AEW UK REIT

Initiation – Proven record of value creation

4 July 2024

Price
89.5p

TICKER
AEWU

Market Cap
£141.0m

NAV per share
102.73p

Dividend yield
9.2%

Discount to NAV
12.9%

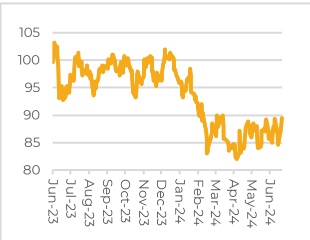
Loan to GAV ratio
26.2%

3mo Av. Daily Volume
338.8k

Management group
AEW UK Investment Management
Laura Elkin, Henry Butt

AIC sector
Property – UK Commercial

Share Price Performance



Source: Bloomberg

AEWU aims for a combination of income and capital growth potential though investing in smaller commercial properties in the UK. Its value-orientated strategy and focus on asset management have fed into to a superior performance record both in absolute terms and versus peers.

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Focus on asset management and active strategy driving total returns

AEW UK REIT plc (AEWU) is a UK real estate investment trust (REIT) with a difference: it is highly focused on value investment, acquiring mispriced assets and then maximising income and unlocking capital upside through asset management initiatives. Launched in May 2015, AEWU has paid dividends of 2p per quarter – the highest gross dividend payment in its peer group, equating to a current dividend yield of 9.2% – for the last 34 consecutive quarters (many peers cut their dividends during the pandemic), and has a proven record of successful exits, with 18 properties sold to date at an average premium of 38% to their purchase price. It has a three-year annualised property total return of 8.9% as at 31 March 2024. Managers Laura Elkin and Henry Butt, supported by the resources of AEW, invest in smaller properties, almost wholly (95%+) outside London, in strong commercial locations but with low capital values versus peers. The result is a higher-than-average income (net initial yield of c 7-10%), with capital growth potential through active asset management and the exploration of alternative use values. AEWU's success has been recognised in a number of awards, including being named Citywire's best UK property fund (based on three-year NAV total returns) in each of the last four years (2020-23), with similar accolades from Shares Magazine (2022) and Investment Week (2023).

Recent purchases include two mixed-use assets in central Bath, where the conclusion of two office rent reviews that were outstanding at the time of acquisition has already had a positive impact on portfolio income. At a retail park in Coventry, a new 20-year letting to Aldi on an index-linked lease has boosted capital values across the park, as well as helping to drive footfall to other units. Even where unexpected vacancies have arisen – such as the former Wilko store in Bristol – AEWU's managers have an eye on adding value through exploring alternative uses such as leisure, with the upper floors of the property already occupied by 'beer and ball games' operator Roxy Leisure. Butt describes asset management initiatives such as these as the 'beating heart' of AEWU's strategy.

While share price performance in 2024 to date has been muted as the REIT sector continues to be unloved, over time – and particularly in the current higher interest rate environment – the fund has tended to trade at a much narrower discount than many peers, with a 12-month average discount of 8.6% as at end-March 2024, compared with 28.9% for the peer group.

Bull points	Bear points
• Value-add strategy offers differentiation, with proven record of capital appreciation. • Low vacancy rates and strong rent collection. • Savvy management of borrowing facilities means low debt costs are locked in until 2027. • High dividend yield of more than 9% (backed by NIY of 8.0%) with dividends paid quarterly.	• Higher-for-longer interest rate environment has dented demand for commercial property versus other income-producing assets. • Difficult economic backdrop could lead to rising risk of tenant defaults. • No guarantee that discount to NAV will swiftly revert to longer-term average.

At a Glance (Yr. to 31 March)	Net rental income (£m)	EPRA earnings (£m)	EPRA EPS (p)	NAV*/share (p)	Price/NAV (x)	Yield (%)
FY24	13.03	11.55	7.29	102.73	0.84	9.32
FY23	10.80	9.02	5.70	105.48	0.87	8.69
FY22	10.18	10.76	6.79	120.10	1.00	6.68
FY21	11.96	9.82	6.20	99.11	0.84	9.64

*EPRA net tangible assets (EPRA NTA) per share

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Capital Access Group's view

Delivering quality returns through value approach

AEWU offers something different for UK commercial property investors: rather than the super-prime, central London office-heavy portfolio of a Landsec (formerly Land Securities) or British Land, it has a relatively focused selection (33 properties and c 130 tenants) of assets around the UK, chosen for their strong commercial locations, compelling value and opportunities for income and value enhancement through asset management. While unglamorous in parts – properties include a local authority recycling centre in Weston Super Mare and an NCP car park in York – the portfolio includes exposure to a wide range of regions and sectors, together offering a net initial yield of c 8% and a reversionary yield approaching 9%. The risk of individual tenant defaults is mitigated by the broad and diversified tenant base, and rent collection has tended to be close to 100%, even during the pandemic.

The managers' focus on adding value can be observed in the company's performance (see Figure 6), with a clear gap opening versus peers since the first wave of sales in c 2019. When selecting properties for purchase, the potential for alternative uses is an important consideration. In general, it is cheaper to convert existing properties (for example, from retail warehouse to trade-counter, light industrial or logistics units, or vice versa) than it is to build from scratch, and recent changes to the permitted development rules may favour conversion to residential, where values per square foot can be significantly higher. With tackling the housing crisis a key point on the government's agenda, this could prove an interesting tailwind for the portfolio.

The REIT sector has had a tough couple of years, with rising interest rates increasing the attraction of 'risk-free' assets such as cash and bonds, and low transactional volumes limiting price discovery and leading to declines in capital values. Until recently, AEWU had bucked the trend of widening discounts to NAV, averaging a low single-digit discount in all but the most abnormal market conditions (such as the beginning of Covid lockdowns and the aftermath of the Truss/Kwarteng mini-Budget). With no obvious bad news to factor in, we consider that the recent widening in the discount to the low teens could be seen as an opportunity for investors seeking exposure to a high-yielding strategy with potential for capital appreciation.

Furthermore, with interest rates perhaps remaining higher for longer, we would note that AEWU's May 2022 move to a fixed rate debt facility – maturing in 2027 and with an interest rate below 3% – looks like a smart decision in the current environment. The team had acknowledged the macro indicators regarding interest rate exposure and took the decision to refinance some months ahead of the expiry of the previous facility. While this increased borrowing costs in the first three to six months, the Bank of England base rate has since moved from 1% in May 2022 to 5.25% (reaching 3% by November 2022), which underlines the benefit of AEWU's early action.

