

Real estate investments and asset backed businesses for private investors

evolve

● Are the UK property markets ready for re-inspection?

● Existing Funds Activity Update

● New Launches! evolve All Saints Fund & Pigeon

● In Search of Returns... The positives and the negatives?

I'm a Property Investor... get me...err... back in there!!?

OK, I admit it, I did see a small part of the Martina in the jungle show...hence the catchy newsletter title...but that does not mean that I am not still recovering from the Britain's Got Talent news! By that I mean, of course, the most incredulous bit of news yet in 2009. Yes, the fact our PM actually telephoned to enquire about the health of Susan the Scottish singer! And then wanted it reported in the papers! Speechless. Nothing else to do Flash?

What does that have to do with property investing? Well, nothing, other than Flash's wasted time (important) and the aforementioned, snazzy title (are you still reading?). Plus perhaps the fact that in our last newsletter you may remember the 60 second, celeb style interview? Prompted by a wonky knee and, consequently, my being off-games for the normal pedal commute? Meaning more time than usual with a newspaper? Hence the 'link' to more useless news...phew!

On a serious note, we did also say we thought the UK commercial real estate markets would be ready for re-inspection within 6 months or so – so around Easter 2009. How did we do? Actually, not too bad. Easter turned out to be a turning point, with the market beginning to see more activity, deals actually completing, from April onwards. At least this is the

feedback from the market, even if we have not been buying ourselves.

The auction houses have been encouraging vendors to supply them with lots to sell, i.e. lots of lots, as interest from private buyers has seemingly returned with a vengeance. Allsops and Savills have recently been in the press reporting strong results and very competitive bidding situations. To us though, as a general rule, the auction room prices appear dear... and the 5% yield paid for the 'Lloyds Bank in Oswestry', to coin a well used evolve cliché, still looks like madness. (I actually even saw the said 'Lloyds Bank in Oswestry' recently on my way to a Welsh half term, and can confirm it is definitely not 'worth' 5%! Cliché confirmed).

So who has been buying? In the sub £10m lot size, perhaps a bit more up to £20m, there are now a large number of UK and overseas buyers queuing up to acquire investments that tick the 5 main boxes – covenant, location, build quality, lease length & rental level. Covenant is the biggest box at the moment. Geography ranges from central London to the provinces. They will compete strongly, if not at the New Star Feeding Frenzy levels previously discussed in 2006-2007. But, note, pricing is more attractive today.

A whole host of property 'gurus' have been raising funds and/or getting their cheque books out already in the £20m plus arena as well. The case for such purchases is made in more detail in our 'In Search of Returns...' article later. But in a nutshell you can see why commercial real estate is back on private investor's radar screens. With initial yields of 7-8% and 5 year swap rates at 3.7%, even a 2.0% bank margin will still enable an

8-10% cash return. And there is the prospect of buying at or close to the bottom of the market giving a possible capital growth 'upside'. And yes, there are banks lending... relationship driven.

Of course the demand is not for secondary stock. Neither from investors nor banks. The consensus on secondary is that there is still probably a way to go. There is no funding for riskier stock, and actually who wants/needs to be risky at the moment? It's a bit like comparing secondary commercial real estate to blocks of ubiquitous type flats – no-one can yet see the bottom, or feel they can. Unless perhaps you buy at build cost? But 'prime' commercial real estate is more analogous to the better residential stock. Investors can see up to 45% off 2007

45% Investors can see up to 45% off 2007 prices

prices and if they are long term investors, not so worried about another 5 or 10% fall, they can buy some nice investments... that is if they can source the stock (treble check the covenant) and avoid paying silly auction prices.

What are we doing? We're busy, busy. The opening of St. Mary's Radisson hotel is time consuming at the moment, but we are also working hard on some new funds. Now is a good time to be raising equity. Read about All Saints and Pigeon overleaf, but we also hope to be growing Strata as well in Q3 '09.

Hoping all OK with you, and you are faring well against the headwinds.

