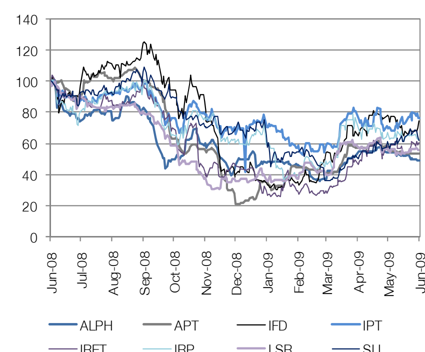
Edison investment research

Double-digit dividend yields

Property: The likely survivors from the small cap real estate sector

The real estate sector has seen a significant rally since the dark days of Q408. The stock market is starting to discount the downturn as a standard property cycle, but the significant structural issue of deleveraging remains to be addressed. Whatever the outcome, there will be survivors and, indeed, some winners. This note introduces those Edison has selected from the FTSE small cap real estate sector.



Cyclical or structural

Real estate rode up on a wave of abnormally cheap debt and while part of the correction to date is purely cyclical (with more to come), the structural need for a significant deleveraging of the sector will slow any recovery.

Necessary attributes

One certainty is that any real estate that is well managed, appropriately financed and securely let to a good covenant is once again viewed, as has been the case traditionally, as a high-quality income-focused asset.

The Magnificent Seven… plus one

The eight stocks (seven are funds, one is internally managed) covered in this report all have the necessary attributes to see their way through to the other side of the downturn while preserving equity value. The fact that the current degree of economic/business uncertainty implies that no one can be sure of the security of any one income stream supports a portfolio approach to the group.

Majority offer double-digit dividend yields

Despite a significant recovery in share prices since early March the group offers high dividend yields ranging from c 8-20%, with all expected to be covered by underlying earnings in the near future. This represents ample returns while the cyclical/structural issues are resolved.

COMPANIES FEATURED IN THIS REPORT

Alpha Pyrenees Trust Ltd (ALPH)
AXA Property Trust Ltd (APT)
Invista Foundation Property Trust Ltd (IFD)
ISIS Property Trust Ltd (IPT)
ING UK Real Estate Income Trust Ltd (IRET)
IRP Property Investments Ltd (IRP)
The Local Shopping REIT plc (LSR)
The Standard Life Investments Property Income Trust Ltd (SLI)

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Introduction: Phoenixes from the ashes

In mid 2007 at the peak of the real estate market there were over 150 listed small cap property companies on AIM and the Main market, with a combined market capitalisation of over £20bn. This has now shrunk to £6.5bn (admittedly up £2.1bn from the low point), principally through price declines as only a handful of stocks have been delisted for one reason or another. We have identified three key necessary (but not sufficient) attributes that are required to enable survival – to be well managed, have an appropriate financial structure and have a securely let portfolio.

Given the greater than 40% fall in the capital value of UK physical real estate since the peak (with more to come generally accepted as consensus), securely let property has once again become the reliable income-orientated asset class that it has been through most of history, rather than the pure capital appreciation instrument it was viewed as in the bubble. Most listed property companies exist to convert a rental income into dividends for the equity holder.

We have identified eight funds/companies, listed in Exhibit 1, that have all the necessary attributes. Most others fail on the first attribute, as we generally require a broader spread of management expertise than just one listed entity. Many then fail on the second, having breached banking covenants and/or facing imminent refinancing issues. The third requires more judgement, as in these extremely uncertain times the definition of 'securely let' has been revised repeatedly as household names have succumbed to the turmoil.

This third point argues strongly for a portfolio approach to the group and we do not attempt to rank the members of the group in any way. The purpose of the note is to screen the c 150 listed real estate stocks in the FTSE small cap and AIM universe and narrow them down to just eight companies – seven funds and one internally managed. Despite significant price performance since the lows, the group offers high dividend yields ranging from c 8-20%, which are expected to be covered by recurring earnings. We have identified the key differentiating factor of each and individual investors should tailor the selection to suit their own particularly risk/reward profile.

Exhibit 1: The magnificent seven plus one

Note: Prices as at 19 June 2009.

Fund/Company	Market cap	Price	Dividend yield	Discount to NAV	Website
	£m	p	%	%	
Alpha Pyrenees Trust (ALPH)	41.1	35.00	20.0	31.4	www.alphapyreneestrust.com
AXA Property Trust (APT)	37.0	37.75	10.6	62.3	www.axa-im.co.uk/index.cfm?pagepath=axapropertytrust
Invista Foundation Ppty Trust (IFD)	99.5	31.50	11.2	40.9	www.ifpt.co.uk
ISIS Property Trust (IPT)	55.6	73.50	10.9	13.7	www.fandc.com/new/it/Default.aspx?id=78486
ING UK Real Estate Income Trust (IRET)	103.3	31.50	12.7	50.8	www.ingreit.co.uk/
IRP Property Investments (IRP)	59.7	53.25	13.5	24.7	www.fandc.com/new/it/Default.aspx?id=78487
The Local Shopping REIT (LSR)	34.2	41.50	8.2	33.1	www.localshoppingreit.co.uk/
Standard Life Investments Property Income Trust (SLI)	47.3	45.25	8.8	13.8	uk.standardlifeinvestments.com/ifa/funds/investment_trusts/standard_life_property_income_trust_limited.html

Source: Edison Investment Research from company announcements

Real estate just cyclical or is it structural this time?

