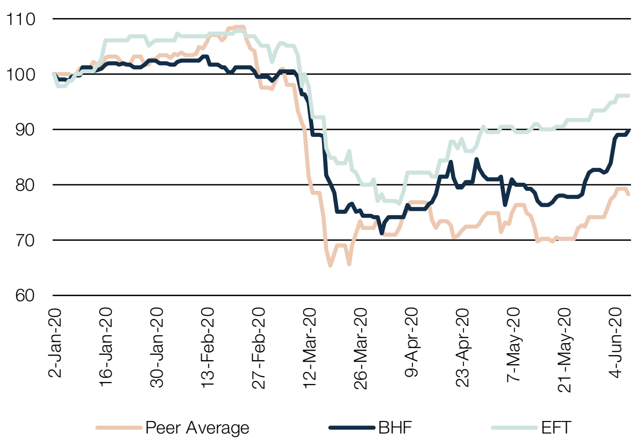
EfTEN's Valuation Update

Valuation is highly sensitive due to extremely volatile market conditions

LHV recently published reports for EfTEN Real Estate Fund III ('EfTEN') and Baltic Horizon Fund ('BHF') on 26th May 2020 and 8th June 2020, respectively. These reports included revised fair valuation ranges that were determined by a combination of intrinsic and relative valuation approaches.

Rebased Prices, 2nd January 2020 = 100



Source: NASDAQ, Yahoo Finance, LHV

The challenge lies in that these reports were published during a period of great uncertainty on account of the global COVID-19 pandemic. The outbreak led to a significant decline in share prices globally across most sectors. The property market sector was also not immune to this shock, especially with the retail and office markets being impacted by countrywide quarantines. The severity of this crisis can be seen from the rebased prices of the EFT and BHF listed peers.

Moreover, we are aware of misinterpretations being made by investors due to the timing factor for reports being released, i.e. reports of different funds not being released at the same time.

Recap on the Baltic Property Market

According to Ober Haus, amid the COVID-19 pandemic, the property market in the Baltics is looking favourable for investment. The Baltics experienced a strong year of growth in 2019, with at least two records in Lithuania – (i) the volume of investments placed into the core commercial properties increased annually by c.a. 15% to EUR 463m, and (ii) residential sector investment reached EUR 2.3bn.

However, the pandemic has been accompanied by a large amount of uncertainty. This uncertainty can distort the outlook for the market and the companies involved in the market – any prolongation of the outbreak and restrictions on movement could lead to an extended negative outcome. The sooner the situation is controlled in a manageable manner, the sooner the market may return to normal.

The pandemic has been a setback in a market that has been under intensive development for the last two years. In 2018 and 2019 alone, the office segment in Riga, Tallinn, and Vilnius expanded by 290,000 sqm, and it is scheduled that more than 300,000 sqm will be added in 2020 and 2021. The increase is expected to be particularly strong in Riga, which has tended to lag behind the other two capitals in terms of new office space supply.

In addition to the stress caused by the COVID-19 crisis, the retail sector is facing stiffer competition from e-commerce alternatives. This is a global phenomenon, which, in recent years, has put more pressure on Baltic shopping centres. In order to combat this threat, the shopping centres have been upgrading and adapting to allow for other activities, such as increased leisure and entertainment space, and coworking spaces instead of retail spaces. Unfortunately, these are likely to be the spaces that are most hit by social distancing requirements.

Riga, once again, was in the spotlight with the 2019 opening of Akropolis. The centre, with an investment of EUR 180m, became one of the largest shopping and leisure centres in the city. The year also saw the arrival of KFC, IKEA, and Deichmann into Estonia, with the anticipated 2020 arrival of Lidl.

There has also been stronger growth for modern industrial and warehousing premises. While this is mostly concentrated around the capitals in Estonia and Latvia, in Lithuania there are developments in Kaunas and Klaipeda, in addition to Vilnius. Kaunas has been seen as a particularly attractive investment avenue, with rapid growth between 2017 and 2019, across most segments. It has attracted investments from companies such as Continental, Hella, Hollister, and Hegelmann, which has resulted in a significant expansion of the manufacturing and logistics sector in Kaunas region.

While the backdrop for the Baltics is attractive, the countries are unlikely to remain immune to global shocks such as COVID-19, especially if it cannot be curtailed within the next few months. According to a Colliers International's tenant and landlord survey, the opinions are somewhat reserved over the interim 12 months but more positive going further ahead.

Despite government support, the retail sector has somewhat subdued sentiment, with an expectation that COVID-19 will adversely affect retail premises demand and decrease rental prices over the coming 12 months. This is due to the drop in the tenants' footfall and sales levels. Although some retailers are shifting to e-commerce platforms, this has not proven to be a perfect solution (and increases the e-commerce competition for shopping centres).