HJDC

Existing Funds – Activity Update

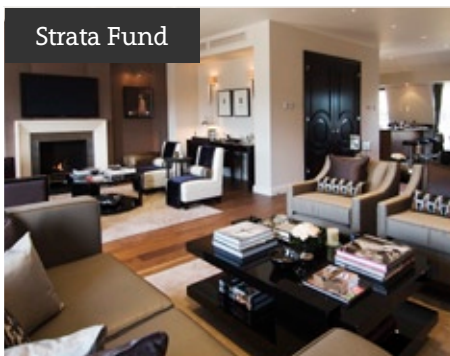
St. Nicholas - Domino's Pizza signed in May 2009 for 1,000 sq ft unit. Construction works to commence on 6th July. Investors fully subscribed offer to participate in securing extra income and profits from this development.

St. Ursula - Ashtead Plant Hire unit sub-let to G&K Holland Ltd (t/a Oxford Pram Centre).

St. Mary - Opening of hotel delayed from mid 2008 until July 2009. Discussions currently on-going with HBOs to extend availability of loan facility to revised opening date, and developer to agree settlement. Rights issue for £1m underway and favourably received by investors.

Lifehaus - c£1m to invest in property company joint ventures as equity or mezzanine.

Strata Fund - 2nd loan redeemed in April 2009 from developer of c£5.25m, 13 house scheme in Windsor. 5% dividend to be paid in July 2009. Fund c40% in cash. Over £1.034 billion of properties rejected by Fund since April 2007. The current unaudited Unit price is £1,055 (£1,000 at launch). Proposal to open Fund to new investors later in 2009.



Strata Fund

St. Christopher - Rent review for the 2 units let to Remploy with third party. Old Citifinancial unit on the market.

All Funds - Audits, valuations and annual Investment Manager reports are in process of being completed with a view to distribution to Investors in July 2009 (St. Mary will be later).

St. Mary Fund



New Launches - evolve All Saints Fund & Pigeon East of England

evolve All Saints Fund

We are proposing a similar type of structure as the popular Strata Fund – i.e. a minimum 5 yr period but with a commitment to extend. Dividends of 6-7% and the appeal of acquiring investments through the bottom of the cycle.

We are reviewing some potential first investments, but they will all be securely let to strong covenants, perhaps with RPI or fixed uplifts, and in properties we regard as satisfying our 'lack of land' requirement (i.e. not offices!). It will be a portfolio approach and tax efficient for income and capital gains.

We hope that marketing material and the IM will be available in July 2009.

Pigeon East of England Property LP

We are working with our friends at Pigeon to establish their first partnership.

It is to be a £50m closed ended 'club' with a 12% target IRR and 6% distribution. The real estate will be sourced entirely in the East of England, Pigeon's home territory that they know and cover well.

They are specialists in the region and have an enviable track record of sourcing off market and attractively priced opportunities – always with an 'angle'.

Marketing material and the IM is imminent.

In Search of Returns...

To say forecasters got it wrong over the past 2 years would be something of an understatement. Correspondingly, anyone calling the bottom of the market now does so with some trepidation, especially given the difficulty of assimilating the unprecedented factors that are currently influencing global and UK markets.

Even the Bank of England is guessing. In its latest quarterly inflation report, the Bank estimates that possible outcomes for the economy by the end of 2010 could range between 5% annual growth and 3% contraction. This is an incredibly wide range.

