TR Property

Kepler INCOME & GROWTH RATING

TRY: a unique way to capture a recovery in property valuations...

Update
10 August 2023

Overview

TR Property (TRY) is a unique investment trust, giving investors exposure to pan-European property markets, via a portfolio of predominantly listed property securities and REITs, together with a limited exposure to direct UK property (c. 8% of net assets). The trust is managed by an experienced team led by Marcus Phayre-Mudge, who has been part of the TRY management team since 1997.

As we discuss in the **Performance section**, over the long term, pan-European property shares as a sector have outperformed equities generally, and TRY has a good track record of outperforming this sector. More recently, in 2022, TRY and its portfolio saw a decline in value of over 30%, in line with its benchmark, with rising interest rates being the predominant factor in this decline.

TRY's current dividend yield is c. 5.1% and there is a long history of maintaining or increasing the dividend, as we discuss in the **Dividend section**. The yield is typically lower than direct property trusts, whose primary objective is normally income, whereas TRY is focussed on both income and growth, and dividend growth of 8% annualised over the last ten years is well ahead of inflation over that period.

TRY's long-term average gearing is c. 15%, and after a period of lower gearing in response to market conditions, its current gearing is in line with this. TRY uses a mixture of short- and long-term debt drawn in both sterling and euros.

TRY's discount is currently c. 9%, wider than its five-year average, but narrower than the c. 30% discount which direct property trusts currently average. In the **Discount section** we argue that TRY's relatively narrow discount is a reflection of its shareholders' understanding that the underlying assets are trading at significant discounts.

Analysts:
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Analyst's View

In the **Performance section** we provide a brief reminder that pan-European property shares have outperformed general equities over the long term; important to remember given more recent events which have left property shares trading at very low valuations. M&A provides the empirical evidence that if stock market investors don't care, others do, and are buying up assets. In the **Portfolio section** we discuss some of the M&A in TRY's portfolio, which is an increasingly long list.

The TRY team have a bird's eye view of the asset class and thus are able to navigate strategic changes such as we are seeing now, as well as more tactical opportunities. A portfolio of equities in property companies is potentially subject to bigger swings in its own net asset value than those of its underlying holdings, and this was certainly true for TRY in 2022. On top of the enduring case in favour of TRY, which gives investors access to an expert manager in a specialist field, this large swing represents the more tactical opportunity that TRY's portfolio is trading at much lower valuations than just two years ago, but in contrast, underlying companies are performing well. Given the stage in the cycle, with TRY's own 9% discount on top of the very low valuations of the underlying, TRY should be of interest not only to generalist investors seeking a specialist manager in property but also to property specialists seeking a unique recovery play.

BULL
A straightforward and relatively low-cost one-stop shop for property investing
Experienced management team has successfully managed TRY through cyclical downturns before
Long-term dividend growth is ahead of inflation

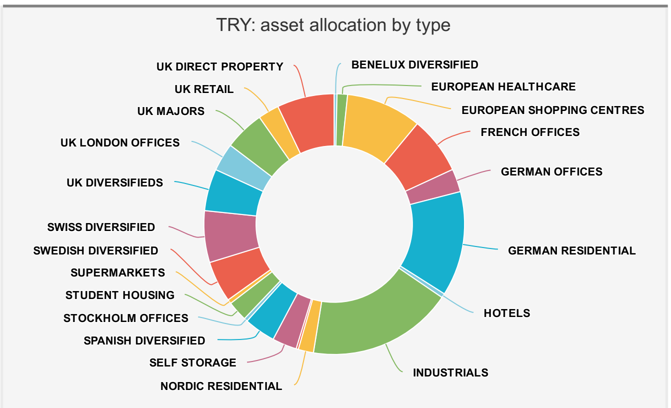
BEAR
European property values could fall further in 2023
TRY uses gearing, which in the above scenario could amplify losses
Initial dividend yield is lower than for direct property investment trusts

Portfolio

TRY is predominantly invested in listed pan-European property securities, but also retains a c. 8% exposure to direct UK property assets. Marcus and the team believe the direct property portfolio provides them with a hands-on sense of the property market and makes them better able to relate to management of their investee property companies. TRY therefore has a largely liquid portfolio, which means it is less susceptible to concerns around e.g. debt refinancing, since if it became necessary TRY could repay its short-term borrowings very quickly, or fund share buybacks. Both of these issues are currently genuine concerns for direct property trusts. TRY can also choose to reposition its portfolio much more swiftly than a direct property trust.

