evolve Fund Services Limited

Newsletter June 2011

Real estate investments and asset backed businesses for private investors

evolve

"Access is the key"

It is nine years since evolve was formed and it is amazing how that time has flown. '...when you are having fun' you complete the cliché. 'At times' we reply. 'Well done for surviving, many have not' some say. 'Thank goodness we have been around long enough to know an overheated market when we see one' is our overused, but true, response. 'What have you learnt?' is the more thought provoking question and one that we need to answer and apply going forward.

In this context the opening few paragraphs of our first newsletter in 2003 are interesting to review. Poignantly, they are pretty much as true today:

"The last 6-12 months have seen a continued interest in commercial property from the private investor, particularly at the auctions and limited partnership offerings. Our hope is that these investors have begun to become more sophisticated, or better informed, and selected only those opportunities that offer the level of returns that commercial property should offer (ie over 8-10% pa IRR) when appraised using appropriate assumptions.

Since these investors are typically investing via their SIPP or SSAS, or are adopting a medium term risk approach (perhaps thinking about school fees), it is evolve's view that they should be investing in the least volatile sectors of the market – those least exposed to the peaks and troughs typically seen in the office and, to a lesser extent, industrial markets. This is not to say that every deal in the office and industrial markets is unworthy of consideration. However, the retail and retail warehouse sectors typically benefit from a scarcity of supply and a more stable, consistent balance between demand for and supply of new accommodation.

These factors are particularly evident in the out-of-town retail warehouse market, evolve's current preferred property sub-sector when considering the medium term."

Real income returns

The overall evolve message is broadly the same today, post boom, bust and (prime asset) recovery. Differences? Today there is certainly more of a focus on producing yield than capital growth, and from prime assets with little/ no debt. In this regard, the all property initial yield is again at its long term average of c6.5%, reflecting a 'normalised' market and a +2.5% discount to (non index linked) gilts at c4%.

> Commercial property is alone in offering positive real income returns. With the right business plan, these can be enhanced by 'real' capital growth.

If you look at index linked gilts with a current negative real return of c-2.2% and the nominal FTSE All Share Dividend Yield at c3%, the difference is very appealing.

Dumbing Down

Another significant change is the range of investment opportunities available to private investors. The new rules about Unregulated Collective Investment Schemes, for example the partnerships that were so popular with IFAs and investors in 2000-2007, mean that the risks to PI can outweigh the benefits for the majority of IFAs to recommend such products to clients today. This is of course due to so many 'non experts' promoting products in the bubble or those that should have known better. It represents a 'one rule fits all' dumbing down. And did all the 'safe' institutional funds really cover themselves with so much glory?

We sense from our contacts in the world of advisers and investors a continued scepticism towards the big branded institutions. There is no doubt that the emotional element to investing, or rather dis-investing, played a big part in many of the institutions having unwelcome redemption requests at a time when property values had fallen up to 40%, post credit crunch, pre recession. Of course the expert fund managers would have preferred not the sell the family silver at big discounts to satisfy the redemptions, as much as the REITs did not want to sell at the behest of the banks. However, that is the nub of it. The institutional funds are listed and thus encourage redemption floods when the

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Existing Funds – Activity Update

St. Nicholas - Bennetts Electrical go into administration. Agents re-marketing.

5,400 sq ft unit let to Lithuanica, on assignment from the original developer, at the passing rent of £13.00 psf, subject to planning.

Fund achieves £0.25 psf uplift in Wickes rent review. Savills acted.

Re-finance from Lloyds to Barclays completed in May 2011.

St. Ursula – First round of rent reviews commenced at end of 2010.

Potential sale of asset being considered.

St. Christopher – The car park rent increased from £19,731.73 p.a. to £21,620.13 p.a. following review on 26 January 2011. This lease expires on 30 September 2011 and we are negotiating with the current tenant ahead of formally marketing the spaces.

Mortgage Point has their unit on the market for assignment.

Chutney and Everyday loans have rent reviews in September and November 2011 respectively.

St. Mary – The hotel is now fully finished and trading. Updates on this Fund can be found by visiting www.cisx.com, searching for the St. Mary Fund and then clicking on 'News'.

