open air during a pandemic. Next plc reported that its like-for-like sales on retail parks have returned to 2019 levels, whereas town centre sales are down by 15%. The other key difference is that retail park rents and service charges are significantly lower than in shopping centres. As a result, although some out-of-town retailers will fall into insolvency, we expect there to be steady demand for retail park units from discount retailers, gyms and coffee chains.

The office market appears to be past the worst. Take-up in the second half of 2021 was close to 2019 levels and vacancy rates in central London and major regional cities have levelled off at 10% and 8%, respectively. However, while fears that remote working would make offices redundant have proved wrong, demand has become much more focused on Grade A, high-quality offices which have state-of-the-art conditioning and connectivity, provide plenty of space for team-working and are energy efficient. Over 70% of take-up in the City of London in 2021 was in offices with either a BREEAM excellent, or outstanding rating. This reflects the importance occupiers attach to attracting staff back into the office and to environmental targets. However, it also poses a serious challenge to secondary offices and the jump in construction costs over the last 12 months, means that some older offices risk becoming stranded assets, because it is no longer viable to refurbish them. Given the two-tier nature of demand and limited new building, we expect the increase in prime office rents which began last year in Cambridge, London and the big regional cities to continue through 2022-23. Rents on secondary offices in other cities are likely to decline, or at best stagnate.

Industrial take-up hit a new record in 2021, propelled by the growth in online retail. Amazon alone committed to over 30 distribution warehouses and smaller "last-mile" units and the need to match Amazon's delivery times put pressure on rival retailers to upgrade their logistics. Last year also saw strong demand from pharmaceutical companies and trade counters and rental growth accelerated to 5%, from 2% in 2020. Looking ahead over the next 2-3 years, rental growth is likely to slow to 3% per annum, partly because lower profit margins mean that online retail and logistics firms are very cost-conscious and partly because of an increase in development of big distribution units. Multi-let estates in stronger regional conurbations such as Birmingham, Leeds and Manchester could be an exception. Rental growth has, so far, lagged behind that in London, but there is a similar combination of strong demand and tight supply.

The total value of investment transactions rose by a third in 2021 to over £60 billion, driven by strong interest from both UK and international investors. The most liquid parts of the market were industrial and retail parks and both sectors saw a sharp fall in yields. Prime yields on London multi-let estates and distribution warehouses fell to new lows of 3.0% and 3.5% respectively at the end of 2021, and prime retail park yields stood at 5.5%, down from 7.0% at the end of 2020. In general transaction volumes in other sectors such as hotels, offices and residential recovered last year, but remained below pre-pandemic levels and yields were either stable, or fell by up to 0.25%. The exceptions were care homes, shopping centres and leisure parks which remained generally illiquid, due to concerns about weak covenants.

We expect all property total returns to average 5-7% per annum over the three years to end-2024. While industrial is likely to remain one of the best-performing sectors, we think that the favourable fall in industrial yields has now largely run its course and that the gap in returns between it and other sectors will therefore narrow. Retail parks and grade A offices should also out-perform, with the former supported by a relatively high income return of 6% and the latter benefitting from a steady increase in prime office rents in London and other winning cities. By contrast, shops, shopping centres and secondary offices are likely to under-perform. We think that certain niche types, including self-storage, social supported housing and retirement villages should also out-perform.

Fund commentary and key activity

Over Q4 and since quarter end, the Fund has concentrated on developing the income return and building on its pipeline of transactional activity to drive performance. 25 new lettings and lease renewals were completed over the course of the quarter, along with four rent reviews.

Transactions and asset management update

Acquisitions and strategic disposals

The Brewery, Romford

Since quarter end, SREF has formed a 50:50 joint venture with a Schroders Capital managed, pan-European strategy to acquire "The Brewery", a supermarket-anchored retail warehousing and leisure scheme in Romford, Greater London for £162 million, reflecting an attractive net initial yield of 7.3%. Contracts have exchanged unconditionally and completion is expected to be on 3 February.

The Brewery is located adjacent to the new Romford Crossrail station and comprises of a 21-acre freehold site with 545,478 sq. ft of retail and leisure space anchored by national operators including a Sainsbury's superstore, Nuffield Health, The Range, Boots, a 16-screen Vue Cinema and several food and beverage outlets including Wagamama, Starbucks and Costa Coffee. There are also 1,750 car parking spaces representing a ratio of 1:312 spaces per sq. ft.