TRY's high-level allocation is c. 43% UK property shares, c. 8% direct UK property and c. 64% Continental Europe (the total is greater than 100 as TRY is c. 15% geared, as discussed in the **Gearing section**). The chart below shows the sheer diversity of TRY's portfolio. Given that TRY's portfolio is a mixture of specialist and generalist REITs, breaking the portfolio out like this is incredibly useful, as it gives a much greater sense of the underlying exposure than simply looking at the largest portfolio holdings.

Fig.1: Asset Allocation By Type



Source: TRY, as at 30/06/2023

We discuss in the **Performance section** the importance of the backdrop of 2022 with rising interest rates and corresponding falls in valuation across the board for property despite many sectors recording strong occupier demand and rental growth. Many of the themes in the portfolio were in place before this correction began, and an across-the-board mark down in values hasn't led Marcus and the team to change views on these trends. The portfolio did see a reduction in exposure to highly geared markets such as Sweden, as well as very highly rated markets such as Switzerland, in response to rising interest rates, and more recently modest exposure to UK healthcare and retail has been reduced. Overall though, many of the portfolio holdings have performed badly in share price terms despite good underlying operational performance, and so much of the portfolio remains as it was in 2022. Generally speaking, European valuations have been a little better than in the UK, but Marcus reminds us that property valuations in the UK tend to be more mark-to-market, i.e. they are informed by recent transactions, whereas Continental European valuations tend to be more mark-to-model, which can result in smoother changes in valuation, but also tend to create a slight time lag, as more transactional evidence gradually becomes incorporated into a model. As a result he cautions that European valuations may have further to fall, in order to catch up with UK valuations. He further acknowledges that one of the appeals of European property for an investor is that many leases are linked to inflation, referred to as indexation. He notes that while rental increases in Europe are generally being accepted by tenants, continued high inflation might test that, particularly in sectors where there is space to let. Thus, while Marcus and the team are of the overall view that REIT share prices are too low, and represent long-term value, they are cognisant that within the overall universe of REITs there are still issues to navigate, and a recovery may not be swift and decisive.

One empirical factor that helps confirm their view that REITs are attractive is the level of corporate activity being seen in the REIT space. In 2022 and 2023 TRY has seen take privates for Deutsche Euroshop, Civitas and Industrials REIT, and consolidation with London Metric acquiring CT Property Trust, SBB's acquiring Amasten and LXI acquiring Secure Income REIT. Very recently, TRY portfolio holding Ediston Property has announced the potential sale of its entire portfolio, coming on the back of a strategic review implemented by its board earlier this year. If this were to complete, this would presumably be accompanied by a return of capital to shareholders.

Offices

TRY's exposure to offices is weighted heavily towards London and Paris (over 50% of the underlying office exposure is within these two cities). Marcus notes that offices as a wider sector remain a significant conundrum for investors in a post-pandemic world, but that right location and the right quality of building can still generate rental growth. Canary Wharf in London, which TRY is not exposed to, is a key example of where large amounts of office space are either about to become, or are already, vacant as major tenants relocate to more central locations, and to offices better suited to a new working environment, and which meet more stringent new energy-efficiency standards. Recent valuation rounds for Q2 2023 indicate that values for offices are still falling as investors digest all these issues, and it seems very likely that the focus on the most prime offices in major cities will remain TRY's strategy in this sector.

Retail

Marcus believes that this asset class has probably seen the worst, having experienced dramatic declines in valuation in many areas as the fundamental nature of retailing adapts to both the hybrid online and physical world, as well as to the demand for retail to be mixed with leisure and entertainment. Many REITs in his universe are already well progressed in either repositioning to the right kind of assets, or in plans to adapt existing assets, or a combination of the two. He notes that one of the most difficult parts of retailing are the very largest retail malls, where there is an excess of space even after making adaptation, and persistent voids place extra cost burden on the asset owner. He cites Gunwharf Quays in Portsmouth, owned by portfolio stalwart Land Securities, as a great example of a modern retail outlet development with integrated leisure and entertainment. Ediston Property, cited above, could prove a useful piece of transactional evidence should it sell its entire portfolio, which is largely comprised of retail warehouse assets.

