



Pigeon East of England Property LP

WHERE WE WERE AND WHERE WE ARE...

2009 was the year when shrewd UK commercial real estate investors acquired stock at the most significant discounts. Who sold to them? 'Forced' sales by the largest UK institutions, at a time when values had fallen by up to 40%, demonstrated either a lack of understanding by the retail investors seeking to redeem, or the inherent problem created by fund managers who insist on liquidity in real estate related funds. Without such redemption requests, the REITs should not have had to sell the family silver, although they did in certain instances to appease the banks. But it was the cash rich, 'expert' property investors that capitalised on the retail redeemer's panic button in 2009. At a time when Sainsbury's and M&S were considered companies at risk and most investors wanted to be in cash and nothing else, the clever few were truly opportunistic and have seen significant capital appreciation.

Since Q1 2010, fulfilling a similar business plan has been virtually impossible. The same funds that had to sell investments at big discounts in 2009 (August 2007 to June 2009 IPD Total Return Index down 37%) have returned to the market for the prime real estate investments they only recently sold. In particular, Central London feels immune to the recessionary cold winds with a huge number of sovereign wealth and other foreign investors entering the market for the first time, whether 'flying to quality' or taking advantage of currency movements. More active private UK investors, fed up with negative real returns from bank deposits, have returned to the auction rooms.

In all instances, demand has exceeded supply for prime investment opportunities.

The net result has been that prime property, especially in Central London, has witnessed a rapid recovery in values.

Buying prime property at vulture fund levels, if you can buy it at all, has just not been possible. It still is not today. The IPD Total Return Index has recovered 21.3% of the 37% fall between the nadir in June 2009 and April 2011 (ie 57.5% of the loss) from bargain basement to good value levels, for those who can find it.

TODAY

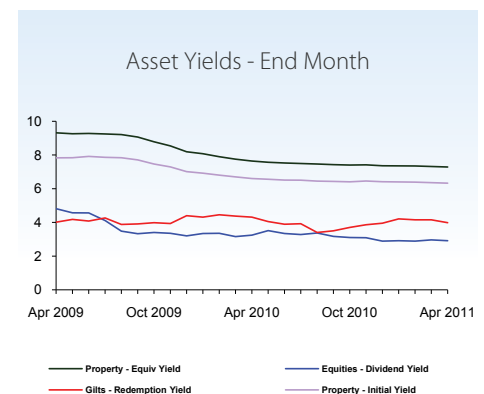
Today? Well, with such an imbalance between demand and supply for lower yielding, prime assets and virtually no demand for most of the secondary and tertiary stock, the equity is still there in the bank - perhaps the same bank that now controls so much of the property? In the absence of much leasing activity to create new investments, the banks are seen as being the ones to help satisfy all this appetite. There is £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. Additionally, NAMA is now in enforcement stage having approved 3bn euros of asset sales (of the 72.3bn in loans it acquired for 30.5bn), and RBS and Lloyds are close behind.

In summary, the investment market is still very tight. The vending banks are not satisfying demand for opportunistic buyers - or indeed demand from borrowers. Occupational demand is limited (NB the few exceptions), ditto rental growth (but the market is not dominated by empty, speculative development as in the early 1990's).

But real estate still offers an attractive income stream compared to other assets.

It also has the wealth protection 'bricks and mortar' characteristic, plus it remains a very imperfect market.