Put simply, no one knows

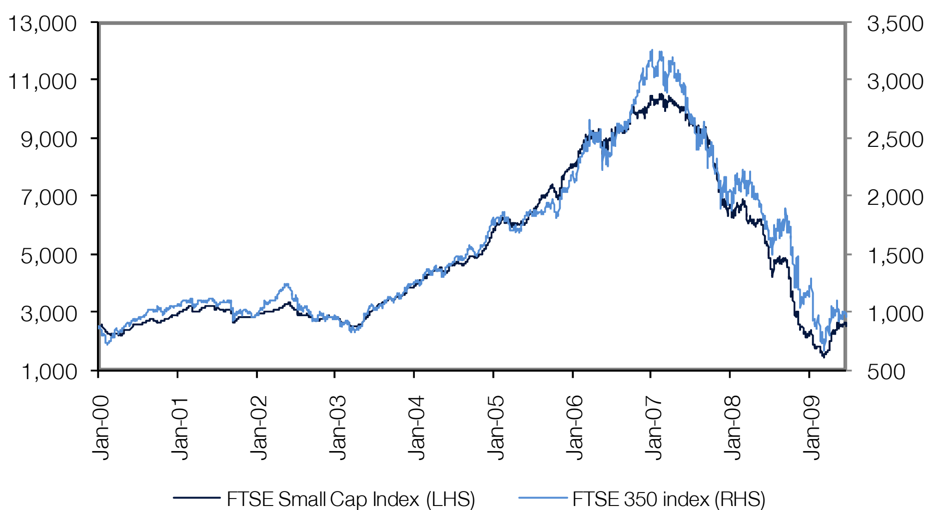
Views on the real estate sector are as divergent today as they have been since the real estate downturn began on 3 January 2007. Agent commentary, derivative pricing, IPF consensus and senior management commentary all point to continued declines in capital values over the next 18 months as phase two of the real estate cycle (rental reductions driven by economic conditions) pans out.

What is clear, however, is that the speed of adjustment (now that it has finally started – rents only peaked in Q408) is as rapid as the shift in yields was through 2008. Declines of 1% plus per month are now the norm. That said, listed real estate equities have seen a mini boom, with the FTSE 350 index rising by 53% between 9 March 2009 (1,099.19) and 7 May 2009 (1,789.70) as the recapitalisation phase (of this very small part of the industry) moved into top gear. Corporate activity in the form of IPOs (Max Property) and mergers and acquisitions (Brixton Estates following on from four bids on AIM) are another clear signal that the bulls are running again.

A cycle when size counted for nothing

If we are in a normal economic cycle then the timing would be about right for a floor to be seen sometime over the next six-to-nine months and a reasonably sharp recovery post that. Listed equity may therefore just be doing its standard job of being the best forward indicator; after all, it peaked in January 2007, well before the physical peak in Q307.

Exhibit 2: Main market real estate indices show no differentiation for size



Source: Datastream

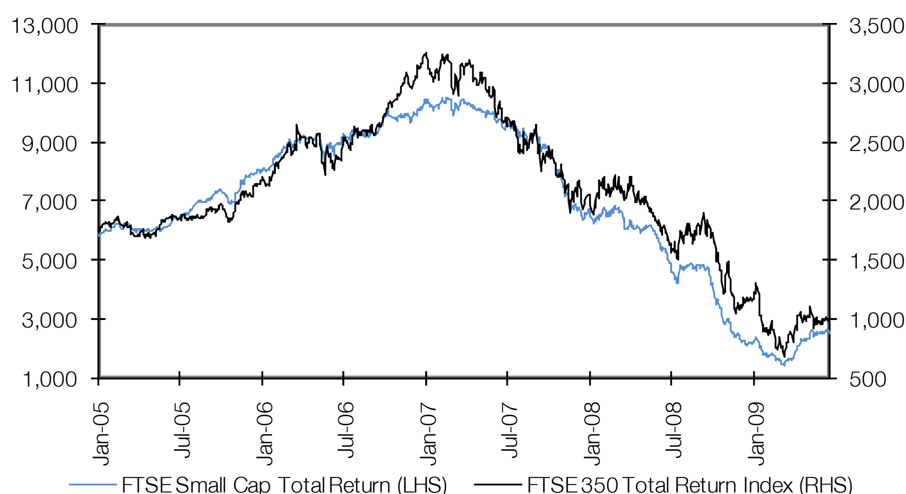
However, this ignores the ‘he who must not be named’ factor – the bank balance sheet or, more specifically, the lack of one. Commercial property lending is not a vote winner and is the clearest area for the necessary bank deleveraging to take place.

Ten years ago bank lending to the commercial property sector in the UK was £41bn. Today it is £225bn and, on the basis of derivative pricing, the value of the physical assets supporting the debt will be lower.

The quantum of equity that needs to be created (through debt for equity swaps) and/or attracted (through rights issues and new investors) dwarfs the c £4bn that has been injected into the listed sector in the UK. On top of this there is £75bn nominal value of outstanding bonds that, as things stand today, are unlikely to be reissued on expiry.

Unfortunately, every real estate market across the globe is in the same boat. Debt across Europe is estimated at £1tn. In the US, S&P is contemplating a methodology change which would downgrade 90% of commercial mortgage-backed securities (CMBS) issued in 2007, 60% of those issued in 2006 and 25% of those in 2005. This alone is a $700bn market, with bank debt on top of that taking the total to $3.2tn. Having ridden the wave up on a sea of low-priced debt, the industry may be facing a 'once in history' scale of deleveraging that would necessitate a prolonged bottom to the cycle and a much more gentle rise in capital values thereafter.

Exhibit 3: Main market real estate indices show no differentiation for size in terms of total return



Source: Datastream

The taxpayer to the rescue, so far

With no painless solution available, UK tax payers have stepped in to assume the majority of the losses through one scheme or another. While a property continues to produce income, the financing system opts for the temporary solution, ie loan to value (LTV) covenant waivers rather than foreclosure and refinancing. However, as we move through the expiry and refinancing phase (some £40bn in the UK this year), the decision becomes much more complicated for the banks and in this phase there will be casualties.

The fateful day looms

As unemployment rises so will void rates and when a property becomes empty a permanent solution must be found. This is particularly acute in the UK, where the imposition of empty building rates adds a significant cash burden on the property owner. You cannot call a bottom to the real

estate market (particularly the minority equity part of the funding) without making an assumption on the structural issue of leverage and the debt available to the industry at a price which allows a satisfactory return on equity. If the industry has to move back to a higher (some would say more realistic) cost of debt and higher levels of equity, then the downturn will be prolonged as the excesses are unwound. Having ridden the wave up on a sea of low-priced debt, the industry may be facing an unprecedented period of deleveraging.

That said, one certainty is that any real estate that is well managed, appropriately financed and securely let to a good covenant has once again become the traditional, high quality income focused asset that it has been for most of history.

The real issue is the available amount of this type of asset and how what is left obtains financing. This is particularly true in today's low interest rate environment where the alternatives have all but disappeared.

Quantitative easing and real estate

Should quantitative easing work as hoped and return liquidity and volume to debt markets then real estate would be a winner. Should quantitative easing overshoot and feed inflation then, with an inevitable lag, real estate would win again, given the rental link to inflation.