Likewise, the office segment could be dampened for the rest of 2020 with demand originating from small- and medium-sized tenants being limited. As such, landlords may be under pressure to reduce rental rates as a means of combatting higher vacancy rates. However, the office segment offers greater optimism in terms of a rebound by the end of the year.

Although there are more options available for employees to work remotely, the Colliers International survey indicates that there is still a demand for office-place work, and that most professionals prefer the collaborative and social environment offered within an office space. It is therefore likely that many employees will want to return to offices at the end of the quarantine. This should support the office market for landlords in the Baltics.

Relevance to BHF and EFT

The aforementioned conditions increase the risk for two listed property funds (EfTEN and BHF) in the Baltic region. Both funds have exposure to the Baltic retail and office markets, and these funds have had to engage with their tenants and banks to mitigate the negative impact of the coronavirus pandemic.

31st March 2020	Baltic Horizon Fund	EfTEN Real Estate Fund III
Listing	Baltic Fund List	Baltic Main List
Market capitalisation	EUR 112.6m	EUR 58.3m
Cities	Riga, Tallinn, Vilnius	Kekava, Laagri, Riga, Siauliai, Tallinn, Vilnius
Number of properties	16	13
NLA	153,351 sqm	110,753 sqm
Portfolio market value	EUR 360.3m	EUR 129.1m
Occupancy	98%	99%
Total revenue	EUR 7.6m	EUR 2.4m
P/EPRA NAV	0.822x	0.908x
Sector split		
	Leisure – 4%	Logistics – 30%
	Office – 46%	Office – 29%
	Retail – 50%	Retail – 41%
Geographical split		
	Estonia – 26%	Estonia – 25%
	Latvia – 40%	Latvia – 19%
	Lithuania – 34%	Lithuania – 56%

Source: BHF, EfTEN

EfTEN has a better segment diversification than BHF, with BHF being more concentrated in the leisure and retail sectors, while EFT is relatively evenly split among the retail, office, and logistics sectors. The leisure and retail sectors are two sectors that have been hardly hit by the COVID-19 crisis.

EfTEN's largest tenants include DSV Transport AS, DSV SIA, and DSV Transport UAB, which account for 10.2%, 7.2%, and 7.0% of the consolidated revenue, respectively. EfTEN's tenants include Siauliai-based retailers in the Saules Miestas shopping center (the portfolio's largest property by NLA), airBaltic, ABC Motors, and Hortes. According to EfTEN's management, Hortes has benefitted from the virus in terms of DIY demand from consumers, and the location of the Saules Miestas shopping center in Siauliai places it in a strong position with a high footfall number.

Comparatively, BHF has a wider tenant base with nearly twice as many tenants as EfTEN. At the end of Q1 2020, BHF's main clients include Rimi Baltic (8.8% of total rental income), Latvian State Forestry (5.1%), Forum Cinemas (4.3%), G4S and SEB (4.0% each), Intrum Group and EMERGN (3.1% each), Lithuania Tax Inspectorate (2.8%), Vilnius Heating Network (1.8%), and New Yorker (1.7%). However, in many ways, large tenants could prove to be equally detrimental as they are less flexible in meeting mutually agreeable arrangements during the pandemic and have more bargaining power than smaller tenants.

These two funds are similar in terms of geographical diversity. However, BHF only focuses on the three capital cities, whereas EfTEN also has properties in three other smaller cities. Siauliai, in particular, has been experiencing growing GDP per capita but has the challenge of net emigration from the city. Siauliai city has developed a strategic plan to improve its competitiveness and further enhance its economic development. The central location of EfTEN centre places it in a prime position to benefit from the future economic development of the city.

BHF, though, is the larger fund with 16 properties in its portfolio and a total net leasable area ('NLA') of 153,351 sqm. At the end of the latest quarter, BHF had a total portfolio value of EUR 360.3m – more than double the value of EfTEN's portfolio.

In terms of EPRA NAV value, under current market conditions, BHF is priced at a P/EPRA NAV multiple of 0.822x and EfTEN is priced at a P/EPRA NAV multiple of 0.908x. Both of these funds are currently trading at higher valuation multiples than the peer median (based on 31st December 2019 EPRA NAV values) of 0.778x. However, these two funds adopt different valuation methods and valuators, which somewhat limits the comparability of the EPRA NAV value.

Additionally, below are other significant differences between these funds:

1. Annual NOI to book value – the NOI to book value for EfTEN is 7.5% compared to 6.0% for BHF.
2. Financing – EfTEN amortises its loans monthly (i.e. makes bank loan principal payments) whereas BHF holds bullet loans with only monthly interest payments (i.e. no monthly principal repayments) and corporate bonds.
3. Dividend yield – EfTEN has lower cash flows available for distribution compared to BHF.

Valuation Considerations

In valuing these funds, LHV used the same conservative expectations in terms of the property portfolios. We assumed that the portfolios and occupancy levels would remain unchanged, while rental rates would experience a decline in 2020 and remain unchanged in 2021 but begin to rise gradually from 2022. These are conservative assumptions, but given the current market conditions due to the COVID-19 pandemic, we believe that prudence is required.

