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| PERSONALISED WEALTH MANAGEMENT |



Credo Property Group Limited  
Credo Sterling Properties Limited  
October 2009



The Directors of Credo Sterling Properties Limited ("Fund I") have proposed a dividend of £212,000 (2.3% on the current capital, based on the profit for the 6 month period ended 31 August 2009). This, together with the dividend paid in March 2009, equates to 4.3% per annum.

Since inception Fund I has distributed £16.95m to shareholders (93.8% of the initial capital invested) and the Net Asset Value ("NAV") is £13.7m.

## UK commercial property market

September 2009, the anniversary of the collapse of investment bank Lehman Brothers, was marked by the first monthly UK commercial property capital growth in 26 months.

According to the latest Investment Property Databank ("IPD") Monthly Index capital values rose 0.2% in August, thanks to further easing in negative rental value growth, which improved by 10 basis points to -0.48%, together with a second-consecutive positive yield impact of 0.64%. The consecutive 25-month peak-to-trough capital decline ended at -44.2%.

All-property initial yields have contracted to 7.86%, following falls in both retail and industrial yields to 7.53% and 8.18% respectively.

Despite the signs that the market may have bottomed out, rental values are still falling. Well-let portfolios are rising in value (as investors chase secure income streams) – but plenty of property still has further to fall as leases expire and tenants default.

According to Colliers CRE, "Product availability is limited as banks choose not to sell distressed assets. More equity continues to seek to take advantage of a market perceived to be at the bottom, but there are few distressed sellers around. Even with improving yields, disparity between prime and secondary values continues to grow as income falls. "

## Net Asset Value "NAV"

Fund I NAV is now £79.53 per share as summarised below which is a fall of approximately 5% from £83.35 per share in February 2009.

| Property       | % of fund   | NAV Aug 2009  | Pro Rata Value |
|----------------|-------------|---------------|----------------|
| NCP            | 55%         | £7.5m         | 0.4352         |
| Volkswagen UK  | 28%         | £3.9m         | 0.2263         |
| Wellingborough | 8%          | £1.0m         | 0.0597         |
| Cornwall       | 9%          | £1.3m         | 0.0741         |
| <b>Total</b>   | <b>100%</b> | <b>£13.7m</b> | <b>0.7953</b>  |



While the value of the property assets held by Fund I has decreased since our last report, they continue to perform well compared to the IPD UK Pooled Property Fund Index which produced a 12 month decline of 36% as at June 2009.

Our strategy is to hold the assets which are all cash generative and wait until the market improves before we exit. The income streams have been protected as most assets are funded on long term loans at fixed interest rates.

The major risk is that a tenant will be affected by the downturn in the economy and will no longer be able to meet its lease commitments. We currently believe that the quality of the tenants of the Fund I properties is such that this is unlikely to happen.

Given the current market conditions we anticipate holding the assets of Fund I and working to enhance value through active asset management for example, lease extensions or enhancements to the assets where appropriate.

## Tenant: National Car Park "NCP"

### Location UK

#### **Background**

Fund I owns 5.35% of the NCP portfolio. The Portfolio today comprises 130 car park facilities located in the UK (61 are held freehold, 63 are held on long leasehold of 50 years or more and 6 are short leasehold (less than 50 years)). The NCP leases commenced in June 2002 for a term of 34 years and 11 months (approximately 28 years unexpired on the lease). The annual rental income is circa £43m and there is a guaranteed increase in rental of approximately 3% per annum.

#### **Funding**

The acquisition of the NCP portfolio was financed by Royal Bank of Scotland ("RBS") by a number of non-recourse loans which totalled £543.2m. An interest swap transaction fixed the interest of all the loans at an average of 7.25% per annum. During the reporting year, the bank lowered the margin of some of the loans, and as a result, the latest average interest rate including the margin was about 6.8% per annum. Some of the interest accrues to the loan principal and is not paid on a regular basis. The loans are repayable in July 2027. The loan balance at December 31, 2008 was £547.8 million. Under the loan agreement, RBS is entitled to receive part of the profits upon sale.



We previously reported that:

1. A number of the car parks have been sold since we purchased the portfolio as a result of Compulsory Purchase Orders. This has necessitated the repayment of part of the loan from RBS.
2. The element of the interest rate swaps relating to the loans repaid was not cancelled at that time as it was thought that the distributions would be enhanced and it was possible that the rates would go up and therefore the amount of breakage costs could be curtailed.
3. The Bank agreed with this strategy of maintaining the swaps on certain conditions. Unfortunately because long term swap rates fell, RBS informed the company that if the SWAP was not broken it would be in default.

