



## General Overview - German Economy

Over the past year, the German economy has underperformed the Eurozone. According to latest estimates, the European Union expects the German economy to contract by 5.4% this year, which is worse than the 4.0% average of the 27 European Union countries. However Germany's GDP growth of 0.3% in Q2 2009, compared with a drop of 3.5% in Q1 2009, shows that the economic environment is beginning to improve.

Sentiment in Germany and globally has improved significantly over the last six months. The business climate indicator for Germany produced by the IFO Institute has improved across all sectors over the past 9 months. The German DAX-30 Index has rallied strongly since March, up some 60.0% to around 5,800 points. This surge has led to speculation that the psychologically important 6,000 point barrier will be breached in due course. In spite of such optimism the economy still has some way to go before a full economic recovery is assured.

The outlook for exports, which the German economy heavily depends on, has also improved and employment figures released in December from Germany's Federal Labour Agency announced that the unemployment rate fell slightly by 0.1% from October to November, again indicating that the German economy is on its way to recovery.

The Federal Election took place in Germany at the end of September 2009 and the Christian Democrats and their Christian Social Union sister party were successful. Both parties are now forming the new coalition with the liberal Free Democratic Party (FDP). The FDP are pro-business and favour less government intervention, which could have repercussions for the occupier market and subsequently

commercial real estate in the long run. One consequence maybe that the new government might be less inclined to help ailing companies than the previous coalition. The new government may also have to deal with a soft occupier market as companies continue to recover from the effects of the credit crunch.

## European Commercial Property Market

Stronger corporate balance sheets and increasing liquidity in the global lending markets are leading to improving real estate fundamentals. In one sign of increased liquidity, the issuance of Euro-denominated covered bonds has surged as banks and corporations seek to raise money in the capital markets. These loans are typically secured against receivables from consumer loans on houses. In total €172 billion has been issued this year by prominent players such as ING, BNP and Volkswagen. Central banks across Europe have purchased €14 billion of these bonds as part of their efforts to ease liquidity in the credit markets, and these purchases are likely to continue. As a result spreads have tightened to a degree where it is becoming significantly cheaper for some corporations to raise money through these means than through the issuance of senior unsecured debt.

In Germany, covered bonds known as 'Hypothekendarlehen' have provided a major source of capital for real estate lending, with some €36 billion of new mortgages issued in H1 2009. This has allowed German lenders to continue to be most active in real estate lending markets across Europe. The conservative valuation regime and historic

record of no defaults since their inception nearly 250 years ago make these instruments popular with investors.

However, across Europe, the occupational market is weak. Fewer leases were taken up by corporate occupiers - volumes for Q3 2009 were down by 5.0% overall, and capacity is an increasing issue as more space is becoming available. The majority of rental markets in Europe are expected to bottom out in 2010, but a significant rebound is not expected until 2011.

Transaction volumes in Europe are expected to exceed €60 billion by year-end. Volumes increased in most major markets in Q3 2009 and the movement of investors to other markets is another milestone as new transaction appetite starts to spread.

The worst of the global commercial property meltdown is over. Now, the case for a commercial property recovery is gradually being fortified by recent, ongoing improvements in the global economy, investor sentiment and market liquidity.

There are clear signs of a short to mid term recovery in commercial real estate globally although the speed and type of recovery differs from region to region. Traditionally the UK has functioned as a leading market with other markets in Western Europe following. It seems that one can follow this logic again. There are strong signs of a recovery in the UK, although this is being driven in part by a lack of stock as well as high investor demand. This could lead to rising capital values and decreasing yields in the short term and Germany could follow, as the fundamentals for the recovery are similar to the UK.