For both funds, under this conservative, low-growth scenario, the intrinsic values derived from the cash dividend discount model ('CDDM') imply that the current market prices are trading at a premium. However, it needs to be emphasised that this valuation is based on quite conservative assumptions due to the current market conditions.

In valuing these two funds, we considered several peer multiples. Taking into account the volatility of the market, the date of peer data can have a significant impact on the valuation outcome as there can be a wide variation in share/unit prices on different dates. The EfTEN and BHF valuations (as published in the two reports mentioned earlier) were based on the peer data taken on two different dates, with the share/unit prices of peers being significantly lower at the time of setting the EfTEN valuation range. The below table shows the sensitivity of the fair value range ('FVR') to changes in the underlying assumptions.

At the time of determining EfTEN's FVR, the share/unit prices of the peers were significantly depressed due to the coronavirus crisis. Since then, the prices have recovered, and the BHF's valuation was based on these recovered prices, which resulted in a significantly better implied fair value range for BHF.

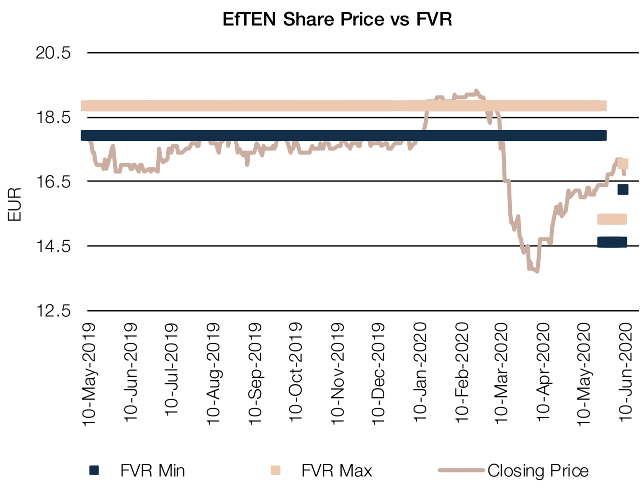
Therefore, under current market conditions, care and prudence should be taken when considering prevailing fair value ranges, as there is a high level of volatility in the market that has a significant impact on the valuation outcome. While the FVR reflects a medium-term outlook, it is also based on the prevailing market conditions, which, in a time of volatility, may change over a short period. For better comparison with BHF valuation, we used the peer data as of the same date what we used for BHF valuation, without changing any assumptions or outlook, which led to a revision in EfTEN's FVR to EUR 16.20-17.00 per share. (closing price as of 10th June: EUR 16.70).

	Old	New	Closing Price (10th June)
BHF	n.a.	EUR 1.30-1.45	EUR 1.1659
EfTEN	EUR 14.60-15.30	EUR 16.20-17.00	EUR 16.70

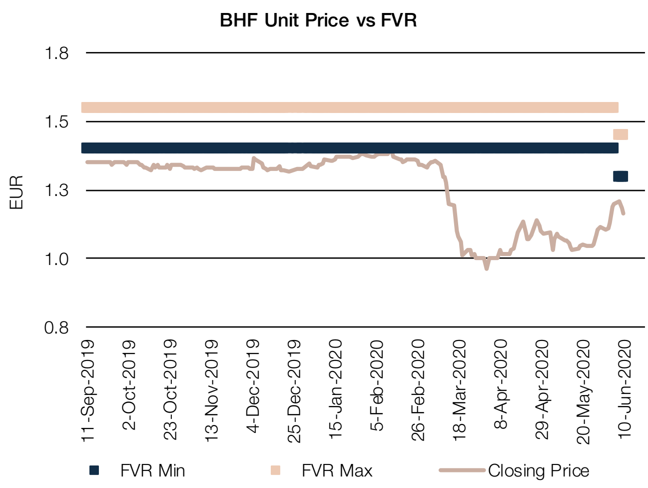
Source: LHV

	EfTEN		BHF
	Average Peer-Implied Price Using EfTEN Report 26th May Data	Average Peer-Implied Price Using BHF Report 8th June Data	Average Peer-Implied Price Using BHF Report 8th June Data
P/EPRA NAV	14.32	14.68	1.12
Distribution Yield	14.68	16.12	1.69
P/Book	15.16	16.81	1.25
EV/EBIT	29.24	42.13	1.98
P/E	32.93	47.37	2.34
Implied FVR	EUR 14.60-15.30	EUR 16.20-17.00	EUR 1.30-1.45
Last Price, 10th June	16.70	16.70	1.1659

Source: Bloomberg, BHF, EfTEN, LHV



Source: NASDAQ, LHV



Source: NASDAQ, LHV

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Date and time of sign-off: Thursday 11th June 2020, 16:00

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