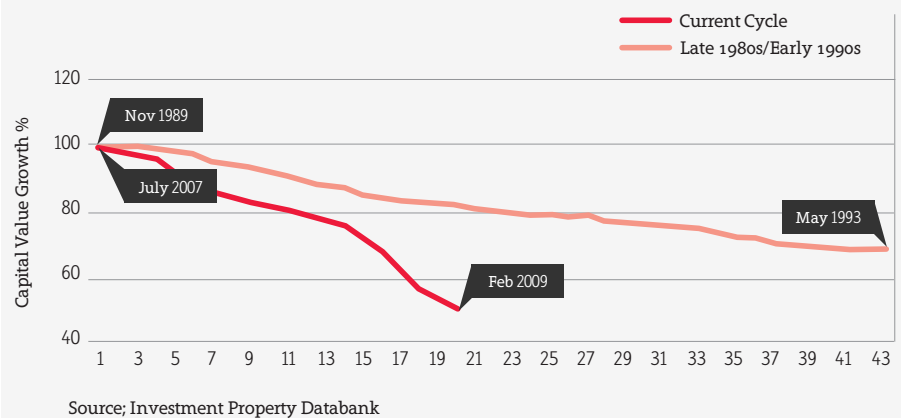
The Bank pointed to the "considerable stimulus" stemming from the easing in monetary and fiscal policy at home and abroad, the depreciation in sterling, the falls in commodity prices and the running down of inventories. This should lead to a recovery in economic growth, but the Bank states "the timing and strength of that recovery is, however, highly uncertain."

In terms of the impact on the real estate markets, it is similarly difficult to balance the conflicting influences.

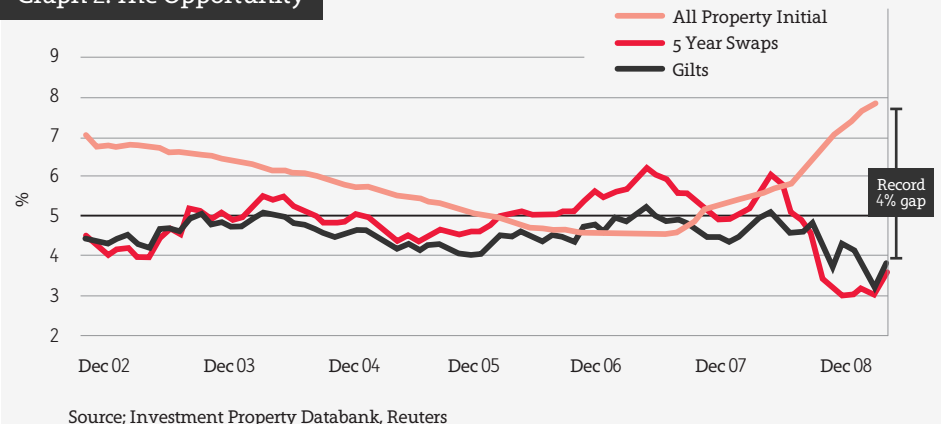
The positives

- Interest rates are at record lows and appear to be underpinning retail sales figures, outweighing the impact of falling wealth due to the house and stock market corrections and the fear of unemployment.
- Property values have fallen by over 40% from their peak in mid 2007, although these levels were clearly over-inflated. The speed of the price correction has also been much quicker than the early 1990s as shown in Graph 1.
- The yield gap between property initial yields and gilts is 4%, a record high and double the perceived (albeit slightly arbitrary) historical risk premium of 2%. In relation to affordability, the difference

Graph 1: Speed of Recession - Price Corrections



Graph 2: The Opportunity



between initial yields and the 5 year swap cost of funds is an unprecedented 4.15%, giving the chance to improve dividend returns with sensible leverage.

- The depreciation of sterling has increased the UK's competitiveness from an export and inward investment perspective. The impact can be seen in the demand from overseas investors for UK property.
- The government's £125bn quantitative easing programme, equates to an injection of around 10% of GDP. Although the result of this initiative remains uncertain, there will undoubtedly be some increase in liquidity.
- The creation of the toxic asset insurance scheme has prevented a flood of forced sales of property assets from the UK's largest property lenders. Even where banks are not involved in the scheme, there has not been a rush to clear out bad loans. This is because the holding costs are manageable with low interest

rates and there is little to be gained from selling into this market, particularly to the opportunity funds with their unrealistic IRR hurdles of over 20%.

...and the negatives?

- The alarming figures released in the recent Budget, with total public debt forecast to reach £1.4 trillion by March 2014 (and net debt totalling 70% of GDP) will prove a medium and long-term drain on UK plc, even if the underlying measures were required in the short-term to avoid complete financial meltdown. Balancing the books will require tax rises and spending restraint, as well as higher gilt yields in the medium term to attract buyers to UK government paper.