Profile: Differentiated UK REIT

AEWU was launched in 2015 with the objective of delivering an attractive total return to shareholders from investing predominantly in a portfolio of smaller commercial properties in the UK. It follows a value investing approach, aiming to find properties that are attractively priced versus local comparators – usually with low capital values and low passing rents per square foot – and seeks to add value through asset management initiatives, boosting both rental income and the eventual sale price.

AEWU's manager follows a sector-agnostic, opportunistic approach (see **Process** section) to both purchases and sales, which can lead to high levels of portfolio activity. There are currently 33 properties in the portfolio; since launch, 18 have been sold at an average premium of 38% to their purchase price. This underpins the total return performance of the company (see **Performance** section), with AEWU ranking near the top of its Association of Investment Companies (AIC) peer group over three and five years for both share price and NAV total returns. While one-year returns have been more muted, they are still ahead of the sector average.

The REIT is externally managed by Laura Elkin and Henry Butt at AEW (see **People** section). AEW is one of the world's largest real estate asset managers, with €78.8bn of assets under management as at 31 March 2024. AEW has over 900 employees, with its main offices located in Boston, London, Paris and Hong Kong and offers a wide range of real estate investment products including commingled funds, separate accounts and securities mandates across the full spectrum of investment strategies. AEW represents the real estate asset management platform of Natixis Investment Managers.

AEWU uses the MSCI/AREF UK PFI Balanced Funds Quarterly index as a benchmark for its property total return performance. Dividends are paid at a rate of 2p per quarter and the current dividend yield (as at 1 July 2024) is 9.2%, the second highest in the peer group. (The highest-yielding fund is Regional REIT, whose 33.4% yield at 1 July 2024 reflects a collapse in the share price of more than 75% over the past three years.)

Perspective: Better times ahead?

UK commercial property has been a cornerstone asset for many income-seeking investors (both retail and institutional) in recent decades, particularly since the global financial crisis of 2007/8 and the resulting ultra-low interest rate environment. However, since rates began to rise in 2022 to tackle surging inflation, meaningful returns have once more become available on lower-risk assets such as cash and government bonds, which has led to a flight from alternative income assets such as property. With the majority of funds having used cheap debt finance to fund property purchases, the rise in interest rates has also increased borrowing costs for many players. In the open-ended (PAIF) sector, the result has been restrictions on withdrawals, the closure of some funds, and questions over the suitability of a structure offering daily liquidity while holding illiquid assets. Meanwhile, in the closed-ended (REIT) sector, many funds that had previously traded on appreciable premiums to NAV because of their attractive yields have fallen to wide discounts.

In addition to this rates-induced shift, there are other factors affecting the commercial property world. In the office subsector, changes in working patterns following Covid lockdowns have resulted in many companies downsizing their space as more employees opt for hybrid or remote working. Meanwhile, with the UK still suffering a cost-of-living crisis, the collapse of retailers such as Wilko and The Body Shop has left holes in many British high streets. A lack of transactional activity (see Figure 1) has also affected capital values, as price discovery is partly predicated on completed transactions.

Figure 1: UK All Property annual transaction volume (£m)

Source: AEWU/MSCI, April 2024.

But it is not all doom and gloom in the property sector. While capital values of industrial properties have struggled after a strong run, rental growth has been coming through more strongly in recent quarters, and negativity towards the office sector may have abated, with signs of a plateau in sentiment. In addition, in recent months there has been a spate of merger and takeover bids in the UK REIT space, suggesting the acquirers see compelling value in the opportunity to pick up quality assets below their intrinsic value but above prevailing share prices. LXi REIT, a nearly £2bn fund with a focus on index-linked income, has recently been acquired by LondonMetric Property, while UK Commercial Property was bought by Tritax Big Box REIT and an ongoing strategic review at Balanced Commercial Property Trust could also result in a bid after the board noted 'interest from a number of credible third parties'.

A common factor with most of these transactions is a focus on industrial property over other subsectors of the market. With all eyes turned in one direction, the true value may be found elsewhere. "*We haven't been buying industrials in the last two years as the valuations don't match our strategy, and we have been seeing more opportunities in other sectors,*" says AEWU's

Butt. Further opportunities may arise as industrials-focused acquirers seek to divest 'non-core' assets from acquired portfolios.

People: Experienced specialists

AEWU is managed by **Laura Elkin** (lead portfolio manager) and **Henry Butt** (assistant portfolio manager) at the UK arm of Boston (US)-headquartered global real estate investment manager AEW. Elkin is a qualified chartered surveyor with 17 years' industry experience, and joined AEW UK in 2013. She was assistant portfolio manager of AEWU from its launch and became joint manager in early 2020; she was appointed lead manager in May 2022. Butt has been with AEW UK since 2015 and was a director in the asset management team before being named assistant portfolio manager of AEWU in 2022. He has over 13 years' industry experience. Elkin and Butt are supported by the wider AEW UK team, led by managing director **Nick Winsley**.

There are currently five independent non-executive directors on AEWU's board, with a mix of property and investment backgrounds. Chairman **Mark Burton** – a chartered surveyor by background, with a long history of property investment management both in the UK and the Middle East – has served since the fund's IPO, and will stand down at the AGM in September 2024. He will be replaced as chairman by **Robin Archibald**, who was appointed to the board on 1 October 2023. Archibald, who qualified as a chartered accountant at the start of his career, was head of corporate finance and broking at Winterflood Investment Trusts until he retired from executive roles in 2014. He holds a number of other investment trust directorships, although AEWU is currently the only one with a real estate focus. **Katrina Hart** joined the board in June 2017. Her background is in equity research, specialising in financials, and she holds a number of other investment trust directorships, including as chairman of BlackRock Frontiers and chairman-designate of JPMorgan UK Small Cap Growth & Income. **Mark Kirkland**, a chartered accountant by training who has had a number of CFO roles as well as serving as CEO of pan-European logistics developer Delin Property, was appointed in November 2022. He became chair of the AEWU audit committee on the retirement of Bim Sandhu in September 2023. Joining the board alongside Archibald in October 2023, **Liz Peace** is a former civil servant who moved into the real estate sector, and was awarded a CBE in 2008 for services to the property sector, where her roles included chief executive of the British Property Federation.