Industrial and Logistics

If offices and retail have been influenced by trends around how we work and shop, then the industrial and logistics sectors are being influenced by de-globalisation, with re-shoring and a desire to shorten supply chains leading to significant demands for the associated property assets. Naturally, logistics is also tied to the same trends that are shaping retail, with online and hybrid sales creating more demands for logistics assets. Prior to 2022 these trends, combined with a long period where demand outstripped supply, had driven yields to low levels, which meant this was one of the worst performing parts of the property sector in 2022. However, TRY's largest exposure, Industrials REIT, which is on the list above of portfolio holdings that have been subject to corporate activity, was bid for in 2023 at a 40% premium to its share price, and the trends that are driving tenant demand for these assets remain firmly in place.

Residential

TRY reduced exposure to some of the German residential property companies in 2022, as part of a wider move to reduce exposure to more highly leveraged companies. Regulated rents in markets such as Germany tend to lag inflation, as rent reviews are backwards-looking, but there is an expectation in the team that rents will grow significantly as they catch up with historical inflation. More open markets such as the UK have seen faster rental growth, but all markets face the headwind of necessary improvements to energy efficiency, which in both regulated and more open markets is likely to prove to be a brake on rental growth.

Alternatives

Marcus and the team have invested in a number of specialist property companies over the years. The most successful sector in 2022 was student accommodation, with TRY's largest holding in this sector, Unite Group, being one of the few property companies to see positive capital growth. TRY's long-standing exposure to self-storage remains, with Marcus noting that the sector continues to see rental growth, in spite of scepticism in some quarters. Noting that healthcare real estate is generally seeing slow rental growth and operators are generally being squeezed on earnings, the team has positioned the portfolio with zero exposure to healthcare specialists.

Overall, TRY's portfolio maintains a diversified exposure to pan-European property but through a mixture of the team's own portfolio positioning, and, through picking experienced underlying property management teams, they are able to target the most positive trends and avoid areas such as excessive leverage or valuations. The portfolio is, in our view, well-constructed to capture a recovery, and should not only appeal to generalist investors but also to property specialists seeking a recovery play.

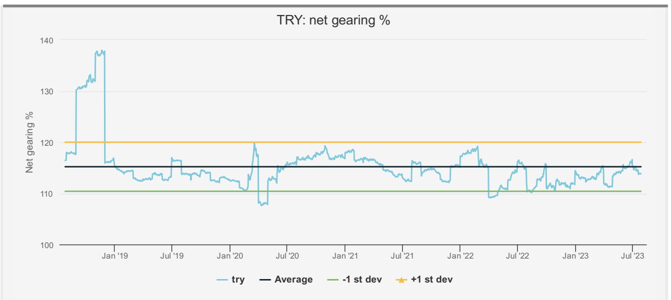
Direct portfolio

TRY's physical property portfolio is a good way for the team to keep hands-on experience of property asset management and gain better insight into the challenges and opportunities faced by their investee companies. The portfolio is valued at c. £74m and is located principally in London, with some exposure to the South West of England. About 50% of the portfolio, by value, is in industrial and also logistics, echoing a key theme of the indirect portfolio. Another 40% is in retail, notably the West London property The Colonnades, which TRY has owned for over 20 years and upgraded significantly over time. About 73% of income from this asset comes from anchor tenant Waitrose. At this point it seems unlikely that the team would make a big strategic re-allocation of capital into direct property, but will continue to maintain and asset manage the existing portfolio.

Gearing

TRY is currently geared c. 15%, which is in line with the long-term average. In 2022 gearing was reduced in response to market conditions, but as the graph below shows, TRY tends to be net geared within the range of 10% to 20%. For clarity, we are using the standard investment trust gearing calculation of gross to net assets for our gearing figure. The alternative loan-to-value (LTV) calculation is commonly used in property investing and investors should be aware references to gearing in property commentary usually refers to LTV.

Fig.2: Net Gearing %



Source: Morningstar, as at 31/07/2023

TRY's gearing is provided by a short-term revolving multi-currency facility for up to £130m, of which £10m was drawn at the year ending 31 March 2023, and through two longer-term loans:

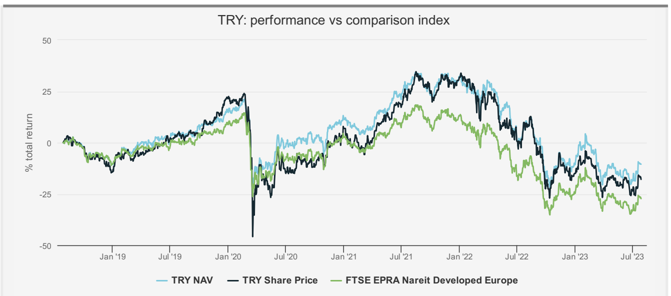
- 1.92% Unsecured Euro 50,000,000 Loan Notes due in 2026 and;
- 3.59% Unsecured GBP 15,000,000 Loan Notes due in 2031

Both these facilities provide debt at lower cost than prevailing interest rates, and provide a positive spread to the dividend yield on the portfolio, which is c . 5.3%. Borrowing in Euros provides a natural hedge to the part of the portfolio denominated in Euros, as the asset and liability are in the same currency.