All Saints – Please see page 3 of this newsletter and www.evolveallsaints.co.uk

Strata Fund – Over 4 years since launch of Fund in April 2007, Distributions totalling 11.5% have been paid and the Unit price increased from £1,000 to £1,099 (unaudited) – a combined total return a little over 20%.

Existing investors considering opportunity to invest another £3m.

Strata Fund: Blackboys –£500,000 loan redeemed in May 2011 with interest

Strata Fund: Gerrards Cross –£500,000 loan redeemed in May 2011 with interest

Distribution of 7% due to be paid in September 2011 to initial investors (less to EPUT investors due to tax rebate).

23 loans have now been completed with a GDV of £94.5m. 10 have been redeemed.

The most recent loan advanced in May was for 4 houses in Newick, East Sussex with total end value of £3m. The borrower had recently redeemed £500,000 loan for a development in Blackboys. Another recent redemption has been from the developer of a property in Gerrards Cross – a £500,000 loan and c£450,000 interest.

Please visit www.thestratafund.co.uk

St. Austell – Savills instructed to carry out the rent reviews.

St. Margaret – Rent review surveyors appointed and potential disposal being considered.

Pigeon East of England Property LP – The first closing took place in September 2010 with the £11m acquisition of Anglia Water's HQ in Peterborough. The Fund is concentrating on commercial property investment opportunities in the eastern region and is intending to grow significantly.

evolve All Saints Fund - Final Closing

www.evolveallsaints.co.uk

Having been out of the market for around 4 years, evolve made its first investment for All Saints within a month of the first close in March 2010. In partnership with a syndicate of clients of one of our adviser friends, All Saints paid c£3.5m for the property that has another 30 years unexpired to Whitbread's budget Premier Inn (above right). The net yield is 6.5%.

All Saints then made a £630,000 mezzanine loan in May 2010 yielding 11%. This loan is well protected in terms of the capital structure.

The Fund has also completed (January 2011) the acquisition of a trade counter unit in Epsom.

"Like the property in Norwich, the one in Epsom was also acquired 'off the market'. The property typifies the All Saints 'lack of land' approach to stock selection given the scarcity value of modern properties such as this with grade A specification within the M25."

The property is only 10 years old and benefits from a low site cover, higher than normal eaves height plus extensive fitting out by the tenant Wolseley. There is a rent review in February 2011 giving the Fund the chance to enhance the running yield and/or improve the capital value should the tenant agree to a lease extension. The Fund paid c£2.5m producing an attractive yield of 8.1%. A £1m loan from Barclays was used to acquire the purchase, a 40% loan to value and the only debt in the Fund. The Fund has instructed a specialist surveyor to negotiate the on-going rent review.

We have a healthy book of other possible transactions that fit the All Saints 'lack of land', prime property profile and hence are keen to grow the fund before the Final Closing. It is similar in structure to our popular Strata

"All Saints can be regarded as a Family Office commercial property fund. Friends of friends and clients of our financial adviser friends can get access to the deals we are happy to put our own money into, or more importantly, let our close friends and family invest in."

Fund – i.e. a minimum 5 yr period but with a commitment to extend. We are aiming for dividends of 5-7% p.a. and expect capital growth through our stock selection and asset management to achieve 10% p.a. plus total returns.

All Saints is tax transparent and available to SIPPs as well as non-pension equity.

The Information Memorandum and other marketing material are now available.

All Saints Fund: Premier Inn

Please also look at the Fund's bespoke website www.evolveallsaints.co.uk. Not only is this convenient for potential investors, but it is also updated with news regarding acquisitions, fund closings and will have NAV Unit prices.

All Saints website

Final Closing

The Final Closing has been put back due to recent enquiries. It is anticipated to be in September 2011

evolve website interactive for Investors

The evolve website is now interactive for Investors. Passwords have been circulated to enable Investors to download the most recent reports and accounts for each fund.

There is a direct link to the All Saints and Strata websites and information about each of the funds.