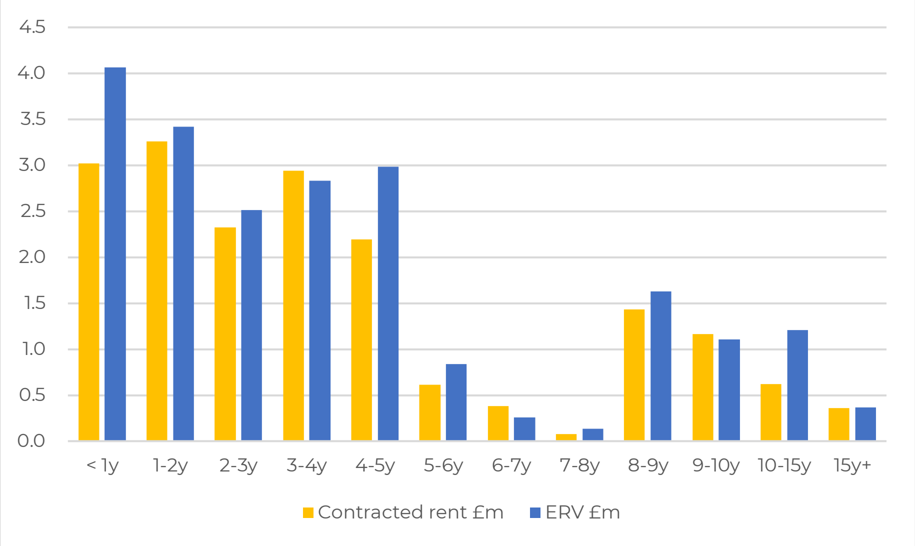
The recent appointments increase the number of non-executive directors from four to five. However, it is anticipated that the number will fall back to four following Burton's retirement later this year.

Process: Seeking to add value

AEWU is a value strategy, meaning its managers use value investing techniques to identify mispriced assets, and then seek to maximise income and unlock capital upside through active asset management.

The investment process begins with stock selection meetings within the AEW UK team, which happen at least weekly to assess the large number of potential investments that come to the managers' attention. While Elkin and Butt focus solely on the REIT, the broad team runs three strategies alongside AEWU – a lower-risk impact fund, typically with a focus on longer leases; a core-plus strategy; and a value-add strategy – meaning that the managers of each strategy do not tend to be competing for the same assets, because they are looking for properties with different characteristics. However, with a wealth of experience across the team in a range of property types and sectors, the managers are able to draw on each other's expertise when evaluating opportunities.

Figure 2: Lease expiry profile shows focus on shorter leases



Source: AEWU, based on Knight Frank valuations at 31 March 2024

AEWU's managers look for properties in strong commercial locations, with net initial yields of 7-10%, low book values and low passing rents per square foot relative to the local area, which maximises the opportunity to add value and helps protect on the downside in the longer term. Across the portfolio, the average book value per sq ft is £65-75 and the average passing rent is £6.46 per sq ft. Considering the average build cost for warehouses is c £100 per sq ft, and at least double that for offices, high street retail or residential – without even factoring in the cost of the land – this exemplifies the value in AEWU's bricks and mortar assets. *"We are sitting on serious value, not only from a capital perspective but also from what it is throwing off income-wise, with a net initial yield of 8%,"* says Butt.

The acquisition strategy is sector-agnostic, although at times the portfolio may tend to have a bias to one or another sector if fundamentals mean there is greater or lesser relative value between asset types. For example, in the past two years, the exposure to industrial assets has fallen as in-demand properties have been sold at premium prices, while retail exposure – where the managers see better value opportunities – has risen as the proceeds of industrial sales have been redeployed.

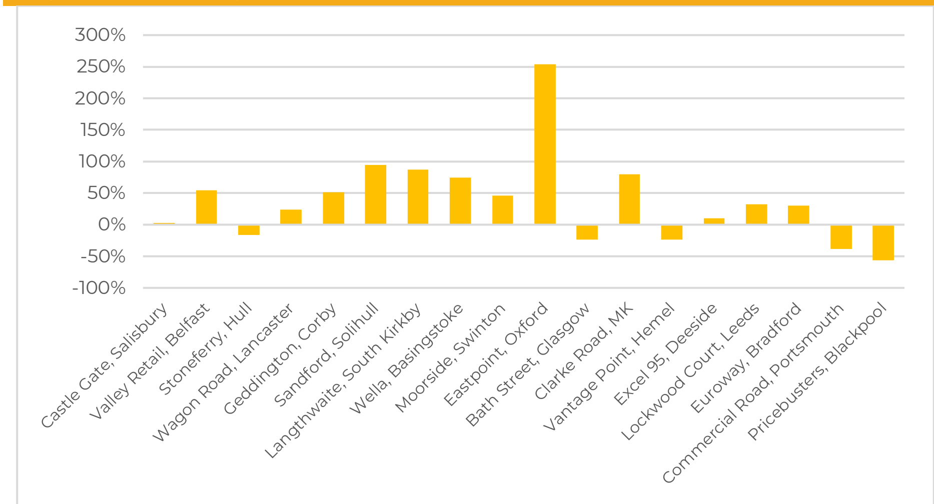
Geographically, assets tend to be located away from major city centre 'prime' locations such as London, Manchester and Edinburgh, with a greater focus on smaller cities and towns where valuations tend to be lower.

Given the focus on unlocking value through active asset management, average lease lengths tend to be quite short (see Figure 2) – the weighted average unexpired lease term (WAULT) at 31 March 2024 was 4.3 years to break and 5.6 years to lease expiry.

Properties with short unexpired lease terms may be attractively valued because they have not been subject to improvement for some time, and also because of the uncertainty of future income when the lease expires. AEWU's managers take advantage of this valuation discount, and look to improve properties to maximise returns before re-letting, or alternatively by selling with vacant possession either to owner-occupiers or for alternative use. As an example, an asset in Corby, Northants, which was bought in February 2018 for £12.2m, was sold in May 2020 for £18.8m to the owner-occupier of the adjacent property. While the lease to the existing tenant still had a year to run, the property had greater value to the new owner than would have been achieved for AEWU's shareholders by renewing the lease.