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- As the recession continues to bite, rents are falling across most sectors, in headline terms and even more so after incentives. Forecasts of rent reductions of between 10 and 40% put initial yields into perspective - a seemingly attractive yield of 7.5%, becomes 6% if rents fall 20%. However, upward only rent review clauses in standard UK leases, mean that falls are postponed until lease expiries, by which time one hopes rental values will have recovered.
- There will be more tenant failures.
- Bank liquidity will remain tight and Banks' appetite for property exposure will be cautious at best in the next 5 years, as they will still be unwinding existing issues, many of which are just being rolled forward on a short term basis at the moment. The toxic asset insurance scheme will provide only limited help in terms of new lending, as property lending is not a core banking activity. On top of this, the market will have to digest the unwinding of tens of billions of CMBS is sues, many of which were structured at the top of the market.

Despite the positives, we still find it easier to side with the long slow recovery theorists

Despite the positives, we still find it easier to side with the long slow recovery theorists, particularly because we think many of the banks are still not recognising the extent of their problems. Indeed there are £43bn of commercial property loans due for repayment this year, and clearly no refinancing market or satisfactory sale market. The de-leveraging process will therefore take some time and it is difficult to see a market for making trading profits emerging any time soon, so the focus needs to be on securing income, whilst preserving capital.

Options for income

With bank deposit rates providing a suitable disincentive to holding cash, the income profile of commercial real estate looks attractive as data (various 'sources') in the table below illustrates.

Gold	0.00%
7 year index linked GiltYield	1.01%
5-15 year Gilt RedemptionYield	3.93%
FTSE All Share Gross DividendYield	4.51%
FTSE Real Estate Gross DividendYield	6.83%
Various Corporate Bond Funds	<7.00%
Commercial Property InitialYield	7.84%
Commercial Property EquivalentYield	9.31%

With modest leverage of up to 60-65% for well-let property, the gross running return on cash invested can be increased to c10%. An income focus is in line with the emerging consensus of opinion as witnessed by Land Securities' recent statements accompanying their shocking results, which showed a two thirds fall in NAV. Land Secs poured a dose of cold water on the recent quoted sector rally, warning of more pain to come as the recession hits tenants and rental levels. They also announced a move to focus on income preservation, rather than capital growth.

Capital protection before growth

Without setting aside capital growth entirely, most investors are perhaps more worried about capital protection / wealth preservation. UK property is some 40-50% cheaper than it was, but is it cheap enough? UK property yields are above their long term averages (for example prime shops at 6% compare to a 20 year average of 4.75%) and the UK property market still retains attractive underlying fundamentals – relatively long leases, upward

only rent reviews, full repairing covenants and a restrictive planning system. The shut down of the development markets will also limit the supply pipeline, bringing rental growth back sooner than would otherwise be the case. In many cases, property is now worth less than the re-building costs, so all in all the downside looks protected.

In a market where all companies are under pressure, we can also fall back on the bricks and mortar argument - if a tenant company were to fail, you're better placed holding an empty property than a share certificate or a corporate bond! Nonetheless, covenant is the rival of cash for 'King' status.

On the flipside, the sector's attractions have been diluted in recent years by the imposition of higher transaction costs (4% stamp duty), the shortening of leases and most recently, the charging of full rates against empty property. Plus the impact of new SIPP rules and income tax rates have not fully emerged. We feel some investors will consequently target income, others prefer growth, but all will want capital protection.

Conclusion

A final thought re the threat of inflation?

In the short term, income returns will compare favourably with other sectors and the downside should be limited. If one does see an over-stimulation of the economy and inflation returning sooner than the current mood suggests, then property's traditional inflation hedging characteristics should provide out-performance.

So in summary, a strategy of acquiring a diversified portfolio of properties at current yields, with income secured by robustly assessed tenants in supply-inelastic sectors, should provide comfort that the risks to income are adequately mitigated... and that one is buying at somewhere close to the bottom of the valuation cycle.



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