The asset produces a total passing rent of £12.43 million per annum (SREF share is £6.2 million per annum), representing an average rent of £19.72 per sq. ft, excluding car park income. The asset has a low void rate of 2.1% and a weighted average unexpired lease term to expiry of 6.25 years.

The Brewery generates consistently strong tenant trade and ample opportunities for our team to perform asset management initiatives both in the short- and longer-term to create long-term sustainable income growth and strong returns for SREF. The site also offers significant future redevelopment potential for residential, commercial and other uses.

The Brewery benefits from BREEAM in-use accreditation and the business plan will enhance sustainability performance in line with SREF's commitment to maximising future resilience and creating desirable spaces that meet evolving occupational requirements.

The acquisition is in line with SREF's strategy to increase income and acquire assets with good fundamentals offering longer-term opportunities to generate significant capital performance from active asset management.

New lettings and renewals

25 new lettings and lease renewals were completed over the course of Q4 across the portfolio, along with four rent reviews.

Industrial leasing transactions

At Acorn Industrial Estate in Crayford, five new lettings and lease renewals completed over the quarter, along with four rent reviews. These nine transactions generated a combined additional rent of £329,681 per annum at the scheme, with the four rent reviews producing a combined 22.6% increase on previous passing rent.

At Hartlebury Trading Estate, two new leases were agreed at the estate in Q4, including a new letting to G Plan Upholstery, who has completed on a 5-year lease on 31,300 sq. ft at £140,000 per annum, reflecting £4.50 per sq. ft, 6% ahead of estimated rental value (ERV) of £4.25 per sq. ft. Development of six new industrial units totalling 58,000 sq. ft at Hartlebury is also progressing well, with a target completion in the first half of 2022. A pre-let has been agreed on 30,000 sq. ft, with strong interest in the remainder.

Self Storage

Flexiss was appointed as the new manager on SREF's 230,000 sq. ft, South-East self-storage portfolio. The portfolio will continue to trade under the existing self-storage company branding and Flexiss will use its experience in the sector and sophisticated management technology to maximise income performance and identify new investment opportunities. The Fund continues to consider further investment opportunities in the sector in order to expand the existing platform further.

Occupier engagement and Covid-19

The fund's rent collection for the September Quarter Day (rent for Q4) totals 86.4% in aggregate. Given the defensive qualities of the portfolio, rent collection remains consistently high, despite the impact of Covid-19 on occupier revenues. Whilst the number of rent concession requests has now reduced, the team continues to engage on a regular basis directly with occupiers across the portfolio.

Liquidity management

The promotion of an active secondary market in SREF remains an important tool to enhance liquidity for investors, and helps maintain a stable capital base to enable the delivery of asset management activities.

SREF completed £275 million of secondary market transactions over 2021, which is a record volume equating to approximately 12% of the total shares in issuance. Pricing tightened materially over the course of the year with strong buy-side demand, and the Fund has most recently traded at a premium of NAV +2%.

The management of SREF's liquidity will, at all times, comply with the binding terms included in the Fund's Prospectus and Instrument of Incorporation.

Q4 2021 Fund update webinar

The SREF Q4 webinar will take place on 2nd February from 09:00am-10:15am GMT. Investors will have received an invitation to register via email. If you have any queries related to attendance or registration please contact realestate@schroders.com.

Strategy and sustainability

Strategy summary

The Fund's key strategic priorities for 2022 are focussed on building income and total returns through active management, capitalising on inherent opportunities within the Fund, and selectively recycling low-yielding capital into attractive segments of the market. Following the acquisition of The Brewery, further sub-sectors of interest include alternatives (such as self-storage, student accommodation, and residential), as well as opportunistic industrial assets. We will look to maintain a robust and well-diversified occupier base across a high quality portfolio of assets which we believe will continue to succeed as polarisation within the office sector grows, benefitting from resilient sustainability credentials and which will remain fit-for-purpose as tenant requirements continue to evolve.