"*We like to get properly under the bonnet to assess all the options when a lease is approaching its end*," says Butt. "*Rather than doing a lease re-gear with 12-18 months to go – which is a more defensive approach as the lease event is further down the line – we are more likely to take the lease up to expiry. At that point, there are two potential outcomes: you could either renew it and push the rent on so it does what you want in terms of the income profile (as we did in 2022 at a long-held asset in Rotherham, delivering a 49% increase on the previous rental income), or you can renew it, increasing the rent, but also seeing significant yield compression, so you might sell it on and crystallise the capital upside. For example, we sold Sandford House in Solihull for a 94% premium to its purchase price, having invested no further capital in the asset during our holding period. What created the value was a new 15-year RPI-linked lease with the existing tenant, the Secretary of State for Communities and Local Government, which increased the rental income from the asset by 30%. Over the past year and more, we have been selling lower-yielding assets (such as industrial properties in Milton Keynes, Bradford and Leeds on yields of c 6.25%), crystallising profits and reinvesting in higher-yielding assets such as the two properties in Bath, as well as York, Preston and Bromley, at net initial yields of 8-10%.*"

Figure 3: Average sale to purchase price premium of 38%



Source: AEWU

A further way of unlocking hidden value can be through exploring alternative uses. For example, Butt points to changes in the permitted development (PD) regime that make it easier to transform various classes of commercial into residential property, including the recent (5 March 2024) removal of a 1,500 sq m cap on the size of office properties that can be converted for residential use under permitted development rights. Alternative residential uses might include student accommodation and hotels as well as private or social housing. Some alternative use cases require lesser degrees of investment; for example, an unsuccessful retail warehouse unit could be re-let as a trade counter, light industrial unit or last-mile logistics space for relatively minimal outlay, or demolished for residential development. While not a strategy AEWU is actively pursuing on a large scale at present, the streamlining of the process of applying for change of use under PD via 'prior approval' – removing the need for the stack of information typical to a planning application, and meaning applications can go through within just eight weeks – provides extra flexibility when considering how best to maximise the value of an asset. The company has recently secured PD approval at an asset in Gloucester, currently let to a government department, meaning there is now the ability to change the use of the building from office to 45 residential units.

AEWU's approach to sales is as opportunistic as its purchase strategy. While on average properties are held for three to five years, individual assets may remain in the portfolio for shorter or longer periods depending on idiosyncratic factors. "*We may sell after a couple of years if we feel we have done the asset management and maximised the value*," says Butt. Conversely, for certain assets it may be better to leave some room for improvement by potential new owners and to sell before leases have expired. "*On a multi-let industrial site, a bit of vacancy at the point of sale gives the chance for asset management [by the buyer] and pushing the rents on*," adds the manager.

As shown in Figure 3, 18 properties have seen sold since the fund's inception, most of them at significant premiums to purchase price (an average of 38%). The standout disposal (at a c 250% premium to purchase price) was Eastpoint Business Park in Oxford. The asset was acquired in May 2015 for £8.2m, reflecting a net initial yield of over 9%. The asset delivered an IRR (internal rate of return) in excess of 22% during its holding period. In 2018, AEWU signed a new 25-year lease at the site with specialist healthcare provider Genesis Care. The lease provided for five-yearly rental uplifts in line with RPI, which increased the asset's value by £2.0m. As a condition of this letting, the manager sought planning consent for change of use away from the asset's existing office use, setting a precedent for healthcare and life science use in the location. This is a good example of the managers being proactive in unlocking value, given the £29m sale price in April 2022 crystallised significant profit, exceeding both the valuation level immediately prior to the sale by 16% and the acquisition price by 254%. The most recent disposal was the March 2024 sale of the Pricebusters Building in Blackpool after tenant Sports Direct served a break notice. Proceeds from the sale have been allocated to asset management initiatives, including at three void units where re-letting is expected to complete in the second half of 2024.

The team is always on the lookout for new investment opportunities so that any sale proceeds can be quickly redeployed, thus avoiding cash drag. The fund is currently fully invested.

Planet: Improving energy efficiency

In the commercial property sector, ESG (environmental, social and governance) considerations are weighted towards the 'E', primarily through reducing the climate impact and improving the energy efficiency of buildings. AEW UK, AEWU's investment manager, has committed to abide by the United Nations' Principles for Responsible Investment (PRI) where these are consistent with the operating guidelines agreed with individual clients. Environmental commitments include putting in place plans to reduce the consumption of non-renewable resources in buildings AEWU manages, implementing renewable energy production systems where appropriate, evaluating and anticipating risks to the natural environment, and considering ESG issues when making investment, asset management and development decisions. At a company level, there is also a significant focus on governance.

The extent to which AEWU can influence the environmental impact of its assets is dependent on whether it directly manages the assets. The manager (via its managing agent, Mapp) controls utilities for vacant and service-charged properties, and since 2018 has reduced overall energy use at these assets by 26.5%, cut greenhouse gas emissions by 40.8%, and eliminated the use of landfill for waste (figures as at December 2023). Where AEWU does not control procurement of utilities, it is harder to influence environmental performance, but the relatively short average lease length means improvements to energy efficiency can be made between lettings.

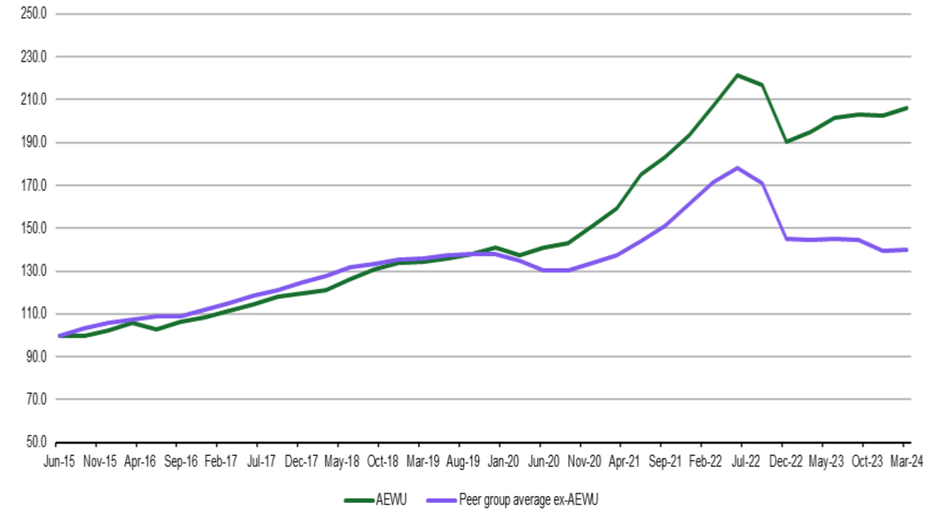
Minimum energy efficiency standards (MEES) regulations came into effect in April 2018, making it unlawful to grant new leases on properties with an energy performance certificate (EPC) rating below E. From April 2023, properties on existing leases must also have an EPC rating of E or better. The number of non-MEES compliant units in AEWU's portfolio was reduced from 14 to five during FY24. Three of the five are anticipated to become MEES compliant once mechanical and electrical improvements have been undertaken (at a non-material cost to AEWU). The other two are currently vacant and therefore are not in breach of MEES or EPC regulations. The focus is not just on ensuring compliance but also making improvements to already MEES-compliant assets, such as an industrial asset in Rotherham, where work carried out to the roof between lettings resulted in an EPC improvement from a C to a B rating, facilitating a 49% uplift in the rent paid by the new tenant compared with the previous occupant.