However, if quantitative easing fails and leaves government finances in tatters then all bets are off and few equities will live to tell the tale. There will be survivors in any scenario and there will be winners from most potential outcomes. This note reviews the probable survivors out of the carnage that is the FTSE small cap real estate sector, where despite the significant rally double-digit dividend yields are still available.

Necessary but not sufficient requirements

Almost all of the constituents of this group of eight stocks are externally managed funds. However, in all such cases the fund manager is a significant, broadly spread asset management company with a reputation to consider and often with a significant shareholding in the listed fund. Thus, despite the now relatively small size of the funds/companies (£40m to £100m market capitalisation) they do have access to a level of expertise well beyond the norm for that size of business.

Exhibit 4: Management and fees

Fund/Company	Management	Fee base %	Asset base	Notice period
Alpha Pyrenees Trust	Alpha Real Capital (Beckwiths)	1.00	Gross assets	1 year
AXA Property Trust	AXA Investment Management	0.90	Gross assets	1 year
Invista Foundation Property Trust	Invista Real Estate IM	0.95	Gross less current	1 year
ISIS Property Trust	F&C REIT	0.65	Gross less current	6 months
ING UK Real Estate Income Trust	ING Real Estate	0.90	Gross property assets	
IRP Property Investments	F&C REIT	0.85	Gross less current	1 year
The Local Shopping REIT	Internally managed			
Standard Life Investments Property Income Trust	Standard Life	0.75	Gross assets	1 year

Source: Edison Investment Research from company announcements

Invariably, the fund is part of a much larger property management unit involving unlisted funds and direct investment. The potential for conflicts of interest does exist, but most are operating in a steady state mode with limited acquisitions/disposals and the chance of one fund manager having more than one suitable property for a potential significant letting is very small indeed.

The fee structures are relatively homogeneous and have been trending down slowly. The link to gross assets is a positive to the P&L in a declining market, with fees falling as asset values decline while (hopefully) income has been at least maintained.

The potential non-alignment of interests (lower fund manager fees through property disposals – the so-called turkey voting for Christmas approach) has not impacted this group, as it entered the downturn with less need for realisations and, indeed, early acceptance that survival was better than the alternatives. Management quality is the main differentiating factor from the vast majority of AIM listed funds, where managing the fund is invariably the fund manager's only activity.

There will always be the exception that proves the rule, as holders of the Invesco Property Income Trust know only too well. The refusal by Invesco to support a vital capital raise in Q407 doomed the fund to failure. The recent move by one of the sector 'zombies' to cut fees (by c 40%) and move to an NAV rather than GAV linked payment structure should be agenda item number one on the next board meeting of each of these funds.

Recent development

ISIS Property Trust agrees a reduction in management fees

ISIS Property Trust's base management fee will reduce from 0.85% of total assets less current liabilities to 0.65%, retroactive to 1 April 2009. Due to the lower asset base (driven by falling values) the management fee would have fallen by c £250k in 2009 from the £1.1m paid in 2008. This change will reduce the base fee by a further £200k to less than £700k per annum from April onwards. There are also changes to the fees payable on cash holdings in the fund. Potentially offsetting this is the introduction of a performance fee. This is based on the fund's benchmark (the IPD quarterly index) and the fund will earn 20% of any return above 120% of the return generated by IPD. Clearly this means that a performance fee can be earned on falling values which seems counter intuitive, but in any circumstances the fee is capped at the level payable under the old scheme so shareholders can only benefit. The performance fee is also subject to a three-year clawback provision. The notice period has been reduced from one year to six months.

In a full year we estimate that the saving (with no performance fee) is worth 0.6p of earnings, an effective 10% uplift, which halves the shortfall in dividend cover. Cost savings are likely to be achieved in the other expenses of running the fund, leaving only a 5% increase in rental income needed to cover the dividend. This is still a tight equation, but heading in the right direction.

Appropriately funded

Simple and with a long maturity is the ideal debt financing in the current environment. The more bells and whistles that were added during the heyday of structured financing, the greater the chance that something in the small print will come back to bite you in the current financing market.

Exhibit 5: Debt and structure

Fund/Company	Gross debt £m	Average fixed rate %	Repayable	Cash £m	LTV covenant %	ICR covenant	Source
Alpha Pyrenees Trust	237.3	5.26	Feb-2015	33.5	87.5	1.10x	Barclays
AXA Property Trust	86.4	5.21	Apr-2011	21.3	50.0	N/A	Barclays
Invista Foundation Property Trust	213.5	5.62	Jul-2014	36.0	60.0	1.50x	BoS
ISIS Property Trust	40.3	5.66	Jan-2017	12.6	60.0	1.50x	Lloyds TSB
ING UK Real Estate Income Tr.	225.0	4.86	Jan-2013	20.1	60.0	1.75x	Credit Agricole
IRP Property Investments	60.0	5.66	Jan-2017	2.5	60.0	1.50x	Lloyds TSB
The Local Shopping REIT	116.0	5.69	Apr-2016	9.4	N/A	1.20x	Barclays/HSBC
Standard Life Investments Prop. Inc. Tr.	84.4	5.62	Dec-2013	33.7	55.0	N/A	RBS

Source: Edison Investment Research from company announcements

The standard financing package for a basic property company will: 1) have a term similar to the average outstanding lease; 2) be fixed rate (either directly or by the use of derivatives); 3) be in the same currency as the underlying assets on which it is secured; 4) have LTV and interest cover (ICR) covenants compatible with the strategy of the company; and 5) ideally be from a source that will still exist when refinancing comes about.

The distance from refinancing and the headroom before covenant issues are the two main reasons that this group of eight stocks has not entered the 'zombie' club – the (from an equity perspective) walking dead that still exist in listed form because it is better for the financiers to have a performing loan from a plc than to take physical control of the underlying assets.

While disclosure has improved significantly during the downturn it is still far from complete across the sector and issues with the lending or lead bank can and have had material impacts on listed propcos. Further details of debt structures and the latest management commentary are included in the appendix.

Two examples of the problems that have been caused by what seemed like eminently sensible financing decisions at the time that have come back to cause problems in these exceptional times involve currency hedging. The Matrix European Real Estate Investment Trust has a significant issue with its currency hedge position, which could trigger a cash settlement. Some European funds hedged, some did not, and no one expected the scale of currency moves we have seen. The terms of this hedge have turned it into a potentially life threatening issue. A similar hedge cost Hansteen €57.6m to close. Most of the listed sector would realise significant savings if interest rate hedging could be unwound.

