

Hardman & Co

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British Country Inns A Successful First Year

4 June 2007

- Unquoted freehold pub EIS Specialist British Country Inns has launched a fourth and probably final version of its investment scheme ahead of the restrictions to be placed on new EIS schemes from July. The latest scheme will specialise in freehold pubs in the Wales and Welsh Border area.
- The three previous schemes launched, British Country Inns Mk. 1, 2 and 3, have between them purchased 13 pubs and have instructed solicitors on two more.
- Pub purchases and turnover have been better than we expected. Costs have been higher as well, however.
- A revaluation has shown better than expected growth in the underlying pub values over the year. The valuation shows that investors are over 7% up in the first year, after recouping all the initial start up expenses of the scheme.
- The smoking ban will be a non-event for British Country Inns. As pubs have been refurbished smoking bans have been introduced ahead of the legislation. Any hit on trading has already been taken.

BCI 4 Issue Price: 100p

Closing Date: June 29 2007

Maximum Size: £8m

Expected Gearing: Maximum 30% on Total Assets, or 30% on shareholder investment

Sponsor and Promoter: Smith & Williamson

Sales Contact: Christian Elmes,
0207 131 4324

Surveyors and Valuers: HLL
Humberts Leisure and Christie & Co

Auditors: Saffery Champness

PR: -

Website: -

Previous Research Note: 27
September 2006, 'Second Round at
British Country Inns'

Analysts: Roger
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Background

British Country Inns was launched as an EIS, qualifying company in April 2006 in order to buy traditional, food-led freehold and long leasehold pubs in the South of England. The management of the new company is headed by Tim Udell and Peter Mathews, previously Chief Executive and Operations Director respectively of English Country Inns, a very successful EIS pub business originally promoted by Close Brothers. English Country Inns was sold to Wolverhampton & Dudley in 2005 giving shareholders a 28% return on investment over four years ignoring tax benefits, and a return of close to 60% if tax benefits are factored in.

BCI's first round of funding raised £7.5m and invested in pubs in the South of England, in a broad swathe from Colchester in Essex to Andover and Lymington in Hampshire.

Rather than initiate a second round of fundraising, which would have entailed a very early valuation of the estate at the time and a tight cap on the size of the issue, management opted to raise additional funds through a separate company, British Country Inns 2. This company maintained a geographical focus in the South and South West of England. A third company, British Country Inns 3, was formed to invest in pubs in the West Midlands

Because of a change in the EIS regulations from early July that will very much limit their attractions, the current, fourth offering under the British Country Inns label therefore will be the final one. The issue will close on June 29, or earlier if fully subscribed by then.

The management team for BCI 4 is the same as for the previous ones, and the sponsor is once again Smith & Williamson. The scheme's terms once again appear reasonable.

One of the issues with EIS schemes from the investor's point of view is that an otherwise successful investment concept at the gross level can lose much of its value through the deduction of fees to promoters and incentives to management. This has not been the case in the British Country Inns series. In fact it has been the reverse. As the series of companies has rolled out, collecting far more investment money than was originally expected, the directors have cut back their level of fees per company, passing some savings on to outside investors.

BCI 1 – The Performance To Date

British Country Inns PLC, the first of the series and 'BCI 1' for the purpose of easy identification, has released its Annual Report for its first year of operation. The report covers the year to end-January 2007. The company was launched in February 2006 but did not receive funds from the share issue until April and only made its first pub acquisition on April 28 2006.

By the year end it has purchased eight pubs (seven freehold and one long leasehold) at a total cost of £6.26m. Extensive refurbishment work was carried out at four of the pubs, and less serious work at one other. These necessitated extensive closures, so instead of the 416 weeks of trading that was theoretically possible, the pubs were open for only 204 weeks during the year.

We had expected extensive closures for upgrading and refurbishment, and our forecasts a year ago assumed 205 weeks of trading for the first year, so the group has effectively opened and traded pubs right on our target. The Operating Margin came in slightly lower than our scenario. Higher than expected administrative charges meant that the net loss for shareholders was a disappointment.

Y/e January 2007	Hardman Original Forecast	Actual Outcome
Pubs at end Year	8	8
Pub Weeks Traded	205	204
Turnover per Unit	7,800	8,484
Turnover	1,599,000	1,730,723
Gross Margin	8%	6%
Abort Fees & Redundancy	0	65,000
Head Office Costs	110,417	256,280
Management Fees	139,583	158,372
Interest Income	75,000	101,309
Net Loss	-47,080	-276,150
Net Loss as % of Turnover	2.9%	16.0%
Net Value to Investors per £100 of Investment	£85.30	£107.20

In terms of assets, however, the situation is very much more positive.

By end-January, BCI 1 had invested £6.2m, £5.3m of it in freehold buildings, £0.2m in a long leasehold and £0.7m in fixtures, fittings and equipment following the refurbishments. At end-January 2007, an independent valuation by HLL Humberts Leisure put the value of these at £6.9m, an 11% uplift

This is before application of a Lotting Premium. The Lotting Premium was always central to the BCI investment philosophy – a group of pubs together is worth more than the sum of its parts because larger pub groups will pay extra to be able to acquire a ready-made portfolio. Even with a portfolio of only eight units, a case can be made for applying lotting premium.

If this Lotting Premium is taken (and HLL Humberts Leisure believe it should be) the value rises to £7.5m, for a 21% uplift.

In our original calculations we had assumed a lotting premium of 12.5%, but only from the third year of operation.

It must be stressed that for all practical purposes this is less than a full twelve months. On an annualised basis the performance would be even better.

The company also had £0.45m of net current assets (almost entirely cash in hand awaiting further investment) so shareholders' funds, including pubs at valuation, amounted to £7.95m, or 107p/share.