Performance

Over the last five years, TRY's NAV total return is c. -10%, compared to a 27% decline in the FTSE NAREIT Developed Europe Index. Any discussion of performance for property or property securities is coloured by 2022, which saw a c. 32% decline in TRY's NAV alongside a 34% decline in the index, but as the next series of charts illustrate, TRY and its specialist asset class have a longer-term record of outperforming equity markets, and the decision for investors is whether 2022 is a cyclical downturn caused by rising interest rates, or something deeper. As discussed in

Fig.3: Five-Year Performance



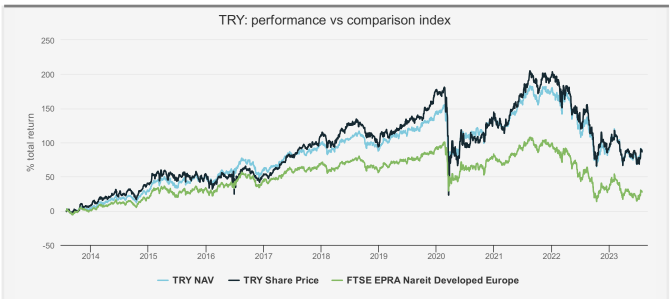
Source: Morningstar, as at 01/08/2023

Past performance is not a reliable indicator of future results.

the **Portfolio section**, Marcus and the team continue to see good tenant demand and rental growth in many sectors, and so the decline in values is not matched by a decline in earnings.

The longer-term chart below over ten years illustrates how TRY has built up a long-term track record of outperformance, with an NAV total return of 86% against the comparative index's 26%. This chart includes a general index of European equities which serves as a reminder that property securities as an asset class can provide long-term outperformance. That outperformance unravelled in 2022; the longer-term pattern is still highlighted below.

Fig.4: Ten-Year Performance

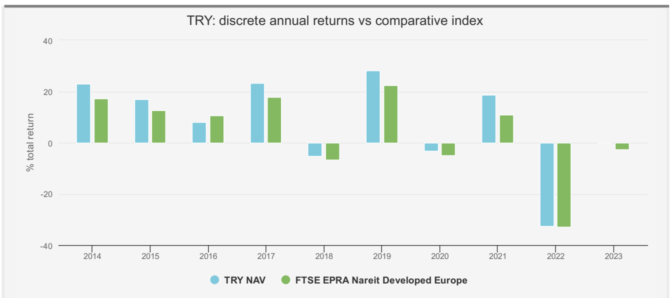


Source: Morningstar, as at 01/08/2023

Past performance is not a reliable indicator of future results.

The next chart below deconstructs the cumulative charts above into discrete annual years, which allows us to see that TRY has a consistent record of outperformance of our comparative index. Strictly speaking, TRY's benchmark is the 'capped' version of the index used in the chart below, although in reality the performance of the two indices is very close, and unfortunately Morningstar doesn't keep the capped version on its system. One of the important takeaways from this chart is how 2022 was a sector-wide issue, rather than a TRY-specific issue, and 2022 will clearly continue to colour performance data for years to come.

Fig.5: Discrete Annual Returns



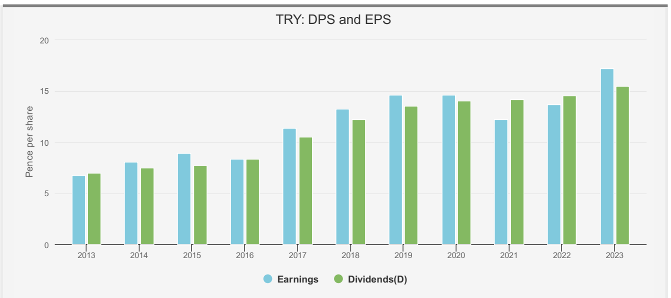
Source: Morningstar, as at 01/08/2023

Past performance is not a reliable indicator of future results.