Well let

The definition of being 'well let' has changed significantly as the severity of the circumstances has seen household names disappear in their droves. From an external standpoint, the amount of work required to independently verify the work done by credit agencies and other ratings bodies which determines the quality of a tenant base is well beyond the realms of possibility.

Operational management tends to rely on their findings in private discussions with tenant management. Hence, this is where the element of trust and judgement must be taken when considering an investment. There are a few numerical pointers such as length of lease to next break/expiry, but this does not protect revenue from an unexpected tenant failure resulting in a total loss. Some rent deposits and guarantees from third parties do exist and can mitigate risk in the short term.

Exhibit 6: Lease length and tenant mix

Fund/Company	Initial yield %	Annual rent £m	Gross value £m	Average lease years	Occupancy %	Tenant mix Grade A	Grade B	Grade C
Alpha Pyrenees Trust	8.20	26.2	320.9	4.6	94.0	82.0	10.0	8.0
AXA Property Trust	6.83	11.9	181.3	6.0	95.3	70.8	14.2	10.3
Invista Foundation Property Trust	7.80	25.7	442.3	8.7	96.2	N/A	N/A	N/A
ISIS Property Trust	7.40	8.4	107.5	10.3	99.8	72.8	14.4	12.8
ING UK Real Estate Income Trust	8.17	35.0	436.0	9.1	92.0	N/A	N/A	N/A
IRP Property Investments	N/A	12.0	190.4	8.3	96.7	63.5	29.2	7.3
The Local Shopping REIT	9.03	15.0	203.7	7.8	88.2	23.9	24.2	51.9
Standard Life Investments Prop. Inc. Tr.	8.00	11.0	134.0	8.3	94.9	N/A	N/A	N/A

Source: Edison Investment Research, from company announcements

Efficient management

The cost base is relatively fixed, with the largest single element (interest) fixed unless renegotiation needs to happen. Fund manager fees will reduce as asset values fall and could be cut more severely, as the market was way too generous at fund initiation; cuts of 40% have been seen where agreement is reached. Many external professional adviser (lawyers, accountants, auditors, valuers) charges can be reduced as the original contract would have been signed in the days of plenty.

There is little or no linkage between revenues and costs. Indeed the link is, if anything, inverse – the loss of revenues can result in higher costs from service charges and empty building costs.

Exhibit 7: Financials

Note: £'000s except for EPS.

Fund/Company	Alpha Pyrenees Trust	AXA Property Trust	Invista Foundation Property Trust	ISIS Property Trust	ING UK REIT	IRP Property Investments	The Local Shopping REIT	Standard Life Inv. Prop. Tr.
Yead end	Dec-08	Jun-08	Mar-08	Dec-08	Dec-08	Jun-08	Sep-08	Dec-08
Gross rental income	19,670	10,850	30,924	N/A	35,812	12,513	16,691	11,526
Service charge income	4,722	930	1,170	N/A	4,284	N/A	N/A	N/A
Property operating expenses	(6,139)	(1,687)	(1,991)	N/A	(8,311)	(384)	(2,622)	(774)
Net rental and related income	18,253	10,093	30,103	8,437	31,785	12,129	14,069	10,753
Realised loss on disposal of investments	N/A	0	551	N/A	2,524	N/A	48	(4,003)
Net foreign exchange gains/(losses)	9,154	280	N/A	N/A	N/A	N/A	N/A	N/A
Valuation losses on investment properties	(35,825)	(1,064)	(65,216)	(33,443)	(141,161)	(40,215)	(44,358)	(39,982)
Gain/(loss) on derivatives	(46,820)	251	N/A	N/A	(19,677)	N/A	(1,347)	N/A
Investment management fees	(3,459)	(1,728)	(6,600)	(1,117)	(5,345)	(1,769)	N/A	(1,486)
Administrative expenses	(1,456)	(1,830)	(2,642)	(717)	(2,667)	(580)	(2,774)	(415)
Total expenses	(4,915)	(3,558)	(9,242)	(1,834)	(8,012)	(2,349)	(2,774)	(1,900)
Other income (Costs)	N/A	138	N/A	N/A	5,522	N/A	(113)	N/A
Net operating profit	(60,153)	6,140	(43,804)	(26,840)	(129,019)	(30,435)	(34,475)	(35,132)
Interest income	1,262	945	2,479	799	2,663	318	540	2,315
Finance costs	(10,818)	(3,224)	(14,767)	(2,366)	(14,059)	(3,508)	(6,535)	(5,451)
Associates and joint ventures	N/A	N/A	(32,842)	N/A	N/A	N/A	N/A	N/A
Loss on sale of associate	N/A	N/A	(649)	N/A	N/A	N/A	N/A	N/A
Profit before tax	(69,709)	3,861	(89,583)	(28,407)	(140,415)	(33,625)	(40,470)	(38,269)
Income tax expense	5,623	(35)	233	(223)	0	0	0	0
Profit for the year	(64,086)	3,826	(89,350)	(28,630)	(140,415)	(33,625)	(40,470)	(38,269)
Earnings per ordinary share (p)	(54.37)	3.83	(25.30)	(37.85)	(42.50)	(30.43)	(44.46)	(36.80)
Average Number of shares	117.9	100.0	353.1	75.7	330.4	110.5	91.0	104.0
Underlying earnings	4,727	4,394	8,157	4,813	17,899	6,590	5,056	5,716
Underlying EPS (p)	4.01	4.39	2.31	6.36	5.42	5.96	5.55	5.50
Operating costs as a % of net rental income	27	35	31	22	25	19	20	18

Source: Edison Investment Research from company announcements

Meaningful financial analysis is obscured by varying presentation, despite the accountancy profession's best efforts to standardise it. Those with the greatest scope to cut controllable costs are clear from the final line of Exhibit 7, operating costs as a percentage of net rental income.

Net asset values

At the height of the crisis last autumn the whole small cap sector had been written off by investors with almost all share prices looking like option money on the slight possibility that some of the banks might survive and the debt remain in place. The 'dash for trash' that followed has seen some remarkable share price moves and more normal valuation measures now have some relevance.

Exhibit 8: Low share prices discount to NAV and yield

Note: Prices as at 19 June 2009.