(Source IPD)

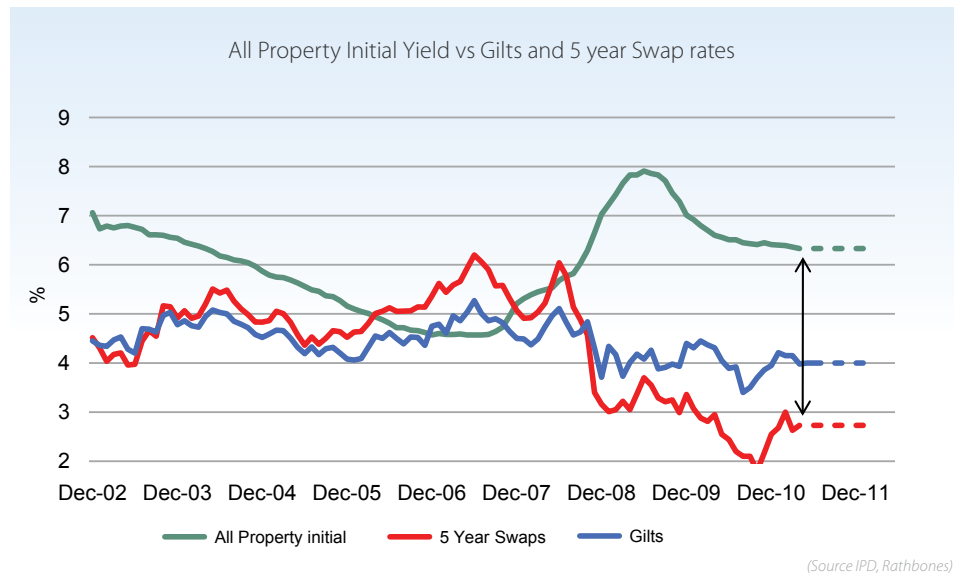
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WINNERS AND LOSERS?

So who will be the winners and losers in 2011? The biggest losers will obviously be those holding secondary or tertiary investments acquired in 2006-2007 who cannot sell, whether due to lack of appetite for the riskiest stock, lack of available debt or any other reason. Many or most of these losers will be the nationalised banks, their borrowers' interests having long gone. The banks are probably not losers per se, but there are many who have over-promised to investors +20%p.a. that cannot now be invested on the same risk profile as originally envisaged. 2012 may be their year, with increased distressed selling. However, the banks appear in no hurry. They will want to widely market, no doubt the bad with the good. They won't want to sell with 'stapled' debt and we will also see secondary stock with prime pricing that will need time to find its appropriate level. It may be 2013?

The winners will be those that are realistic in terms of investment returns.

The all property initial yield is again at its long-term average of c6.5%, reflecting a normalised market and a +2% discount to (non index linked) gilts at c4%. A c3.5% discount to



5 year swaps is unusual and of note to those with access to debt (see graph). With the FTSE All Share Dividend Yield at c3%, commercial property is alone in offering positive real income returns and capital growth options.

The specialists are those who understand their local markets, especially local occupational demand relative to supply. Knowledge of medium term growth enhancing infrastructure projects, house building and planning related factors are important,

as is of course the crucial ability to source appropriately priced investment opportunities. The days of simply treating property as a cashflow on a computer are gone. It is also not good enough to be a tracker - much better to be with a local hunter. If you failed to allocate investment to the sector in 2009-2010, then finding a specialist in today's market should reap rewards.

Hugh Colville, Fund Manager

STATS ABOUT EAST ANGLIA

One of the pillars for investing in the LP is our regional knowledge. With our breadth of contacts we hope to see the majority of opportunities before they reach the general market. However, our starting point is that we believe the Eastern Region has fundamentals that will underpin property values. The region has a diverse economy from producing 13% of all agricultural and fishing output (second only to Scotland as a region) to having one of the leading tech centres in the world at Cambridge. Business in the region spent £4.1bn on R&D in 2009, 26% higher than the next highest spender.

It also has key infrastructure, hosting two of the most important container ports in the UK at Felixstowe and Harwich, these are linked by the cross country dual carriageway, the

A14, to the Midlands and the rest of the UK. In 2009 the Eastern Region added some £111.6bn of value, equating to 9% of the UK total and second only to London and the South East.

The Eastern Region has the second lowest reliance on the public sector for employment, at 18.2% of the workforce.