Further changes to the MEES requirements for commercial properties are expected to be implemented in the coming years, with a minimum EPC rating of C by 1 April 2027 and B by 1 April 2030. AEWU will continue to use asset management opportunities to improve the environmental performance of its assets.

Performance: Solid record since IPO

AEWU's value and income-orientated strategy has helped it to produce good returns, both in absolute terms and relative to peers and its benchmark, at a time when many property funds have struggled. By avoiding highly valued super-prime locations and focusing on properties with low capital costs, high yields and opportunities to add value, it has produced NAV and share price total returns of c 49% and c 37% respectively over five years to 1 July 2024 (see Figures 8 and 9). However, recent returns have been more muted, due in part to valuation declines at some of its leisure assets and two of its tenants – Wilko in Bristol and CJ Services in Runcorn – going into administration.

Figure 7: Cumulative NAV performance vs peers to 31 Mar 2024

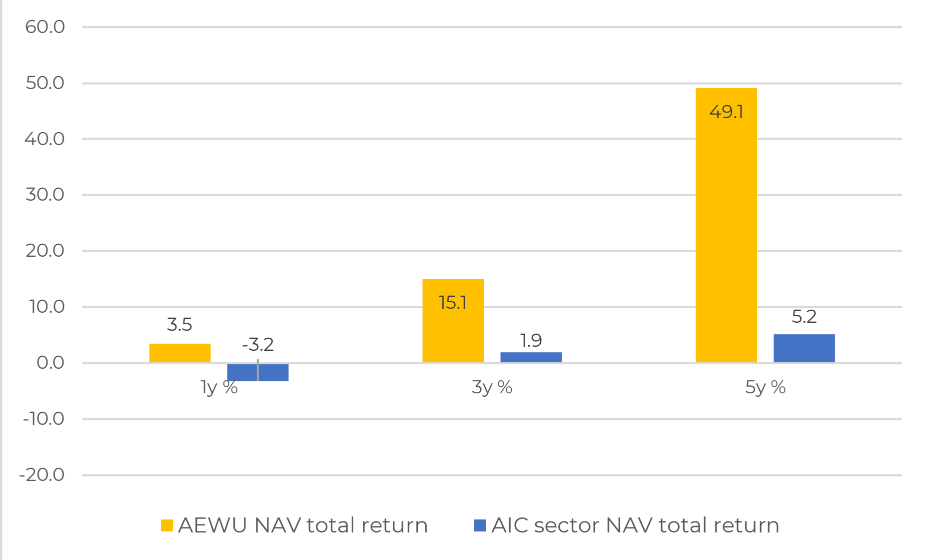


Source: AEWU.

Figure 7 shows AEWU's NAV total return performance versus its UK Diversified REIT peers (see Peer Group section for an explanation) from inception in 2015 until 31 March 2024. The fund's performance was more or less in line with that of its peers for the first four years, but the significant gap that opened up thereafter underlines the differentiation of the strategy: with a focus on adding value and a relatively short average holding period, AEWU was able to pull ahead as it began to dispose of its first batch of assets and recycle the proceeds into higher-yielding opportunities. The NAV outperformance has accelerated in recent months as many peers have struggled in the more difficult market environment.

While a focus on higher-than-average yields helps to drive rental income returns, it is arguably the fund's total return approach – with properties sold to date coming in at an average 38% premium to their purchase price – that has helped AEWU's share price to hold up better than those of its peers in a rising interest rate environment. Until the early part of 2024, the shares had tended to trade at a low single-digit discount to NAV in normal market conditions, compared with discounts of 25%-plus for many of the peers. However, since the start of February, the share price has fallen by c 11.5%, leading to a discount (versus the 31 March NAV) of c 15% at the time of writing. With no obvious catalyst for the decline (the Q1 2024 NAV release was received well by the market, and property market fundamentals have not appreciably shifted), it may be that AEWU's share price has drifted downwards as investor attention has been caught by a number of corporate actions elsewhere within the peer group, with more than £3bn of assets having left the AIC's Property – UK Commercial sector in recent months as a result of M&A activity.

Figure 8: Cumulative NAV performance vs AIC sector to 1 July

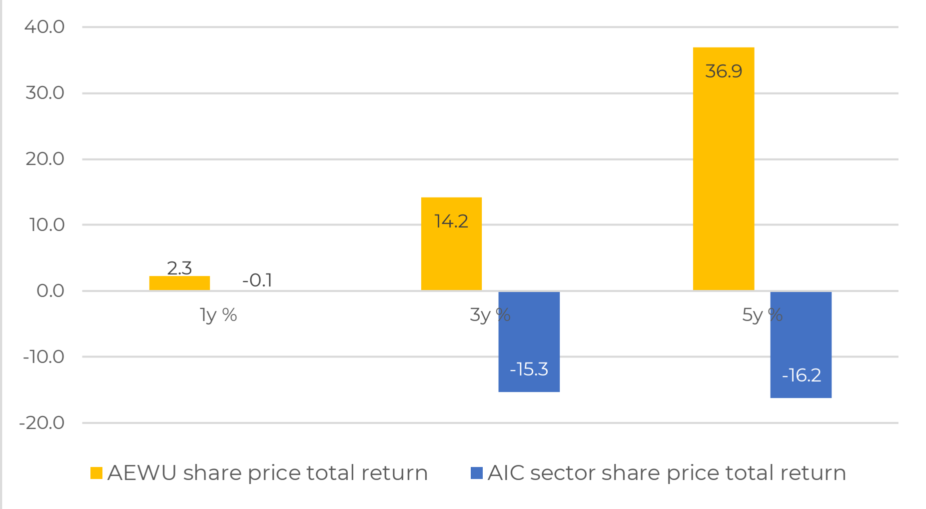


Source: AIC/Morningstar, CAG Research.