Fund/Company	52 week low p	Increase %	From/At Low Dividend yield %	Discount to NAV %	Major shareholder	Holding %
Alpha Pyrenees Trust	24.50	43.0	29.0	54.0	Invesco	18.9
AXA Property Trust	14.50	160.0	28.0	86.0	HSBC Noms	34.2
Invista Foundation Property Trust	11.25	180.0	31.0	79.0	Cazenove	12.9
ISIS Property Trust	40.50	81.0	20.0	52.0	Friends Provident	16.3
ING UK Real Estate Income Trust	13.25	138.0	30.0	79.0	ING	18.6
IRP Property Investments	30.25	76.0	24.0	57.0	Friends Provident	18.3
The Local Shopping REIT	22.50	84.0	17.0	64.0	Schroders	16.0
Standard Life Investments Property Income Trust	24.00	89.0	17.0	54.0	Standard Life	20.9

Source: Edison Investment Research, from company announcements

Dividends

The dividend policy across the group, as a generality, is to pay out all recurring earnings. This has usually proved to be significantly less than originally anticipated, as costs have proven to be higher than expected – particularly the day-to-day operating costs.

That said, dividend policies have been reset for all and are now based on management's up to date view of the earnings capacity of the portfolio with the only significant risk to this being the loss of a significant tenant.

Exhibit 9: Current valuations – NAV and dividend

Note: Prices as at 19 June 2009.

Fund/Company	Price p	NAV p	Date	Discount %	Dividend p	Equity yield %	Underlying EPS p	Dividend cover x
Alpha Pyrenees Trust	35.0	53.1	31-Dec-08	34.1	7.0	20.0	4.0	0.6
AXA Property Trust	37.8	100.2	31-Dec-08	62.3	4.0	10.6	5.2	1.3
Invista Foundation Property Trust	31.5	53.3	31-Mar-09	40.9	3.5	11.2	3.0	0.9
ISIS Property Trust	73.5	85.2	31-Dec-08	13.7	8.0	10.9	6.4	0.8
ING UK Real Estate Income Trust	31.5	64.0	31-Dec-08	50.8	4.0	12.7	5.4	1.4
IRP Property Investments	53.3	70.7	31-Mar-09	24.7	7.2	13.5	5.9	0.8
The Local Shopping REIT	41.5	62.0	31-Mar-09	33.1	3.4	8.2	3.4	1.0
Standard Life Investments Prop. Inc. Tr.	45.3	52.5	31-Mar-09	13.8	4.0	8.8	5.5	1.4

Source: Edison Investment Research, from company announcements

Investment conclusion

The group of eight stocks covered in this report has the necessary conditions that will enable some equity value to be at least preserved through the remainder of the crisis, with the one proviso – no one can be certain of the security of the revenue stream.

With the sector having been largely written off during Q408, this group has emerged as probable survivors, with valuations driven more by dividend yield than NAV. We would argue for a portfolio approach, in view of a combination of a high degree of uncertainty over tenant security (and thus income) and a fixed cost base. It may not be practical to invest in all components of the group, but the selection for individual investors will be driven by the specific risk/reward profile.

The depths of the crisis opened up once in a generation opportunities for capital appreciation in the small cap property area. If the cyclical trough is in sight then the income offered by this group collectively more than offsets the risk of single tenant default in one of the group.

There remains clear potential for re-rating beyond that as capital values and NAVs gain while economic recovery eventually brings through rental (and hence dividend) growth. If the property downturn has necessitated a structural shift in the industry, we nonetheless expect most, if not all, of this group to see their way through to the other side of the economic recession and continue to pay a level of income that more than compensates for the risk.

Company comments

This section of individual company comments is not exhaustive. It is designed to pick out the key differentiating factors to allow a judgement on relative risk as compared to an individual investor's criteria.

Alpha Pyrenees – Dividend security

Alpha Pyrenees' relatively low level of underlying cover is a function of the stage of maturity of the rental stream. All rents across the portfolio are indexed in some way, most specifically in France (89% of the portfolio) where they are linked to INSEE Construction Cost Index. In 2008 the average indexation was 5.1%, with this accelerating to 8.2% (for 59% of the portfolio in Q109). This combined with new lettings and developments in 2008 plus currency moves will drive revenue growth in 2009 and, in a geared way, profits growth. One noticeable vacancy exists in the portfolio (office space at St Cyr L'Ecole – c £1m of rent) which may well be the determinant of whether the dividend is covered in 2009 or not. Management intention, confirmed by the payment of the Q1 dividend at the 7p annualised rate, is that the dividend will be paid.

The fund is the highest geared in the group but has commensurate covenants with substantial cash holdings. If the Cyr L'Ecole property is let this year and the dividend covered then the stock offers significant capital upside and the best income yield of the group.

AXA Property Trust – Shortest financing package

AXA Property Trust is the only member of the group with a refinancing need even vaguely in sight – April 2011 with Credit Agricole its lender. However, with the lowest gearing and covenants in the group of eight stocks, this should not be a significant issue.

Indexation in France is again driving the income line and improving cover so the likely increase in margins (if not offset by the low underlying rates currently available in the market) can be absorbed. The most recent quarterly dividend (May 2009) came with a confirmation that it remains covered by profits and cash flow. The high discount to NAV should be viewed relative to the very low comparative portfolio yield at 6.83% with dividends being the primary valuation driver.

Invista Foundation Property Trust – Income growth potential

The Invista Foundation Property Trust's portfolio is entirely UK-based, which will restrict the potential for revenue growth, while the recent disposals to generate headroom are income dilutive. That said, this must be the favourite in the group to achieve significant investment management fee reductions after its sister fund (Invista European Real Estate Trust) volunteered a 40% reduction recently.

Management hopes that the dividend will be covered in the current financial year (to June 2008) and the regular quarterly dividends have, thus far, been paid. This is one of the largest portfolios in the group and overall it sits somewhere close to the median on most measurable factors.

ISIS Property Trust – The smallest in the group

With the portfolio now valued at c £100m it is almost half the size of the next smallest in the group. Debt is also commensurately low and hence its ability to survive is not an issue. However, if and when recovery starts, the upside will be limited as the above profile has translated into the lowest discount to last reported NAV. Despite its size the fund is the most efficiently run of the group of eight, hence the high dividend payout relative to rental income.