Dividend

TRY pays an interim and an annual dividend in January and August, respectively. For the financial year ending 31 March 2023, TRY paid a total of 15.5p per share, equivalent to a yield of 5.5% . During the year, a number of portfolio companies changed the timing of dividend payments, which in effect brought forward just over 1p of dividends. As a result the dividend cover is higher than it would otherwise have been, although even adjusting for this, the dividend was fully covered. As the chart below shows, TRY has seen some shortfalls in dividend cover in recent years, with revenue reserves utilised to smooth payments. TRY has c. 1.7 years' worth of revenue reserves available to cover shortfalls such as these.

Fig.6: Dividend And Earnings Per Share

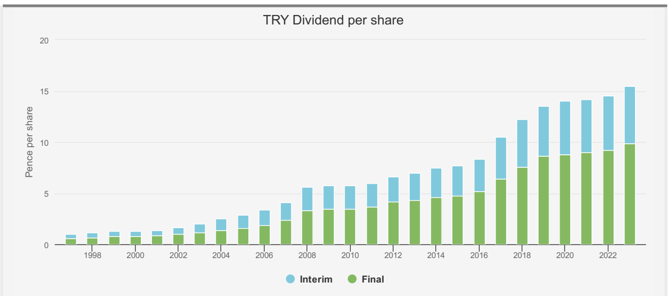


Source: TRY

Past performance is not a reliable indicator of future results.

The chart below shows the annual dividends since Marcus began his role with TRY. Over the long term the final dividend has been c. 60% of the total dividends paid. Over ten years the dividend has grown by c. 8% annualised; over the whole period the annualised increase is c. 11%, both figures being significantly ahead of inflation over the corresponding periods.

Fig.7: Dividend Per Share



Source: TRY

Past performance is not a reliable indicator of future results.

Management

TRY is managed by Thames River Capital LLP, working in a form of joint venture with Colombia Threadneedle. Marcus Phayre-Mudge has been part of the management team since 1997 and lead manager since 2011. He has been assisted by Alban Lhonneur for over ten years and, on the direct property side, by George Gay, who like Marcus is a Chartered Surveyor, and has been with the team for c. 15 years. Thames River Capital and, in effect, TRY itself, has a dedicated CFO, Joanne Elliot, who has worked with TRY since the mid-1990s.

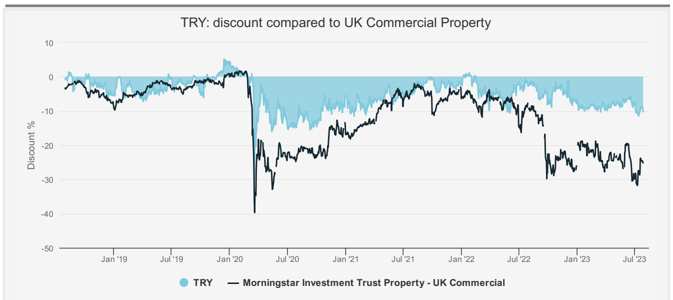
This unusual structure, which in our view means that the team is fully aligned with the success of TRY, is reflected in the management fee structure as detailed in the **Charges section**.

Although TRY is managed by a separate entity, its management still benefits from the insight of, and collaboration with, the wider group. The team manage a total of c. £1.8bn , meaning that TRY is the team's single largest client. Other funds managed include funds owning a mix of direct and indirect property, similar to TRY but with a greater bias to income, together with long-only indirect funds and a market neutral fund. Almost all the mandates are pan-European, with one c. £50m global fund.

Discount

TRY currently trades on a c. 9% discount, which is a little wider than its five-year average of c. 5%, but in the context of the last 18 months or so, is a very resilient outcome. As we've noted previously, a key point about TRY, or any of its close cousins investing in direct property, is that it is tradeable even during times when property as an asset class is difficult to buy and sell, meaning that in our view it is a more appropriate structure for investing in property than open-ended funds.

Fig.8:Discount Compared To Morningstar UK Commercial Property Peer Group



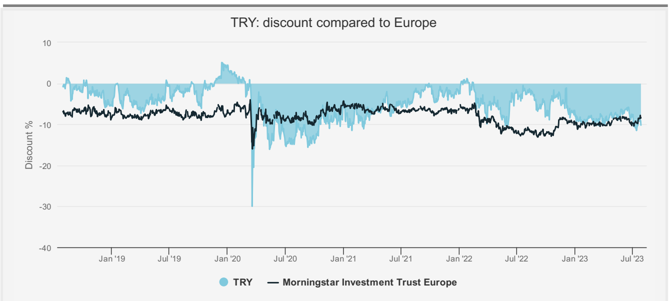
Source: Morningstar, as at 01/08/2023

Past performance is not a reliable indicator of future results.