The final amount of the breakage cost was higher than expected at £5.254m. £2m was paid in March 2009 out of existing cashflow, which leaves a balance of £3.254m which will be embedded in a higher rate for the next three years therefore spreading the effect over that period of time. The uplift to the swap rate for the aggregate of the 7 swaps is 0.4344% per annum. In April 2012 the rate will revert to the originally contracted levels.

#### **Valuation**

The portfolio of 138 NCP facilities was acquired at a gross acquisition cost of £609m, with total shareholders' equity of £56m. The portfolio was purchased at a net initial yield of 6.6% on gross acquisition cost. Fund I invested £3.45m for a 5.357% equity stake. The equity is currently valued at £7.5m based on an offer received in February 2008 which valued the equity in the whole portfolio at £140m. This valuation takes no account of any profit share that RBS may be entitled to or any deferred tax in the holding company.

#### **Cashflow**

NCP will be paying out of cash flow an additional £1,093,300 for the first year, £1,117,497 for the second year and £1,145,915 for the third year as a consequence of the swap break. This additional cash flow will be partially offset by savings made as NCP was previously servicing an element of the SWAP that was not required. The net average amount payable will therefore be more like £500,000 per annum.

A dividend of £137,115 (approx 4% on the initial investment) was received by Fund I for the period ended August 2009. (To date Fund I has received back 73% of its initial investment in NCP.)

The NCP portfolio continues to hold its value and generate strong cashflows and we intend to hold this investment for the next reporting period.



## Tenant: Volkswagen UK "VW"

### Location UK

#### **Background**

Fund I owns 6% of this portfolio which comprises 73 freehold and 12 long leases let to Volkswagen UK, a wholly owned subsidiary of Volkswagen AG. Despite the crisis in the motor industry the tenant remains strong. Speaking at the Frankfurt Motor Show in September 2009, Martin Winterkorn, chief executive, Volkswagen Group stated. "We've done a lot better than the competition in this crisis," Volkswagen has seen its global market share soar from the single-digits to 11.7% so far this year, its sales slipping just 2.1% while the industry as a whole has suffered a 14% drop in sales, according to Mr Winterkorn. Net profits of the group fell during the first half of this year, yet the group was still in the black, netting some £249m.

#### **Funding**

RBS provided £241.5m of 15-year funding, expiring in December 2019, with a blend of senior, stretch senior and mezzanine debt. The level of debt increased as a result of the funding structure until October 2007. After this date the net debt decreased. As at October 2009 the amount of debt outstanding was £242m. RBS is entitled to 25% of capital profits on a sale or refinancing.

#### **Valuation**

The portfolio of 85 VW car showrooms was acquired at a gross acquisition cost of £286m with total shareholders equity of £44.5m. Fund I invested £3m for a 6% equity stake in the portfolio. The portfolio was purchased at a net initial yield of 6.56% on gross acquisition cost. The portfolio has not been revalued externally and, as minority shareholders, we have not instructed external valuers. The investment has been valued internally at £310m or 6.5% on the current rent equating to a value of approximately £4m for Fund I's interest in the portfolio. This valuation takes no account of any profit share that RBS may be entitled to or any deferred tax in the holding company.

#### **Cashflow**

Due to the terms of the funding structure, the distributions are lower in the period 2007 to 2010, and will increase in 2011. A dividend of £40,000 was received from this investment in the period under review. To date Fund I has received back 18% of its investment.



## Tenant: Cummins Ltd

Location : [Wellingborough](#)

### **Background**

Fund I owns 100% of this industrial warehouse property. The property is let to Cummins Ltd until 2020, subject to five yearly upwards only rent reviews (the next increase is in 2010). Cummins Limited is a wholly owned subsidiary of Cummins Inc. The principal activity of the tenant is the manufacturing, sale, distribution and servicing of diesel engines, components and parts.

### **Funding**

The £4m funding from Northern Rock is in place until July 2018. The loan has been amortised by 2.5% to circa £3.9m. The current loan to value is 79% which equals the LTV covenant so there is a risk of covenant default if the value of the property falls.