ING UK Real Estate Trust – Other operating income

The ING UK Real Estate Trust has historically targeted properties with the potential for regearing leases and/or replacing tenants. This has resulted in significant and regular other income such as surrender and reverse premiums. This source of income is likely to dry up in the current environment hence dividend cover will reduce but the dividend has been reset (to 1p per quarter, 4p annually) to take account of this and would almost have been covered in the year to December 2008 by earnings excluding other income.

IRP Property Investments – Dividend security

IRP Property Investments is the sister fund to the ISIS Property Trust and is slightly less mature. The key issue is the security of the dividend, which remains uncovered by underlying earnings. Income growth looks difficult to achieve other than through further income enhancing acquisitions which, while probable at some point, is unlikely for now. The 20% gap that needs closing at some stage is not that significant given the length of the debt package.

The Local Shopping REIT – Dividend policy

The Local Shopping REIT is the only internally managed member of the group and it has an entirely different property portfolio. In terms of security of income, the company utilises the law of averages. With 627 properties and 1,991 letting units with an average value of £160,000, and the largest tenant covering 0.9% of the rent, it would require a systemic failure of multiple local high streets for the revenue stream to face serious damage beyond current expectations.

The issue is the dividend policy, which pays out 100% of recurring earnings leaving the payout somewhat dependent on very short-term factors. Having paid 1.7p against 2.1p of recurring earnings at the interim stage, the full-year payout looks certain to be at least 3.4p (maintaining the dividend level at the final stage implying 1.3p of earnings) and possibly 4.2p (maintained earnings and full payout). Either extreme looks unlikely with the midpoint (2.1p of dividend off 1.7p of earnings) being the most sensible forecast in the current market conditions. This leaves the dividend yield just short of 10%.

Standard Life Investment Property Income Trust – Dividend yield

After a recent late rally, Standard Life Investment Property Income Trust's dividend yield has slipped below 9%. However, the high dividend cover, cash levels and willingness to acquire (as demonstrated recently) imply that this is the one most likely to be the first to increase its dividend.

Honourable mentions – UKCM and F&C CPT

Not included in this analysis but worthy of an honourable mention are two of the largest 10 listed stocks in the sector. They are the UK Commercial Property Trust (managed by Ignis) and the F&C Commercial Property Trust (managed by F&C REIT, which also manages the ISIS and IRP trusts). Both meet the necessary criteria and have dividend yields of 8%. The additional size and liquidity may be preferable to some investors.

Appendix: Debt commentary

Management commentary on debt – Alpha Pyrenees Trust

2008 Annual Report

Uncertainty in financial markets and the downward trend in property valuations has focused greater attention on leverage within property companies and the Trust maintains a conservative position in this regard with net leverage of 66.6% (taking into account cash of £23.5m). The Trust has total borrowings of £237.3m (€243.7m) and net borrowings of £213.8m after taking into account cash as at 31 December 2008 under its facilities with Barclays Bank Plc.

The Trust continues to place great emphasis on the security of its financing, the key features of which are:

- Long term maturities
  - French facility (91% of debt) matures in 2015; and
  - Spanish facility (9% of debt) matures in 2013.
- All interest rates are fixed to maturity at a weighted average rate of 5.26% per annum.
- Next loan to value testing dates
  - February 2012 for the French facility (with the exception of the Alcatel-Lucent property which is tested annually in February); and
  - February 2010 for the Spanish facility.
- Loan to value of mortgaged property at testing date should not exceed 87.5% on a country portfolio basis; with the exception of the Alcatel-Lucent property where it should not exceed 85%.

Interest cover ratio (ICR) should not fall below 110% – weighted average ICR over the year to 31 December 2008 was 179%. The Trust holds £23.5m of cash at 31 December 2008, providing it with financial resources to take advantage of opportunities as they arise. The Trust has additional flexibility as it holds un-mortgaged properties with a value of £16.4m (€16.9m).

Currency hedge instruments are in place that significantly protect the conversion of the shareholders' original equity back to Sterling together with the anticipated dividend on that equity.

Management commentary on debt – AXA Property Trust

Interim Management Statement May 2009

Exhibit 10: Loan facilities – loan to value covenants

Gross loan to value	31 Dec 2008 %	31 Mar 2009 %	Maximum %
Main loan facility covenant	47.0	48.6	50.0
Joint venture Property Trust Agnadello S.r.l.	55.1	56.3	65.0
Consortium investment Porto Kali	68.9	69.8	65.0

Source: Company announcements

Under the terms of the Company's main loan facility, the maximum permitted Gross Loan to Value (LTV) is 50%. At 31 March 2009 the Gross LTV was 48.6%. Gross LTV is calculated as debt over property portfolio at fair value.

A decrease in the Company's property valuations as at 31 March 2009 of over 2.9% would result in a breach of the Gross LTV covenant. As further downward valuations are anticipated, the Investment Manager is continuing its review of the management of the debt position which includes ongoing discussions with its lenders.

The Company and its subsidiaries held total cash of GBP21.27 million (EUR 22.96 million) at 31 March 2009, giving a Net LTV of 35.7% (34.4% at 31 December 2008). Net LTV is calculated as debt net of cash over property portfolio at fair value. Details are included for information purposes; it does not form part of the loan covenants.

The GBP21.27 million cash held by the Company at 31 March 2009 has been allocated between working capital and uncommitted capital expenditure of up to GBP13.0 million, principally to develop the Company's retail asset in Fuerth, Germany. The Fuerth capital expenditure is subject to Board approval of the final terms of the development and the Company's debt position. GBP13.0 million (EUR 14.0 million) cash has been invested in fixed term deposits which will be realised as required for the capital expenditure programme. If the cash allocated to uncommitted capital expenditure were utilised to repay part of the bank debt, property valuations could decline by over 19% before breaching the Gross LTV covenant.

The Company's loans with Calyon are fully hedged at an average rate of 5.21% via interest rate swaps and caps to April 2011 when the loan facility expires. Under the terms of the Porto Kali consortium investment's loan facility, the maximum permitted Gross Loan to Value (LTV) is 65.0%. The LTV maximum was breached at 31 December 2008 and at 31 March 2009 the Gross LTV was 69.8%. Discussions with the lender HSH are in progress. The business plan strategy is under review.