Looking at the general deal flow in the market, yields for this region do not reflect this economic strength.

GROWTH PATTERN

We see this growth pattern continuing. In contrast with many areas in the south east, councils in the East of England remain strongly supportive of the allocations confirmed under the now disbanded Government housing targets. The East of England is projected to have the fastest growing population, 6.8%



compared to a UK average of 4.8%, increasing the population from 5.9m to 6.9m by 2028. With housing growth will come improved infrastructure, both in terms of transport links and upgrading of amenities such as schools and hospitals. This will in turn lead to greater demand from commercial property occupiers. We believe that due to the lack of bank funding for speculative development there could be a period during which supply will not meet demand. This will be important in driving rental growth, and ultimately capital growth in commercial property.

INVESTMENT REPORT

The Fund acquired its first property in September 2010, the Anglian Water headquarters building in Peterborough. It paid £10.65m, reflecting a net initial yield of 7% (assuming full purchase costs of 5.75%) and, given that the lease had 18 years unexpired to this very strong tenant with fixed rental growth at each review, it was clearly acquired at a discount to its market value. The most recent valuation suggests that the property is now worth in the region of £11.9m, reflecting a net initial yield of 6.25%.

Our attention has now turned to securing the next property.

Given that the Fund has purchased a single let property with a loan to value of 75%, our focus has been to identify a project that is multi-let and higher yielding. We have therefore been looking at multi-let industrial/trade parks, as well as multi-let offices. It is our intention that the next purchase will be geared to a maximum of 50% to balance the Fund's overall LTV level. Our objective is to purchase a property with a yield of 7% or higher, ideally with a mix of tenants to mitigate the letting risk. A higher yielding property will also help to support the dividend going forward.

KEEN PRICES ARE BEING PAID FOR PRIME PROPERTY

There has been a mismatch in the market between vendors' and purchasers' expectations. Noting the keen prices being paid for prime property, vendors of core plus property have wrongly interpreted this as a sign of strength in the market as a whole. The banks remain very cautious about lending on anything other than prime property, and this will continue to suppress prices for all but this type of property. We have turned down many purchase opportunities in recent months, including an industrial estate in Thetford, a multi-let office in Hatfield and a trade park in Cambridge.



In each of these cases there were particular reasons for deciding not to proceed but a common theme was simply that the vendor's expectations did not allow the pricing in of risk. Over the last two months there has been an increase in stock coming to the market, and in the Eastern Region this has been predominantly core plus to secondary property. We have also seen several properties that have been remarketed at a lower asking price. This has undoubtedly helped to inform vendors where pricing needs to be, and we are now seeing some more attractive opportunities both coming to the market and direct from vendors who are seeking a swift, off market transaction.

Vendors have knocked on our door.

Having discounted several higher yielding properties, we have found two opportunities on which we are undertaking due diligence. One is an industrial park, the other a trade park, both well located and with potential for asset management opportunities. Both properties provide a spread of risk over a number of tenants in a sector underpinned by strong tenant demand. Both of these opportunities are off market, brought to us by vendors wishing to work with the Fund.

We hope to be in a position to formalise offers for these properties very shortly, and they will be good additions to the portfolio. Going forward, we will continue to look at properties which will prove resilient to lower tenant demand, and provide tenants with value for money. While these criteria are relevant to all property investments they are especially important in the retail market where affordable rents, coupled with strong trading positions, will be crucial. With growing competition from internet retailing we foresee high street retail in any but the most prime locations coming under serious pressure. On the other hand, there will be substantial investment in distribution and logistics to support this growing market.

While the Eastern Region is in a strong position to provide above average returns to investors, the Fund team will need to continue to use its knowledge and contact base to find attractive opportunities and add value. Following a further round of fund raising in the first half of 2011, we are looking forward to our next acquisition, which will continue to generate both capital and income growth in the Fund.