Although TRY is in a peer group of one, there are some comparisons that can be made in order to put its discount into context. First, the chart below shows TRY together with Morningstar's UK Commercial Property peer group. This is the largest group of property trusts in our universe and accepting that TRY is a pan-European portfolio, it still provides a picture of how discounts on direct property trusts and REITs have behaved. As we discuss in the **Portfolio section**, widening discounts in REITs is an important factor in understanding TRY's recent performance. As the chart shows, 2022 marked the beginning of a very significant widening of discounts for these trusts, which currently sit at an average of c. 30%.

Second, we show TRY against Morningstar's European equity peer group. As we look at the **Charges section**, TRY can be thought of as a sector specialist European equity fund and so again, while this isn't a perfect comparison, it helps provide some context for TRY's own discount. In this context we can see that the discount is currently very similar to European equity trusts, although looking across the whole five years it's also evident that there isn't always a strong correlation between TRY and more conventional European equity trusts.

Fig.9: Discount Compared To Morningstar Europe (Equities)



Source: Morningstar, as at 01/08/2023
Past performance is not a reliable indicator of future results.

Taking these two comparisons together, and considering the performance of property of an asset class in 2022, TRY's discount has been quite resilient. Fundamentally, discounts widen when there are more sellers than buyers. Although it is of course impossible to know what every shareholder of TRY is thinking, our view is that shareholders have on average taken the view that 2022 was a cyclical event beyond the control of TRY's manager and that selling now would be to sell at a time when the underlying portfolio is undervalued. This suggests to us that a recovery in property would most likely be accompanied by a narrowing of TRY's discount.

Charges

As we've done before, we think the fairest comparison to make to TRY's OCF is to look at the AIC Europe sector, as although TRY is a hybrid equity / physical property investor, it is predominantly a specialist equity fund investing across Pan Europe. This isn't a perfect comparison, but the fact that there is no direct peer group highlights the unique nature of the trust.

TRY's most recent OCF is 0.82%, compared to an average of 0.79% for the AIC Europe sector. The reduction in yield (RIY) figure published at the end of December 2022 was 1.08%, compared to an average of c. 1.2% for the same AIC Europe sector (Source: JPMorgan Cazenove), albeit with the usual caveat that RIY calculation methodologies do vary.

TRY's management fee consists of base fees split into:

- A fixed fee which, for the FY ending 31/03/2024, will be £4,090,000 (2023: £3,895,000). The board reviews this fixed fee every year.
- 0.2% of net assets.

At the time of writing, the fixed fee is equivalent to c. 0.45% of net assets, meaning the overall fee is equivalent to c. 0.65% of assets. Because such a large proportion of the fee is fixed, it means that if net assets rise, the OCF can fall quite significantly, unlike a more conventional management fee, although the reverse is also true. The base fees are charged 25% to revenue and 75% to capital.

TRY also has a performance-related fee. If the net assets outperform the benchmark plus an additional hurdle of 1%, then a performance fee is payable. This is 15% of any outperformance, but the total amount payable in any one year is 1.5% of net assets. Any performance fee not paid out due to this cap is carried forward to future years. Any underperformance of the benchmark in a financial year is also carried forward and is offset against future outperformance when calculating performance fees. In the financial year ending 31/03/2023, TRY underperformed its benchmark by 1.5%, meaning no performance fee was paid. Carried-forward performance fees were reduced from 1.9% to 0.4% to offset this underperformance.

ESG

TRY has an above-average ESG rating from Morningstar, which analyses the characteristics of the underlying portfolio to give a rating. TRY's manager has a very long-standing Responsible Investment team that Marcus and his team can call upon. TRY's dedicated team are also one of the largest specialist investors in property securities in Europe and their scale means that they can make their voice heard when talking to investee companies. For the last two years TRY has provided a significantly more detailed ESG report in its accounts, tracking its engagement with underlying companies. The team emphasise that their long-term support for underlying company management is predicated on those companies being able to demonstrate positive momentum on relevant ESG measures.

Beyond the strict ESG policy that the team operate under, we would argue that TRY's typical focus on high-quality property assets means that it is invested in companies that are incentivised by market forces to provide efficient, fit-for-purpose buildings. Market forces are also being driven by stricter regulations for such things as energy efficiency (EPC), meaning that many aspects of ESG are not 'nice to have' but essential in order to meet regulatory standards phasing in over the next few years.

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