Exhibit 11: Loan facilities – interest cover covenants

Interest Cover Ratio at 31 March 2009	Historic %	Minimum %	Projected %	Gross rental income headroom %
Main loan facility covenant	294.8	250.0	313.5	20.3
Joint venture Property Trust Agnadello S.r.l.	268.6	125.0	274.4	54.4
Consortium investment Porto Kali	180.0	120.0	267.0	26.2

Source: Company announcements

Interest Cover Ratio is calculated as net financing expense payable as a percentage of gross rental income less movement in arrears.

Management commentary on debt – Invista Foundation Property Trust

Interim Management Statement April 2009

The group has two interest rate swaps that fully hedge the group's interest payments for the duration of the principal securitised loan term that matures in July 2014. Details of the two swaps are set out in the table below:

Exhibit 12: Loan facilities – interest rate hedges

	Amount £m	Fixed rate %	Expiry	Mark-to-Market 31 Mar 2009 £m	Mark-to-Market 31 Dec 2008 £m
First	102.5	5.10	15/07/2014	(11.70)	(10.65)
Second	111.0	5.71	15/07/2016	(19.13)	(18.90)
Total	213.5	5.42		(30.83)	(29.55)

Source: Company announcements

As at 31 March 2009 the group had securitised on-balance sheet debt of £213.5m at a total cost of funds, including a margin of 20 basis points, of 5.62%. The loan to value ratio covenant is 60%. Adopting the 31 March 2009 valuation and on completion of contracted disposals the company has cash of approximately £84.1m and a loan to value ratio, net of all cash, of 42.33%.

Interim Results November 2008

Finance

As at 30 September the company had £263.5m of on-balance sheet securitised debt fully hedged against interest rate movements until 2014 at a total cost of funds of 5.58% per annum. As part of the strategic review, £50m of this debt was repaid on 15 October 2008, leaving total on-balance sheet debt of £213.5m. To optimise the efficiency of the debt repayment the marginally more expensive 'AA' notes were repaid in full with the balance of the repayment directed towards the 'AAA' notes.

As part of repaying the debt an equivalent amount of the interest rate swap was broken. Due to the fall in interest rates between July and October, the company incurred a £915,000 break cost in addition to the £50m debt repayment. The blended swap rate following the repayment is 5.42% resulting in a total interest rate of 5.62%. This reduces the annual interest rate payment from £14.7m to £12.0m per annum.

Following the debt repayment the company has a loan to value ('LTV') ratio in the securitised debt facility of 46% compared with a LTV ratio covenant of 60%. In addition to the assets in the securitised debt facility the company has uncharged free cash of £36m which results in a LTV ratio, net of all cash, of 37.5%. The other key banking covenant is the interest cover ratio ('ICR'), expressed as a percentage of total annual rent over total annual interest. Following the debt repayment the Company had an ICR of 225% compared with an ICR covenant of 150%.

Joint ventures

Market conditions have negatively affected the group's three joint venture investments, which are financed by separate non-recourse, off-balance sheet debt. The Manager is pro-actively seeking to renegotiate banking terms to preserve value for the group while in each case the loans are being fully serviced from rent.

In July 2008 the company announced that it had taken a full provision against the net asset value of the group's 28.19% interest in the joint venture that owns the City of London office building Plantation Place, EC3. There are ongoing discussions regarding a LTV ratio covenant breach affecting the securitised debt facility secured against the property.

The group's two other joint ventures, Crendon Industrial Partnership Limited and Merchant Property Unit Trust, are also subject to LTV covenant breaches and negotiations in both cases for removal or waiver of their covenants are ongoing. Following reductions in property values, these two investments are held at a carrying value of nil.

Liquidity

Following the disposal of the Bolton property and the repayment of the debt the company will have £15.32m of cash in the securitised debt facility. The company will also have £36.34m of free cash outside of the securitised debt facility.

Management commentary on debt – ISIS Property Trust

Annual Results May 2009

Borrowings

The company is in a strong financial position with a long term facility of £50m available until 2017. Of this facility, £40m has been drawn down to date and, as at 31 December 2008, the loan to value ratio ('LTV') was 22.0 per cent, net of current assets and liabilities of £11m. This is comfortably within the LTV restriction of 60 per cent. The other important covenant is the amount by which rental income covers interest, with a minimum restriction of 150 per cent. As at 31 December 2008 the interest rate cover was 266 per cent, providing significant excess capacity.

The interest rate on the £40m loan has been fixed with an interest rate swap at 5.655 per cent. The valuation of the swap has turned significantly negative as interest rates have fallen, with a liability being shown on the balance sheet as at 31 December 2008 of £5.4m. This valuation is a fall of £5.1m since 31 December 2007 and reduced the NAV by 6.8p per share for the year. This liability will reduce as the loan facility gets closer to its expiry date in 2017 and as interest rates increase from their current very low levels.

In the current environment, where new finance is proving difficult to achieve and re-financing extremely expensive, the company is well placed, with a loan facility which extends to 2017 at a margin of 50 bps, reducing to 45bps next year and with £10m of the facility un-drawn and available on the same terms.

Management commentary on debt – ING UK Real Estate Income Trust

Interim Management Statement May 2009

The main focus of the company over the quarter has been on the proposed restructuring of the Securitised Loan Facility which was approved by Noteholders on the 15th May. The principal amendments include a relaxation of the LTV Covenant from 50% to 60% and a tightening of the interest cover ratio from 1.5 times to 1.75 times. Furthermore, the company will pre-pay £ 35m of the loan by January 2010. These changes have been achieved without increased margin costs.

Annual Results Statement April 2009

Debt

The group has issued a total of £225m of AAA rated loan notes in the debt market, with interest payable on the initial £200m at 4.795% and the further £25m at 5.3804%, both fixed by way of interest rate swaps. These loan notes are repayable on 31 January 2013.

The group also had a loan from JP Morgan with a balance outstanding of £82m at 31 December 2007. This loan was repaid in full during the year, as part of a strategy to reduce the overall level and cost of debt.

At 31 December 2008, and following this repayment, the weighted average cost of debt was 4.86%, excluding loan arrangement costs, compared to 5.16% at 31 December 2007.

On 17 April 2009 the group announced it had breached the loan to value ("LTV") covenant on its securitised loan facility. The covenant states that the LTV of the property portfolio must not exceed 50%. At the reporting date the loan to value was 53.4%.

The loan documents allow for a 30 day remedy period from the date of breach of a covenant. The Board has a number of initiatives in place in an effort to remedy the breach within this period. A number of measures are being taken, as detailed below.