Although portfolio rental income has increased as a result of asset management activity in recent quarters (additional annual income of over £250k secured in Q4 2023, and another £535k in Q1 2024), capital values have been a mixed bag, with industrials and retail warehouses improving in Q1 2024 after all sectors were down in Q4 2023. The first quarter of the calendar year saw an average like-for-like increase in capital values of 0.41%, after a decrease of 1.59% in Q4 2023 and an increase of 0.90% in the previous quarter. Retail warehouses again held up best in calendar Q1, rising 1.85% compared with a small (0.65%) decline in Q4 2023, while the largest declines were again in the leisure sector, with a like-for-like decline of 3.66% (-6.14% in Q4 2023). While the value of the Odeon cinema in Southend on Sea (where sentiment had been adversely affected by a lack of new films following the SAG-AFTRA strikes) stabilised in Q1 2024, further declines were seen at a nightclub in Cardiff, which has been hit by the cost-of-living crisis. This is a small holding, however, at less than 1% of the portfolio capital value. In percentage terms, the best-performing asset on a capital basis was an industrial property in Droitwich (c 2.3% of the portfolio), which saw its value rise by 13.1% in Q1 2024.

Elkin noted earlier in the year that a lack of transactional activity in 2023, with higher interest rates dampening demand, had fed into lower like-for-like valuations, as a paucity of completed transactions makes it harder to put an accurate price on assets. Last year saw the lowest annual transaction volume in the UK (all properties) of the last 10 years, undershooting even 2016 (Brexit) and 2020 (Covid). However, historically these poor years have been followed by a recovery, which could signal better times ahead for the sales market in 2024.

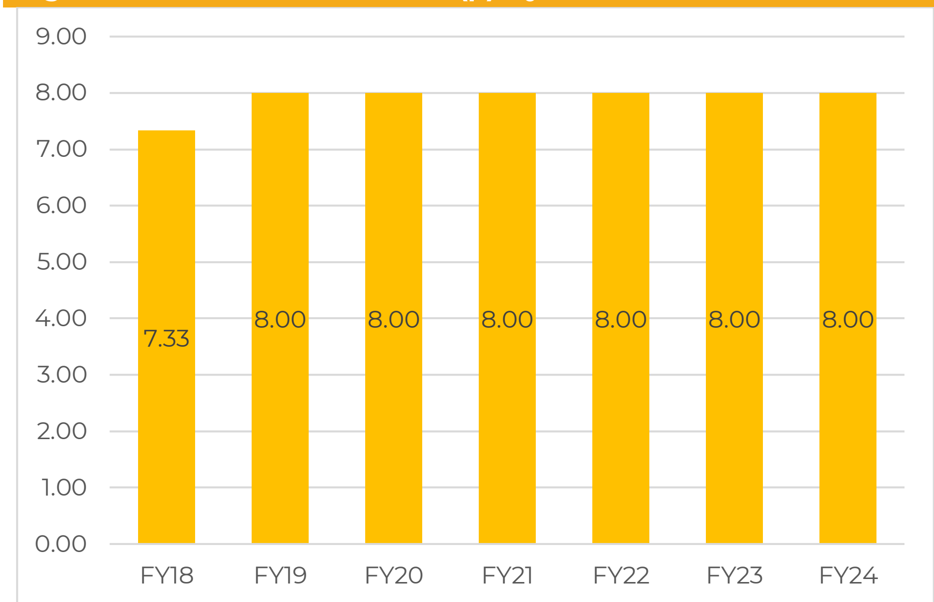
Figure 9: Cumulative price performance vs AIC sector to 1 July



Source: AIC/Morningstar, CAG Research.

Dividends are paid quarterly, in February, May/June, August and November/December, and have been maintained at a level of 2p per quarter (8p per year) since June 2016; the 7.33p shown in Figure 9 for 2018 is as a result of a change in the company's year-end from 30 April to 31 March, meaning FY18 had only 11 months.

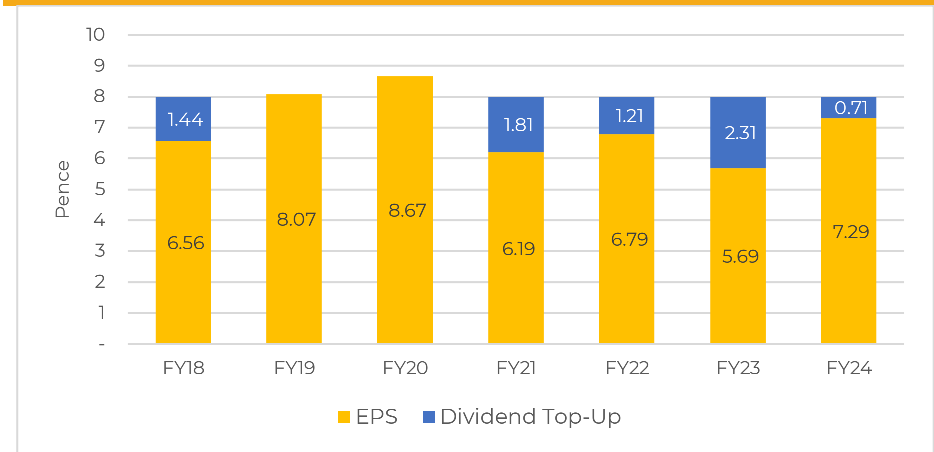
Figure 10: Dividends since FY18 (p): 5y CAGR 0.0% to end-FY23



Source: AEWU, CAG Research.

Dividends have tended to be somewhat uncovered by income in recent years (68.4% covered by EPRA EPS in FY23, 75.1% in FY22 and 90.1% in FY21). However, with EPRA EPS having improved to 7.29p per share in FY24 (91.1% cover versus 8p paid in dividends), AEWU is making good progress towards rebuilding earnings. As shown in figure 11, EPS exceeded the 8p dividend target in FY19 and FY20, but there have been small top-ups in other years to keep the payout consistent. However, AEWU's managers are keen to stress that given it is a total return strategy, the board has made the choice to fund dividends from total returns, including capital gains on disposals – which have been significant, with 18 properties sold at an average 38% premium to their purchase value – not just income. There is a large distributable reserve that can be used to top up the quarterly income payments if necessary. Based on the 8p annual dividend and the 1 July closing share price of 87.1p, AEWU has a forward and historic dividend yield of 9.2%.

Figure 11: EPS and dividend top-ups since FY18 (p)



Source: AEWU, CAG Research.

Portfolio: Diversified, value-focused

At 31 March 2024, there were 33 properties in AEWU's portfolio, let to c 130 tenants with a weighted average unexpired lease term (WAULT) of 4.3 years to break and 5.6 years to expiry. The vacancy rate is c 6.4% and across the portfolio the net initial yield is 7.99%, with a reversionary yield of 8.77%.