### **Valuation**

The property was acquired at a gross acquisition cost of £5.23m, at a net initial yield of 6.67%. Fund I invested £1.2m. We are commencing the rent review. The property is currently valued at £4.9m or 7% yield and will be formally revalued following completion of the rent review. In July 2009 the tenant requested approval to build a mezzanine floor in the warehouse area and to make some alterations to the external wash areas including installing a waste water cleaning and recycling unit. The fact that the tenant is carrying out alterations to the building is a demonstration of its commitment to the premises. At this stage it is uncertain whether we will achieve an increase in rent at the rent review, however it will provide an opportunity to discuss the possibility of a lease extension with the tenant which would add value.

### **Cashflow**

Loan repayments commenced in March 2008 hence the cashflow from this investment was only 1.5% in 2009. To date Fund I has received back 20% of the initial investment in Wellingborough and the debt has been amortised by 2.5%.

## Tenant: Cornwall County Council

Location: [Cornwall](#)

### **Background**

Fund I owns 80% of this property with the balance owned by another Credo fund. The property is let to Cornwall County Council until 2020 subject to five yearly upwards only rent reviews (11 years remaining on the lease). The tenant has an option to break in September 2015, subject to a six-month rental penalty.



### **Funding**

The £5.1m funding from Leeds & Holbeck is in place until June 2014. The loan has been amortised by 1.8% to circa £5m. The current loan to value is 76% which is within the LTV covenant of 80%.

### **Valuation**

The property was acquired at a gross acquisition cost of £7.2m in 2005 at a net initial yield of 6.7%. It was valued in 2008 by King Sturge at £6.6m (implying a yield of 6.85%). It will be revalued following the next rent review

### **Cashflow**

Loan repayments commenced in March 2008 hence the cashflow from this investment is forecast to decrease to 4% per annum for the next two years but increase to circa 7% following the next rent review in October 2010. Based on the indexation provisions in the lease, the rent should increase from £478,248 to approximately £531,000 per annum from October 2010. To date Fund I has received back 23% of its initial investment in Cornwall.

## Conclusion

Fund I's minority interests in the NCP and VW portfolios continue to generate strong cashflows and due to the length of the leases and strength of the covenants, the portfolios have held their value.

Whilst the capital value of the two smaller assets will decrease in the short term as the length of the leases decrease, the tenants are solid and the assets are income producing. Both properties also present opportunities to enhance the value of the investments through active asset management.

Our strategy remains to hold these investments for the next reporting period.

## Important notice

The fund invests in property which can be difficult to sell and you may not be able to encash your investment when you want to. Investment should be intended for the long term. The value of property is generally a matter of valuer's opinion rather than fact.

Past performance is not a guide to future performance. The value of your investments may go up or down, returns are not guaranteed and the original amount invested may not be returned. The value of your investments may rise or fall due to changes in tax rates and/or rates of exchange in which the investments are determined from the investor's own currency and such changes may have adverse effect on the price or income of investments.

## London

83 Pall Mall London | SW1Y 5ES | United Kingdom  
Tel +44 (0)20 7968 8300  
Fax +44 (0)20 7968 8301

[credolondon@credogroup.com](mailto:credolondon@credogroup.com)

## Geneva

15, Boulevard Helvetique | CH-1207 | Switzerland  
Tel + 41 (0)22 718 7200  
Fax +41 (0)22 718 7201

[credogeneva@credogroup.com](mailto:credogeneva@credogroup.com)

## Johannesburg

Wierda Mews, Block B | 41 Wierda Road West | 2196 | South Africa  
Tel +27 (0)11 883 3222  
Fax +27 (0)11 883 9905

[credojohannesburg@credogroup.com](mailto:credojohannesburg@credogroup.com)

## BVI

Geneva Place | 333, Waterfront Drive | Road Town, Tortola | British Virgin Islands  
Tel +1 (0)284 494 4388  
Fax +1 (0)284 494 3088

[credobvi@credogroup.com](mailto:credobvi@credogroup.com)

## Bermuda

Century House | 16 Par-la-Ville Road | P.O. Box HM 1806 | Hamilton | HM HX  
Tel +1 441 292 7478  
Fax +1 441 295 4164

[credobermuda@credogroup.com](mailto:credobermuda@credogroup.com)

[www.credogroup.com](http://www.credogroup.com)