Our original calculations had shown only 85p/share of n.a.v at the end of the first year. BCI 1 is therefore running well ahead of our original asset and total return estimates.

This slightly overstates the position for ordinary shareholders because of the likely application of management incentives at the end of the vehicle's

life, but even so we find it encouraging. Even after absorbing all issuing costs and intermediaries' fees, investors have shown a 7% capital gain. Future years will not bear these one-off costs; From the current financial year onwards the vast majority of the closures for refurbishment will have taken place. From the second half of 2007 the business will also start to benefit from the gearing effect of using some borrowed money against the freehold properties, rather than having a wad of near-dead cash stuck in the portfolio earning a low rate of interest. The portents for 2007 and beyond, assuming the pub marketplace generally holds up, look good.

Prospects

The latest Annual Report from valuers Christie & Co says that 'the creation of REITS, together with the volume of funds available from lenders and the insatiable appetite of investors, should guarantee another strong year for the business property market'. Last year pub prices increased by 8.5%. This follows increases of 6%, 9% and 5% in the preceding three years. The prices of restaurants (an important measure for BCI because its pubs are food led) also showed a strong upward trend.

For the current year, Christie & Co. says that 'the ongoing shortage of quality freehold properties has driven further price increases as pub companies, brewers and private individuals fight to acquire them. . . The quantity and quality of freehold units coming onto the market has also deteriorated.'

Further asset value increases, therefore, appear to be almost certain short term. The BCI management's biggest challenge, for all its schemes, will be to find enough properties of sufficient quality and sufficient earning potential to invest the portfolio fully. We suspect that will mean further purchases of units in need of refurbishment/renovation/market repositioning.

The British County Inns Group of Companies						
Name	Geographical Area	Launch Date	Fist Unit Purchased	Amount Raised	Amount Invested	No. of Units
				£m	£m	
British Country Inns	S.E./Southern England	Apr-06	Apr-06	£7.5m	£6.2m	9*
British Country Inns 2	S.W./Southern England	Jan-07	Nov-06	£7.8m	£2.5m	3
British Country Inns 3	West Midlands	Apr-07	Mar-07	£7.8m	£0.9m	1
British Country Inns 4	Wales/Welsh Borders	Jun-07	?	?	?	0
Totals Under Management				£23.1m	£9.6m	13
* One unit purchased since year end						

BCI 4

BCI 4 will follow the same strategy as BCIs 1, 2 and 3, in that it will buy existing pubs located in character buildings, preferably with gardens, and they will be a food led operations. They will be either freehold or long leasehold, and will be 'destination pubs' rather than local boozers. The operation will be geared up, borrowing up to 40% of the amount of money raised.

BCI 4 is likely to take the amount of investment held in the scheme series to over £30m, giving an

ultimate estate across all four schemes of approximately 40 pubs. This will give considerable economies of scale, in terms both of food and drink purchases and in terms of central costs.

Conclusion

British Country Inns has had a first rate start in all respects other than central cost control. Investors are certainly well up overall on where we expected them to be. This augers well for the latest vehicle BCI 4.

British Country Inns 1

29.5.2007

Profit & Loss Account					
Year End 31 January	2007A	2008E	2009E	2010E	2011E
Number of pubs, Start Year	0	8	10	11	11
Number of Pubs, End Year	8	10	11	11	11
Average No of Pub Weeks Trading	204	468	560	572	572
Average Weekly Sales Per Pub £	8,484	8750	9100	9,464	9,843
Total Sales	1,730,723	4,095,000	5,096,000	5,413,408	5,630,196
Operating Margin	6%	11%	14%	15%	15%
House Operating Profit	111,193	450,450	713,440	812,011	844,529
Head Office and Other Costs	321,280	240,000	270,000	280,800	292,032
Annual Management Fees	158,372	160,000	164,800	169,744	174,836
Interest Credit on Uninvested Money	101,309	0	0	0	0
Interest Charge on Debt	0	0	50,000	120,000	120,000
Pre-tax Profit	-267,150	50,450	228,640	241,467	257,661
Corporation Tax at 30%	0	0	0	48,293	77,298
After Tax Profit	-267,150	50,450	228,640	193,174	180,363
After Tax Profit per £100 of original investment	-3.57	0.67	3.05	2.58	2.41

Table of Potential Investor Returns					
Per £100 of original investment					
Year End 31 January	2007A	2008E	2009E	2010E	2011E
Gross Investor Payment In	100				
Up Front Commissions and costs %	7.80%				
Other Costs %	0.00%				
Available from Investor, net	92.2	107.2	128.0	172.9	184.1
Total Amount Spent on Pubs	83.5				
New Bank Borrowing	0.0	10.0	30.0	0.0	0.0
Total Available for Investment	92.4	117.2	158.0	172.9	184.1
Assumed Revaluation % (2007 Actual %)	5.6%	5.6%	5.0%	5.0%	5.0%
Uplift on Improvements %	5.6%	3.0%	0.0%	0.0%	0.0%
Lotting premium on end sale%	10.0%	0.0%	2.5%	0.0%	0.0%
Total Revaluation Uplift %	21.2%	8.6%	7.5%	5.0%	5.0%
Value of Properties	101.2	127.3	169.8	181.5	193.3
Other Assets/Liabilities (net cash etc)	9.6				
Retained operating profits	-3.6	0.7	3.1	2.6	2.4
Possible Investment Value at Year End	107.2	128.0	172.9	184.1	195.7
Bank Borrowing to be Deducted	0.0	-10.0	-40.0	-40.0	-40.0
Directors' Incentive Payment per £100					-7.6
Promotor's Incentive Payment per £100					-1.9
Possible Net Return to Investors per £100 of original investment	107.2	118.0	132.9	144.1	146.2

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