Figure 4: Regional breakdown of portfolio

Region	End-March 2024	Change (pp)	Region	End-March 2023
South West	26.6	+4.0	South West	22.6
West Midlands	21.1	+2.3	West Midlands	18.8
Yorkshire & Humberside	15.4	-1.8	Yorkshire & Humberside	17.2
Eastern	10.0	0.0	Eastern	10.0
North West	8.6	-1.2	North West	9.8
Wales	6.8	-2.1	Wales	8.9
Rest of London	4.9	0.4	Rest of London	4.5
South East	3.8	-1.6	South East	5.4
East Midlands	1.8	0.1	East Midlands	1.7
Scotland	1.0	0.0	Scotland	1.0
Total	**100**			**100**

Source: AEWU, CAG Research.

As shown in Figure 4, at 31 March 2024, the South West was the top geographical location, accounting for just over a quarter of the portfolio by value. This includes recently purchased assets in central Bath, which have helped to drive the 4.0pp increase in exposure to the region over 12 months. The portfolio is broadly diversified by geography, although in line with the managers' value-orientated approach, there is no exposure to central London, where capital values tend to be highest.

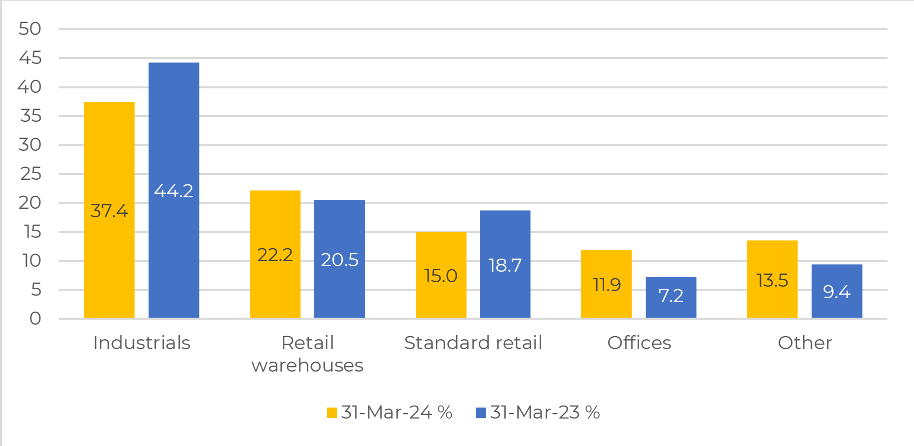
Figure 5: Top 10 holdings (% of portfolio)

Name	Sector	Region	End-March 2024	End-March 2023
Central Six Retail Park, Coventry	Retail warehouses	West Midlands	10.7	9.0
Northgate House, Bath	Mixed use (retail and offices)	South West	6.1	6.1
Gresford Industrial Estate, Wrexham	Industrial (single let)	Wales	6.0	5.3
Cambridge House, Bath	Mixed use (offices and retail)	South West	5.2	N/A
40 Queen Square, Bristol	Offices	South West	5.1	5.6
London East Leisure Park, Dagenham	Other (leisure)	Rest of London	4.9	4.5
Tanner Row, York	Other (multi-storey car park)	Yorkshire & Humberside	4.8	N/A
Arrow Point Retail Park, Shrewsbury	Retail warehouses	West Midlands	3.9	3.9
Apollo Business Park, Basildon	Industrial (multi-let)	Eastern	3.4	3.3
Wyndeham	Industrial	Eastern	3.0	2.8
Top 10 (% of portfolio)			**53.0**	**49.2**

Source: AEWU, CAG Research. Note: N/A where not in portfolio at end-March 2023.

The largest asset in the portfolio is Central Six Retail Park in Coventry, bought for c £16m in late 2021 at a net initial yield of 7.8%, with around a quarter of the space unoccupied at the time of acquisition. The property's value has subsequently increased notably, as lease activity and asset management initiatives have helped to increase income and improve the tenant mix. A cornerstone new tenant is Aldi, which has signed a 20-year inflation-linked lease. AEWU's managers note that the presence of a retailer such as Aldi has historically been proven to drive footfall in retail park sites, thereby benefiting all the tenants. A relaxation of planning laws on use class – offices, banks, retail and restaurants all now come under the E use class – has helped to drive the investment case for retail parks. Butt says that while such parks typically used to be either fashion or bulky goods (DIY, electricals etc), they can now be akin to an old-style high street, with a more eclectic mix on offer. As well as the new Aldi, Central Six also includes such diverse destinations as Iceland, Next, Tui, Sports Direct and Boots. With the net initial yield on the park site now at c 7.7% as a result of the improvements made in AEWU's two years of ownership to date, it would not be a surprise to see Central Six sold in the next couple of years and the proceeds reinvested in assets where the managers see similar opportunities to add value.

Figure 6: Sector breakdown (% of portfolio at 31 March 2024)



Source: AEWU, CAG Research.

The remainder of the top 10 properties are a diverse mix of office, industrial, retail and leisure assets. This mirrors the sector diversification of the portfolio as a whole (see Figure 6). In the past two years the sector weightings have changed markedly, with industrials exposure falling from over 50% to 37.4% and offices down from c 18% to 11.9%, while retail (high street and warehouse) has increased from c 25% to c 37%. Elkin says that going after the value opportunities in retail has led the team to a different type of asset management activity, with more of a focus on capital incentives to help with fit-out costs, rather than direct spending on building work.

New purchases in the past 12 months have included Cambridge House in Bath, a mixed-use building with offices above retail units in a central location, Tanner Row in York – another mixed-use site, the majority of which is an NCP car park – and a retail warehouse in Preston, let to Matalan. Sales have mostly been in the industrials space, with the disposal of sites in Deeside, Bradford, Leeds and Milton Keynes, while a high street retail asset in Portsmouth was also sold with two new tenants in place. Elkin explains that the location of the property had deteriorated over time, with other areas of Portsmouth town centre trading better, and that this was the primary reason for the sale.

While many REITs favour defensive income streams such as RPI-linked rents, these currently make up only 11% of AEWU's portfolio, with the large majority of rents on open market reviews. The benefit of open market reviews can be seen in examples such as the conclusion of the outstanding 2022 rent review at the recently acquired Northgate House in Bath (increasing the annual rent by nearly £100k or c 25%), and settling three outstanding rent reviews at 40 Queen Square in Bristol, dating back to 2021, which will see a near £50k (c 32%) uplift in annual rents received from the three tenants of the property. All of these examples are in the office sector, making them notable achievements given the general perception of demand for office space having been negatively affected by post-pandemic changes in working patterns.