Sustainability: EU Sustainable Finance Directive

Following the introduction of the EU Sustainable Finance Directive on 10 March earlier this year, SREF had updated its Prospectus to ensure it complied with the regulatory requirement for an Article 6 strategy, including appropriate environmental, social and governance risk considerations. New binding ESG targets are currently being reviewed by the FCA as the Fund is targeting an upgrade in its status to Article 8 classification, which will cement our commitment to enhanced ESG performance facilitate international marketing of the Fund, potential for liquidity and stability of the capital base. We anticipate the new Prospectus will be available during Q1 2022.

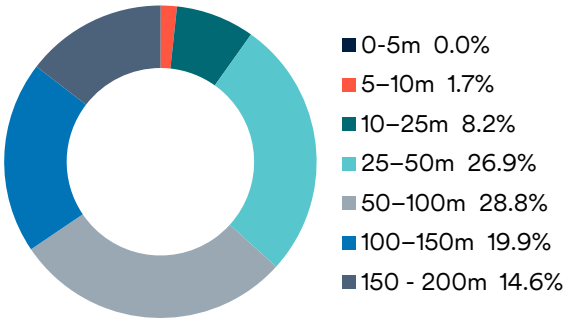
The Brewery, Romford

Hartlebury Trading Estate

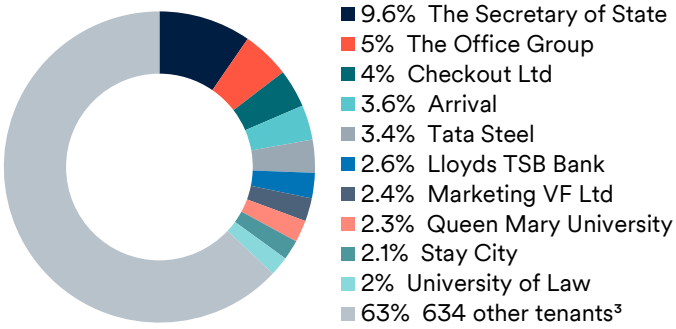
Portfolio analysis

Segment	Absolute segment positions, %		Relative segment positions, %[1]	
	SREF	Benchmark	Underweight	Overweight
Offices – Central London	10.7	11.4	-0.7%	
Offices – South East[2]	31.1	9.1		22.0%
Offices – Rest of UK	4.4	5.2	-0.8%	
Industrial – South East	21.7	25.9	-4.2%	
Industrial – Rest of UK	8.6	13.8	-5.2%	
Standard retail – South East	3.7	4.6	-0.9%	
Standard retail – Rest of UK	1.7	1.9	-0.2%	
Shopping centres	0.5	0.9	-0.4%	
Retail warehouses	4.5	10.6	-6.1%	
Other	8.9	10.2	-1.3%	
Cash	4.1	6.5	-2.4%	

Lot size bands, by GPV[2]



Tenant profile, % contracted rent



Top Ten Holdings	Sector	% of NAV
Building 1, Ruskin Square, Croydon	Offices	8.0%
Wenlock Works, Shepherdess Walk, London	Offices	6.4%
Acorn Industrial Estate, Crayford	Industrial	5.9%
Building 2, Ruskin Square, Croydon	Offices	4.8%
Bracknell Town Centre	Retail and Office	4.3%
One Lyric, Hammersmith, London	Offices	4.1%
Hartlebury Trading Estate, Worcestershire	Industrial	3.7%
City Tower, Manchester	Mixed Use	3.2%
Woking Business Park, Woking	Industrial	3.0%
Kensington Village	Offices	2.7%

Source: Schroders, 31 December 2021, figures subject to rounding.

[1]Positions relative to AREF MSCI UK Quarterly Property Fund Index – All Balanced Property Fund Index Weighted Average. Absolute deviation vs. benchmark is 44.2%; [2]Of SREF's 31.1% allocation to South East offices, 42.1% comprises offices let or pre-let to the UK Government in Croydon; [3]GPV: gross property value; [4]Look through analysis.
The sectors, securities, regions and countries shown above are for illustrative purposes only and are not to be considered a recommendation to buy or sell.