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Sunday newspapers say that commercial property is a 'sell' just because of future public sector redundancies and the empty offices in Middlesborough that will result. It may sound crass, but I read this pearly piece of investment wisdom. It is about as logical as saying house prices in Chelsea will fluctuate in a similar manner to a terraced house in Wolverhampton!

So whilst the FSA is pushing investors, retail and sophisticated alike, towards the larger funds through a policy of dumbing down, these are the funds that have the volatility inherent with listings. They also do tend to be the followers not the leaders.

Fees

'What are the fees?' is, of course, an even more important question today than ever. It can be the key influence in an investment decision when comparing 2 funds, especially 2 big 'managed funds', which perhaps market the brand on the billboard, not the fund manager? But how much is right?

'Passive' is a word more appropriate than 'long only' for property. 'Core' or 'Core plus' goes with the same territory. Whatever the term, this is all about getting the initial investment decision right. The key, with property, it is also about having access to the asset in the first instance. Thereafter, rents are collected, dividends paid, and investors hope values increase by more than the costs and inflation. Fees will be around 0.5-1.0% NAV p.a. depending on fund size, perhaps plus transaction or property management roles.

If, however, the investor is seeking a superior return through a more 'active' fund, then by its very nature the fees are more to compensate for extra expertise and labour. Shopping centres are very investment manager intensive, as is any form of development or other types of active asset management. Fees will be around 1.25-1.50% NAV p.a. for the larger funds, more for the smaller, niche activities or real estate asset backed businesses.

Market and Access to Market

As mentioned above, a key consideration, perhaps the most important above all, is the fund manager's access to market. It is of little interest to an investor to believe the sales pitch and for the fund to then stay in cash. But it is even worse for the wrong investments to be made at the top of the market, or driven by the need to invest due to 'cash on deposit', rather than the quality of the opportunity.

2009 was the optimum 'opportunity' moment in this current cycle to have had equity and access to market. Sainsburys and M&S were considered companies at risk. Most investors wanted to be in cash and nothing else. It was the cash rich, 'expert' property investors that capitalised on the retail redeemer's panic button. They were truly opportunistic and sourced the right deals.

The boutique 'experts' were buying when the 'non experts' were selling. Make your own conclusions please.

Since Q1 2010, fulfilling a similar business plan has been impossible. But the fundamentals for property investing remain convincing and sentiment has turned. Consequently, the same funds that had to sell investments at big discounts in 2009 have returned to the market. Sovereign wealth and other foreign investors have also entered the London market. More active private UK investors, no doubt fed up with negative real returns from bank deposits and wary of the stock market and corporate bonds, have likewise returned to 'bricks and mortar'. Private equity has been pushed higher up the risk curve, into speculative development or otherwise taking on letting risk.

The net result is that prime property, especially in central London, has witnessed a recovery in values from 'buy anything prime' to 'buy prime at the right level if you can find it'. (IPD Total Return Index has recovered 21.3% of the -37% between the nadir in June 2009 to April 2011 (ie 57.5% of the loss).) With virtually no demand for secondary and tertiary stock, and an absence of much leasing activity to create new prime investments, the banks are seen as being the only one's to help satisfy all this appetite. Will they?

Epsom: Off market acquisition by evolve All Saints

The Banks

There is, apparently, £207bn of UK commercial property debt, of which more than a fifth is in default or breach, and more than half is due to mature within 3 years. CMBS and NAMA add another c£80bn (Source: De Montfort). Although the banks maintain they will not 'flood the market', the last 2-3 months have been notable for an increase in investments brought to market by administrators. NAMA is not alone in moving towards enforcement stage, but it has approved 3bn euros of asset sales (of the 72.3bn in loans it acquired for 30.5bn).

Forecasts

Our expectation for the next 6 months is that there will be an increasing mis-match between distressed selling of secondary stock and new lending on prime. The two will not meet for a minimum 2-3 years. Pricing of prime will be flat as investors resist yield compression to 2007 levels. evolve will stick to its 'lack of land' stock selection philosophy, whether for commercial real estate or for Strata.

For those that failed to invest in 2009 current pricing affords attractive returns. Access, as ever, is the key.

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