Other asset management initiatives include agreeing a turnover-linked rent for a Next store in Bromley, South London, which resulted in a 78% increase in rent received versus forecast, as the site has traded so well (a top-up of £195k versus an expected £110k in addition to the base rent of £350k). There have also been multiple rent reviews and new lettings at Central Six Retail Park in Coventry and at several industrial assets. All of these have acted to boost portfolio income, with over £535,000 of new annual income added in Q1 2024 (Q4 of FY24) alone.

Peer group: Superior return profile

Figure 11: AIC Property – UK Commercial peer group

Name	Total assets (£m)	Price TR 1y	Price TR 3y	Price TR 5y	Price TR 10y	Discount	Gearing	Dividend yield	5y div growth (% pa)
AEW UK REIT	**216.3**	**2.3**	**14.2**	**36.9**	**N/A**	**-15.2**	**122**	**9.2**	**0.0**
abrdn Property Income Trust	424.7	18.1	N/A	-24.3	21.9	-31.8	129	7.7	-3.4
Alternative Income REIT	*105.5*	*15.6*	*N/A*	*28.1*	*N/A*	*-15.6*	*148*	*8.7*	*13.2*
Balanced Commercial Property Trust	1,061.3	30.8	4.7	-7.8	8.4	-24.8	124	6.5	-3.3
Custodian Property Income REIT	612.7	-6.7	-9.4	-17.9	18.1	-24.5	140	7.5	-3.4
Life Science REIT	*392.6*	*-48.1*	*N/A*	*N/A*	*N/A*	*-58.2*	*131*	*5.9*	*N/A*
Regional REIT	698.2	-63.2	-76.0	-77.6	N/A	-76.5	100	33.4	-8.2
Schroder Real Estate	467.3	20.8	14.8	6.5	43.5	-28.1	145	7.3	5.6
Supermarket Income REIT	*1,709.7*	*6.1*	*-26.9*	*-8.5*	*N/A*	*-20.5*	*100*	*8.5*	*1.8*
Value & Indexed Property Income	*136.4*	*5.5*	*2.3*	*-1.1*	*19.6*	*-10.7*	*141*	*6.9*	*2.3*
Sector average*	**582.5**	**-0.1**	**-15.3**	**-16.2**	**16.8**	**-30.6**	**130**	**8.4**	**-0.2**
AEWU rank in sector	**8**	**7**	**2**	**1**	**N/A**	**1**	**8**	**2**	**5**

*Source: AIC/Morningstar, at 1 July 2024. All % unless stated. *Size-weighted averages.*

AEWU is a member of the Association of Investment Companies' Property – UK Commercial sector, a peer group of funds that invest in UK commercial property but do not specialise in the three subsectors of the market – logistics, healthcare and residential – that have their own AIC peer groups. This leads to a grouping where some funds are generalists but some are specialists in other areas. In Figure 11 above we have included all the members of the AIC peer group (excluding Channel Islands Property Fund, for which very limited data is available). However, it is worth noting that AEWU uses a reduced group of 'UK Diversified REITs' for its own comparison purposes; this list excludes the four italicised funds in the above table, all of which have some kind of specialism, such as concentrating on a particular sector, or having a focus on inflation linkage.

Although one of the younger and smaller funds in the group, AEWU has an impressive medium-term performance record, ranking first for share price total returns over five years and narrowly beaten into second over three years. Share price declines in recent months have dented its one-year ranking, although its NAV total return performance remains well above average over all periods (see Performance section, Figure 8). While its discount to NAV has widened substantially in the short term, it is still the narrowest in the peer group. Gearing (based on AIC methodology) is lower than the average for the sector, and is the second lowest among the Diversified peer group. Meanwhile, the dividend yield is the second highest in the group, after Regional REIT, whose yield has been inflated by a steep decline (c 70% in the past two years) in its share price. Having chosen to maintain the dividend at a quarterly 2p even when not fully covered by income, AEWU's five-year dividend growth is flat, although it should be noted that many of the peers have negative growth rates, largely as a result of Covid-era dividend cuts.

Policies

Gearing: AEWU has a £60m borrowing facility with AgFe. The five-year fixed-rate loan (with a total annual interest cost of 2.959%) was taken out in May 2022, replacing a previous floating-rate facility (1.4% above SONIA) with Royal Bank of Scotland International, which had been due to expire in October 2023. Locking in the financing at a low fixed rate near to the beginning of the current rate-hiking cycle has averted a potentially steep rise in financing costs: while 1.4% above SONIA was equivalent to just 2.2% in March 2022, it would now be around 6.6%.

The loan facility is fully drawn and represented a loan to gross asset value (loan to GAV) of 26.2% and a loan to net asset value (loan to NAV) of 36.9% at 31 March 2024. AEW's managers note that this is a conservative level of borrowing; the value of the properties secured under the loan would have to fall by c 47% from their end-March 2024 valuation before the 60% loan to value (LTV) covenant was breached. The maximum permitted loan to GAV is 35% at the time of drawdown and the target maximum loan to GAV is 25%; the marginally higher figure at 31 March 2024 is as a result of a decline in capital values since the loan was drawn.

Discount/premium management: AEWU has the authority, renewed annually, to allot up to 10% and repurchase up to 14.99% of the issued share capital in order to manage a discount or a premium to NAV. No shares were allotted or bought back in FY23, FY24 or so far in FY25 (started 1 April 2024). For majority of its history, AEWU's shares have traded fairly close to NAV, with the exception of periods of market dislocation such as the start of Covid lockdowns in Q1 2020 and the Truss/Kwarteng mini-Budget in Q3 2022. Having begun 2024 at a low single-digit discount, AEWU's share price has since drifted downward, and at the time of writing (based on the closing share price at 1 July) the discount to the 31 March NAV was 15.2%. While wider than historically, this is the narrowest discount in the AIC Property – UK Commercial peer group.

Fees and charges: AEW UK Investment Management LLP, AEWU's Alternative Investment Fund Manager (AIFM) receives a quarterly management fee equivalent to one-quarter of 0.9% of the prevailing NAV, excluding any uninvested proceeds from fundraisings. There is no performance fee. In respect of FY24, the management fee was £1.39m, equivalent to 0.85% of year-end net assets. Including other costs, the ongoing charges figure for the year was 1.60%. This compares favourably with the peer group average of 2.37%.

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