Shareholder information

Minimum investment	£100,000
Total expense ratio (TER)[1]	0.75%
Annual management charge (AMC)	Tiered structure with discounts for scale Headline rate of 0.70% per annum
Frequency of pricing	Monthly
Valuation point	8am on the first business day of each calendar month
Distribution frequency	Monthly paid last business day
Distribution yield (% NAV)[2]	2.8%

Shareholder dealing

Subscriptions	Monthly
Redemptions	Quarterly, subject to 3 months' notice at quarter end
Dealing cut off	12 noon on the last Business Day of the calendar month
Secondary market dealing	Please phone Freya Petty on +44 (0)207 658 7904
Number of shares in issue	48,568,223
NAV per share	£51.73
Offer price per share	£53.86
Bid price per share	£50.99
Pricing methodology	Dual priced
Offer spread[3]	NAV +4.1%
Bid spread[3]	NAV -1.4%
Number of new shares issued – Q4 2021	633,123
Number of shares redeemed – Q4 2021	0
Number of shares matched – Q4 2021	1,046,139

Related party holdings

Related party	Shareholding
None	

Fund literature

Sustainable Investment	https://www.schroders.com/en/uk/realestate/products--services/sustainability/
SREF Prospectus	http://www.schroders.com/sref
Audited Annual Report and Accounts	http://www.schroders.com/sref
Dealing forms	http://www.schroders.com/sref

Investment parameters

Legal limits	PAIF Limit (%)	Current status (%)
Minimum % of assets (NAV) forming Property Investment Business	60%	100%
Minimum % of income from Property Investment Business	60%	100%
Aggregate exposure to indirect investment	40%	0.3%
Investment in a single asset	15%	8.0%
Commitment to development[4]	20%	5.6%
Borrowing[4]	25%	0.2%
Shorter/medium term leaseholds (< 50 years)[4]	20%	0.0%
Speculative development	15%	0.9%

[4]On/off balance sheet.

Fund codes

	ISIN	SEDOL
Schroder UK Real Estate Fund (gross)	GB00B8215Z66	B8215Z6
Schroder UK Real Estate Fund (net)	GB00B8FPXR30	B8FPXR3
Schroder UK Real Estate Fund Feeder Trust	GB00B8206385	B820638

[1]Calculated in accordance with industry standard Association of Real Estate Fund guidelines which include fees charged by the Investment Manager, Property Adviser, Depositary, Registrar, Auditor, Legal Adviser and Valuation Agent.

[2]Calculated gross of tax, net of fees and expenses. Distributions are paid monthly on the last business day of each calendar month. Yield presented is annualised backwards-looking distribution yield.

[3]Offer and bid spreads are reviewed monthly and are subject to change.

Source: Schroders, 31 December 2021.

Further information

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For your security, communications may be taped or monitored.

Important information

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The value of investments and the income from them may go down as well as up and investors may not get back the amount originally invested.

The Schroder UK Real Estate Fund is authorised by the Financial Conduct Authority (the 'FCA') as a Qualified Investor Scheme ('QIS'). Only investors to whom a QIS can be promoted, as specified in COBS 4.12.4R of the FCA's Handbook, may invest in Schroder UK Real Estate Fund. A QIS may not be promoted to a member of the general public. Investors and potential investors should be aware that past performance is not a guide to future returns. No warranty is given, in whole or in part, regarding the performance of the Fund and there is no guarantee that the investment objectives of the Fund will be achieved.

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Risk factors

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The forecasts included should not be relied upon, are not guaranteed and are provided only as at the date of issue. Our forecasts are based on our own assumptions which may change. We accept no responsibility for any errors of fact or opinion and assume no obligation to provide you with any changes to our assumptions or forecasts. Forecasts and assumptions may be affected by external economic or other factors.

This fund does not have the objective of sustainable investment or binding environmental or social characteristics as defined by Regulation (EU) 2019/2088 on Sustainability-related Disclosures in the Financial Services Sector (the "SFDR"). Any references to the integration of sustainability considerations are made in relation to the processes of the investment manager or the Schroders Group and are not specific to the fund.

The Company is generally exempt from UK tax on capital gains realised on the disposal of its investments (including interest paying securities and derivatives). Overseas investors, depending on their tax status, may be liable to capital gains tax (or corporation tax) upon disposal of their holding. Investors who qualify as exempt (including overseas qualifying pension funds, charities and sovereign wealth funds) will benefit from full exemption. Schroders does not provide tax advice and investors should seek advice from professional advisers.

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