William van Cutsem

DIARY DATE

PIGEON LP AGM 29 NOVEMBER 2011 at 11am at The Bedford Lodge Hotel, Newmarket, followed by lunch.
Please email k.clinton@pigeon.co.uk if you would like to attend.

INTERVIEW WITH JAMES BUXTON, PIGEON EXECUTIVE CHAIRMAN

Q. You have been busy raising funds for the Property Fund over the past few months. Why do you feel that it is the right time to invest in commercial property, bearing in mind the state of the economy and the property markets?

A. First of all, I would not be in a great hurry to invest. The market for prime property is extremely tight, with yields at very low levels.

This has raised the expectations of owners of secondary property, many of which are over-priced. However, as more property is released by the banks, there will be some excellent opportunities for cash buyers. We intend to take advantage of those opportunities for the benefit of our investors.

Q. And what do you think the prospects are for rental and capital growth over the next few years?

A. In the short term there is unlikely to be strong rental growth. However, there has been very little new development during the past 3 years, and surplus space will be taken up quickly as the economy recovers and demand increases. This will drive rents up until sufficient new space is available to satisfy demand.

Q. Are there any particular hot spots in the East of England in which you would encourage people to invest?

A. Cambridge has been an investor's favourite for many years, for obvious reasons. It is the economic hub of the East of England and this is reflected in its property market. However, there are many other locations in the East of England where there is strong demand for good

quality property. Norwich, Peterborough, Milton Keynes and Brentwood are all good places to invest, and many of the market towns such as Huntingdon, Bury St Edmunds and Colchester are also popular. The important thing is not necessarily to follow fashion, but to buy good quality property at the right price in a market that you fully understand.

Q. What are your thoughts about the East of England generally – its economy, population and prosperity over the next 10 years?

A. The East of England is expected to be the second fastest growing region in the UK, after London. This will, of course, put enormous strain on the region's infrastructure, particularly its roads and railways. The cancellation of the A14 upgrade is a great disappointment, but the long awaited dualling of the A11 from Barton Mills to Thetford will be a huge improvement.

All Local Authorities are concerned about economic growth at present, for obvious reasons. I hope that the Government's Localism Agenda will not encourage those authorities to make the wrong decisions to satisfy parochial interests at the expense of national and regional interests. In order to maintain the vitality and prosperity of the East of England, we must allow sustainable growth in the right locations. So with a substantial increase in the region's population to contend with sufficient public money must be made available to fund essential infrastructure – not only transport but also education, health and welfare.

The East of England has the potential to be enormously successful over the next few decades provided there is sufficient investment to underpin growth.

Pigeon East of England Property LP Investment Committee



James Buxton

James joined Pigeon as Executive Chairman in January 2011 after a career of 32 years at Bidwells, of which 10 years were as Senior Partner. He is a well recognised figure in the national property market having advised landowners, developers and institutions on all aspects of property development and promotion.

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William Stanton

William was appointed to the board of Savills (L&P) Ltd in 2005 where he had overall responsibility for the Eastern Region. He joined Pigeon in 2008, where he has used his extensive knowledge of the regional property market and his experience to identify opportunities and provide solutions to complex property matters.

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Richard Stanton

Richard has a wide range of business experience gained from management roles in the property, financial and agricultural sectors. Having co-founded Pigeon Holdings in 2001 Richard has managed a series of successful property transactions, creating value from both development and investment opportunities. He is responsible for the day to day management of the Pigeon business.

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William van Cutsem

William is a qualified Chartered Surveyor and was formerly a member of the Savills investment team. He is Investment Manager for the Pigeon East of England Property LP where his role is to evaluate opportunities and provide the analytical expertise to build a secure and balanced portfolio.

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Hugh Colville

Director and co-founder of evolve Fund Services Ltd in 2002. Hugh specialises in the establishment and management of collective investment schemes and provides private investors with improved access to real estate and real estate asset backed investment opportunities.

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