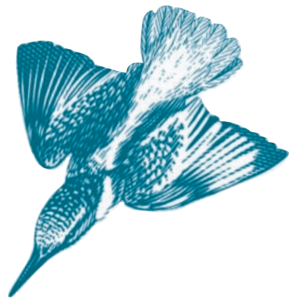
SPLASH

NOVEMBER 2007 THE NEWSLETTER FROM KINGFISHER PROPERTY



The Credit Crunch

The credit crunch has had greater impact on commercial property lending than just closing down lines of funding. There are a sizeable number of commercial mortgage backed security (CMBS) funded lenders who are now effectively out of the market. Typically they either admit to being out or suggest they are not approached just at the moment!

The first reaction of the remainder of the lender market fell into two distinct groupings. The majority used the opportunity to quote higher pricing and the rest said it was business as usual with the objective of increasing market share at the expense of the former category.

Return on Equity

The second phase of the reaction to the new market conditions has now started. The run on confidence had the effect of pushing up interest rates to the extent that LIBOR became uncoupled from the Base Rate set by the Bank of England. This has now settled down, but the legacy is that the market has paused to reflect on the risk premium, not just in commercial property, but across the board.

When commercial property prices were rising successively, no one took much notice of Bank of England warnings to the sector which were voiced from the early part of 2007. Now the market has convinced itself that prices will be lower in 18 months time as compared with now, buyers are thin on the ground.

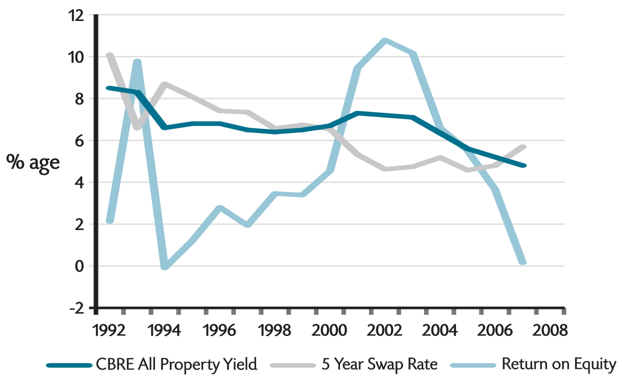
A look at the graph suggests why. The graph compares the CBRE All Property Yield with the 5 Year Swap Rate in order to calculate a Return on Equity. A loan of 75% LTV at a margin of 1% is assumed with the surplus income expressed as a percentage return on the implied equity in the transaction. Before the Property Crash in 1991, the Return on Equity was negative going back to before 1980.

The commercial property loan book peaked in 1988 at £40 billion. The majority of the debt was secured on developments with repayment anticipated from sales to institutions following completion. The 1990's brought considerably lower interest rates and with it a new approach by lenders, where cashflow became king. For the first time, investors saw surplus rental income after debt service and were not totally reliant on capital growth for return. As the graph shows, the Return on Equity has ranged from 0%, but not less, up to 11% in 2002.

Implications for Prices

If interest rates stabilise at their current level, and the 5 year swap rate has been around its current level for 6 months apart from a spike during the crunch, then a 5% Return on Equity implies a rise in the CBRE All Property Yield to 6.6%. This is a rise of 1.8% from the June 2007 level, implying a fall in prices of some 25%, unless interest rates fall.

RETURN ON EQUITY 1992-2007



The level of return that tempts debt financed investors to buy, 5% or some other level, undoubtedly depends on what capital growth investors can see in addition to their income return.

In the short term most seem to see little chance of capital growth. Historically it has taken the property market 6-9 months to adjust.

Higher Inflation?

This is one way of analysing the current market. On the other hand, an increasing number of economists are suggesting that the world economy has reached a watershed, with a major rebalancing of the US current account deficit and Far East surpluses in prospect.

Depending on how smoothly this happens, an economic downturn is possible. At the same time Alan Greenspan has written a book suggesting that the period of low inflation enjoyed since the early 1990's is coming to an end. Should there be a return to higher inflation then conditions could be similar to those that prevailed prior to 1991, when interestingly, the Return on Equity in the UK commercial property market was always negative. Debt financed investors relied on capital growth alone for their return and invested in commercial property as a traditional hedge against inflation.

It is going to take time for the picture to unfold and for the implications of general economic conditions in the UK property market to become clear. In the meantime lenders are tightening up loan terms with some closed other than to existing customers and others reducing LTV ratios in addition to increasing pricing. This is likely to exacerbate the immediate problem. There is also a view that there is plenty of money to be invested in property just as soon as price reductions feed through.