A meeting of Noteholders is scheduled for 12 May, where the following measures have been proposed:

- Increase the LTV covenant from 50 per cent to 60 per cent until January 2012, when it will reduce to 55 per cent, falling back to 50 per cent in July 2012;
- Increase the interest cover ratio from 1.5 times to 1.75 times until maturity of the Securitised Loan Facility in January 2013;
- Reduce the group's flexibility to make non-core investments, residential investments and undertake developments or major upgrade projects within the Securitised Loan Facility;
- Remove the group's ability to hold any additional indirect property investments within the Securitised Loan Facility for the purpose of the various financial covenants; and
- Reduce by up to £35m the principal amount outstanding under the £225m Facility by January 2010 through one or more tender offers for an equivalent principal amount of related secured notes, with the first tender offer being held in July 2009 for a minimum of £15m principal amount of notes:
  - the group intends to offer to purchase up to £35m of the outstanding notes by way of a 'modified Dutch auction' tender offer, with the first tender offer expected to close in July 2009. If the first tender offer is for less than £35m of notes, further tender offers will be held on a

quarterly basis until the company has offered to purchase at least £35m of notes; and

- the group intends that only Noteholders that vote in favour of the re-structuring proposals will be eligible to participate in the proposed tender or tenders should the proposals be approved by Noteholders at the meeting to be held on 12 May 2009.

If, after 30 days, this breach is not remedied, a Borrower Event of Default will occur under the Facility. This will result in, inter alia, restrictions immediately being imposed on the group's ability to utilise the cash balances held within the Facility structure from which the company makes dividend payments and finances some of its ordinary activities. If the breach is remedied at any time, these cash restrictions come to an end. Following a Borrower Event of Default, the Borrower Security Trustee has the right to take such actions necessary to protect the security granted over the assets, on behalf of the lender under the securitised loan facility.

The group's Investment Manager continues to seek to make further asset sales and several properties are currently under offer. Taken together with the group's cash balances outside of the Facility structure, should completion of approximately £9m of such sales occur before the expiry of the 30 day remedy period, the breach of the loan to value covenant would be remedied and no event of default would occur.

Whilst the group remains in breach of the Facility's LTV covenant or utilises cash resources held outside the Facility structure to remedy the LTV covenant breach, the Board does not expect to pay dividends to shareholders.

The bank accounts of the holding company would not be affected, therefore all other costs of running the business would be met from cash held in bank accounts outside the securitisation structure. The Investment Manager has prepared forecasts of this eventuality, and the group has sufficient funds to operate for the foreseeable future on this basis.

We believe that the implementation of the amendments to the Securitised Loan Facility, if approved by the Noteholders, together with the activities already undertaken, will both remedy the breach and strengthen the group's ability to withstand market conditions. The changes would therefore remove the ability of the group to purchase any indirect property investments within the securitisation structure, however the group would retain the ability to acquire these types of assets outside this structure.

Management commentary on debt – IRP Property Investments

Interim Management Statement April 2009

The cash proceeds from this sale reduced the net borrowings of the company to approximately £44.0m, giving a Loan to Value ('LTV') percentage of 30.6% as at 31 March 2009, compared with an LTV of 38.1% as at 31 December 2008, comfortably within the LTV restriction of 60%.The other important covenant is the amount by which rental income covers interest, with a minimum restriction of 150%. As at 31 March 2009 the interest rate cover was 245%, providing significant excess capacity.

Interim Results Statement February 2009

Borrowings

The company is in a relatively strong financial position with a long term facility of £75m available until 2017. £60m of this facility has been drawn down to date and, as at 31 December 2008, the loan to value ratio ('LTV') was 38.1per cent, net of current assets and liabilities of £525,000. This is comfortably within the LTV restriction of 60 per cent. The other significant covenant is the amount by which rental income covers interest, with a minimum restriction of 150 per cent. As at 31 December the interest rate cover was 255 per cent, providing significant headroom.

The interest rate on the £60m loan has been fixed with an interest rate swap at 5.655 per cent. The valuation of the swap has been significantly reduced as interest rates have fallen, with a liability being shown on the balance sheet as at 31 December of £8.1m. This liability will reduce as the contract gets closer to its expiry date in 2017 and as interest rate swaps increase from their current very low levels.

Management commentary on debt – Standard Life Investment Property Income Trust

Interim Management Statement April 2009

Cash position

As at 31 March 2009 the company had borrowings of £84.4m and a cash position of £44.7m (excluding rent deposits) therefore cash as a percentage of debt was 53.0%.

Loan to value ratio

As at 31 March 2009 the loan to value ratio was 38.5% – calculated as borrowings less the full cash balance (excluding tenant deposits and adjusted for expected loan break costs) as a percentage of the open market value of the investment property. Under the terms of the company's loan agreement, loan to value is calculated as borrowings over secured assets. The company is entitled to place deposits with its lender which then qualify as secured assets. As at 31 March 2009 the company's loan to value percentage calculated using this method was 55% and the covenant level is also 55%. As at 31 March 2009 the value of the company's Investment property could fall by 30% before the company would be unable to comply with its loan covenant (prior to taking account of the purchase which completed on 1 April 2009).

Annual Results Statement Mar 2009

Loan to Value Ratio

The company was in compliance with its banking covenants as at 31 December 2008 and the Board is confident that this should continue to be the case for 2009. The company is able to manage compliance with its loan to value covenant by either placing cash deposits with the company's lender (The Royal Bank of Scotland plc) in order to increase gross secured assets or by using cash to repay a portion of the borrowings. If the company was to use all its uncommitted cash resources to repay bank borrowings then the market value of its investment properties would need to fall by more than 25% before it would be unable to comply with its loan to value covenant. The Investment Manager remains in regular contact with the company's bankers in light of events in the banking sector. The company's borrowing facilities do not mature until 2013 which leaves the company well placed given the lack of credit available in the banking sector. As a reminder to shareholders £72m of the company's borrowings are at a fixed rate of interest until 2013 and the rate on the remaining £12.4m varies with LIBOR plus a margin. Currently the rate payable on the £12.4m is 2.0% and this is being rolled over monthly. The fixed rate was negotiated down by 0.1% to 5.015% plus a margin of 60 bps, equating to an annual saving of £72,000 (applicable from 1 January 2009).

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