Large Loans

Another issue that has loomed concerns the willingness of lenders to commit to large loans. Before CMBS funded lending became fashionable, there were only a handful of lenders who were willing to provide loans of £100 million or more. Large loans were traditionally provided by "clubs" of banks or syndicates. In a club deal, all the banks were identified before going on risk; in a syndicated loan, a lead bank would go on risk and then syndicate down to others, possibly after obtaining commitments for a portion of the loan.

That all changed following CMBS. Many more lenders were willing to take on large loan commitments in the expectation of laying off risk through CMBS or securitisation. This has now dried up and we are back to a handful of banks being able to provide large loans on their own and otherwise club or syndicated deals. This will affect investment transactions for larger properties and portfolios.

RECENT TRANSACTIONS

Department Store Financing, Sunderland

Kingfisher Property has raised an investment mortgage to assist a client in acquiring a department store let to a new company, formed from the majority of what was Owen Owen, which went into administration earlier in 2007. The facility raised represented 97% of the purchase price and was put in place to enable a swift exchange of contracts.

Speculative Development Finance

Some 2 years ago, we raised equity and debt finance to enable a client to acquire 65,000 sq ft of offices on a modern business park at Edison Park, Swindon. The facility has now been increased, with both more debt and equity, to enable the development of a further 25,000 sq ft of entirely speculative office accommodation, and works have recently commenced on site.

Self Storage Fund

Kingfisher raised both equity and debt to assist in the acquisition, refurbishment and operation of a series of facilities for a 'start up' self storage business. It is unusual for project equity providers to take business start up risk. However, by demonstrating both a strong business plan and management team, we were able to raise 100% of project costs with interest roll up during the project refurbishment period. The opportunity offered a high potential return arising from enhanced asset values. The equity provider allocated sufficient funds to acquire a nationwide portfolio of 11 self storage facilities with a combined spend in excess of £50 million.

Planning Gain

Kingfisher is arranging finance for the purchase of a greenfield site in the South East reserved for residential development but as yet without an housing allocation. These are popular transactions where the risk is mainly one of timing as to when the site will receive its allocation and how much will be developable. The uplift in value once planning consent is obtained is usually substantial.

Caravan Park Fund

Caravan parks have emerged as a popular investment opportunity. Kingfisher's first transaction in this area comprised debt and equity finance for in excess of 99% of costs for the acquisition and redevelopment of a portfolio of 9 caravan parks with interest rolled up. The opportunity offered a high potential return arising from development of luxury timber lodges for sale as second homes as well as active asset management. The total combined acquisition and development facility was some £90 million.

Staff news

As many of you know, Dominic Reilly, a founding partner of Kingfisher Property sadly left us at the end of September to join King Sturge LLP. James Maunder Taylor (a name you may be familiar with) has joined as an Associate Director.

Dominic Reilly

Dominic Reilly writes: "In true Kingfisher fashion my colleagues gave me an excellent lunch by way of send off at the end of September. William recalled our first days in November 1988 working from a garret office in Covent Garden and being very proud of our first successful transactions, which included the financing for the acquisition of a first generation vacant office investment in Canary Wharf and the 100% financing of speculative developments in Glasgow and Wakefield – heady days! There were recollections of moments of hilarity, Christmas treasure hunts shared with the tenants in our building, how to get food poisoning in 3 easy steps (ask William) and how to get mentioned on page 5 of the Daily Mail as a witness in relation to an alleged sexual harassment case.

We moved offices midway through the nineties to Elite House and attracted a mountain of clients who came to see us solely for the model agency resident on the ground floor, all of whom as quickly evaporated when we moved to the West End. To our knowledge we were the only victims of the Millennium Bug which infected our file server much to the glee of our IT consultant who was round in a shot to attempt to fix it.

I shall miss all the fun of working at Kingfisher with lovely colleagues and with wonderful clients, some of whom have moved with me to King Sturge. William, Simon and James will continue to be very successful, of that I am sure, and I look forward to comparing notes with them halfway through 2008 on how we all coped with the Credit Crunch". Au revoir, Dominic.

James Maunder Taylor

James is a Chartered Surveyor having qualified in 1996. Prior to joining Kingfisher Property, he has worked in Asia, Europe and the UK, employed by Jones Lang Lasalle, Tramell Crow Savills and latterly Cushman & Wakefield, where he was an Associate Director. His experience encompasses valuation, leasing, management and corporate real estate.

James is a keen cricketer, fisherman and sporting shot, in pursuit of which he has travelled to most continents.

NEWS ON LIMITED PARTNERSHIPS

Through Kingfisher Property Partnerships Limited, which is regulated by the FSA, we have recently been appointed the operator of 3 major limited partnerships.

One is on behalf of Development Securities plc for a major development in West London. The second involves a town centre redevelopment centred on retailing in the Midlands and the third is on behalf of Capital Shopping Centres plc for a major Northern shopping centre.

The combined funds under management of the 42 funds operated by Kingfisher Property now exceeds £2.5 billion.

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