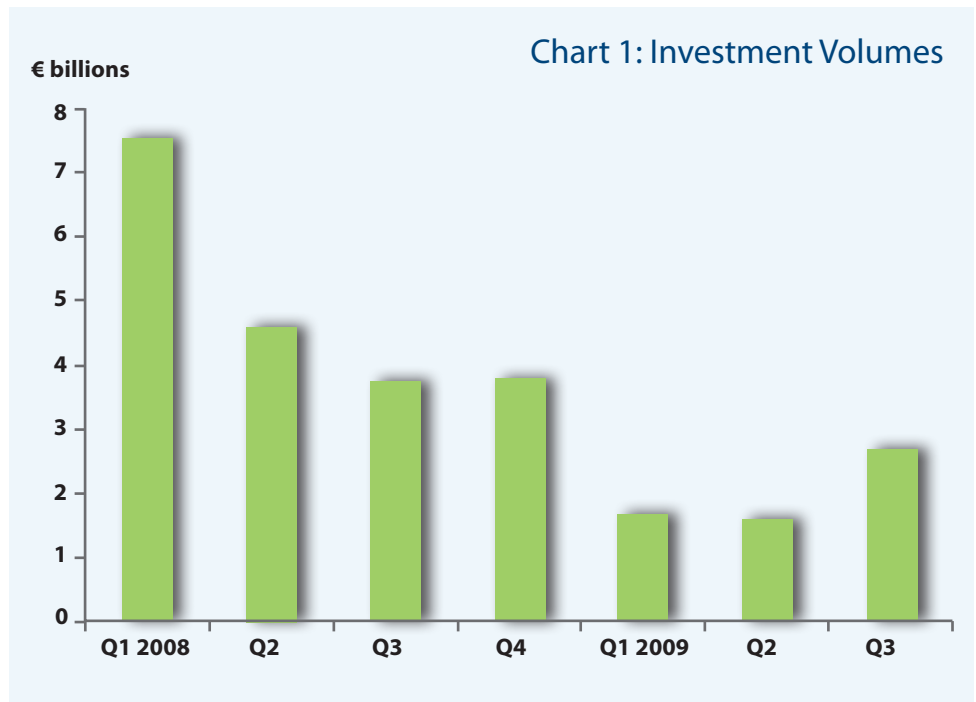
## German Property Market

During Angela Merkel's first term, the German property market peaked and cooled. In 2007, a record €75 billion of commercial property changed hands. Last year, this figure slowed to €27.5 billion and in Q1 to Q3 2009 investment turnover is being reported around the €6 billion mark.

Investment volumes in Q3 2009 have exceeded €2.7 billion, representing a quarter-on-quarter increase of 67.0% (see chart 1). Investment volumes are mostly attributable to domestic players such as German Open Ended and Special Funds which employ a high level of equity in the financing of their acquisitions

The lack of properties traded makes it very difficult for valuers to evaluate exactly where the property values are. Although capital values have gone down, the overall correction has been far milder than in the UK. A year ago many people expected there would be a flow of distressed assets coming to the market. Loan-to-value covenants may have been breached but banks are using a light-touch approach, provided that regular principal and interest is repaid without fail. If however, the occupier market does suffer further and income no longer covers interest payable banks might turn more aggressive and the current sentiments might radically change.

Based on the improved market sentiment and investors' confidence another increase in investment volumes in Q4 2009 and H1 2010 can be assumed, further reducing the valuers' struggle to find evidence for open market valuations. Total investment turnover for 2009 is estimated to be in the region of €10 billion, which would be only 13.0% of the investment turnover in the peak year 2007 and 47.0% of the investment turnover in 2008.



Source: CB Richard Ellis

The occupier market is expected to remain difficult. In Germany's top eight cities office take up is already down by approx. 28.0%. Experts predict that the full year drop in 2009 will be in the region of 35.0%. Occupiers take advantage of this situation by requesting larger incentives on lease renewals or re-lettings. Large companies are mostly to blame for the decrease in take-up, while demand from small to medium sized businesses (Mittelstand) has held up relatively well.

# Fund Overview

## Fund Management

As reported in the previous update, the Fund is concentrating on six key areas of asset management and this focus will continue in 2010:

- maintaining stable cash flow
- increasing liquidity
- monitoring potential tenant defaults
- keeping voids low
- ongoing reduction of costs
- identifying development opportunities to match future demand from the occupational market

From this pool of six key areas the main focus of the Fund is to increase the free cash flow on a month-by-month basis. Chart 2 shows how the rental income has developed from inception. To date the rental income covers all interest payments and other operating costs, generating a monthly cash surplus for the Fund.

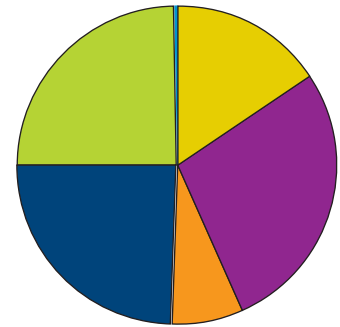
There is an ongoing process of cost reduction and cash flow enhancing activities to further increase the monthly cash surplus. For example one sub-contractor has agreed to reduce his ongoing fees by around 50.0% to compete for the day-to-day business of the

Fund. Similar discussions are currently being held with other sub-contractors and further cost reductions can be expected with effect early next year.

The work of the two external property managers is constantly under review and further clauses have been implemented in their respective management agreements to increase their responsibilities and the rent collection ratio, whilst maintaining the existing cost structure. The Fund has evaluated the suitability of each property manager to ensure the day-to-day business is looked after in the best interests of the Fund and it has been decided to switch three assets between the property managers with effect from the 1st January 2010.

A vacant unit in Eisleben has been successfully re-let to Pfennigfeiffer, a leading German discount retailer, who will complement to the existing retail composition of this out of town shopping centre. The 5 year lease term commenced on 1st November 2009. This letting further reduces the already low level of voids of the Fund, which currently stand at 0.22% of the rental income per annum (as of November 2009).

## Chart 3: Sector Breakdown



- Retail Warehousing 27.6%
- Distribution 24.6%
- Supermarkets 24.5%
- Shopping Centres 15.7%
- Offices 7.3%
- Restaurants 0.2%

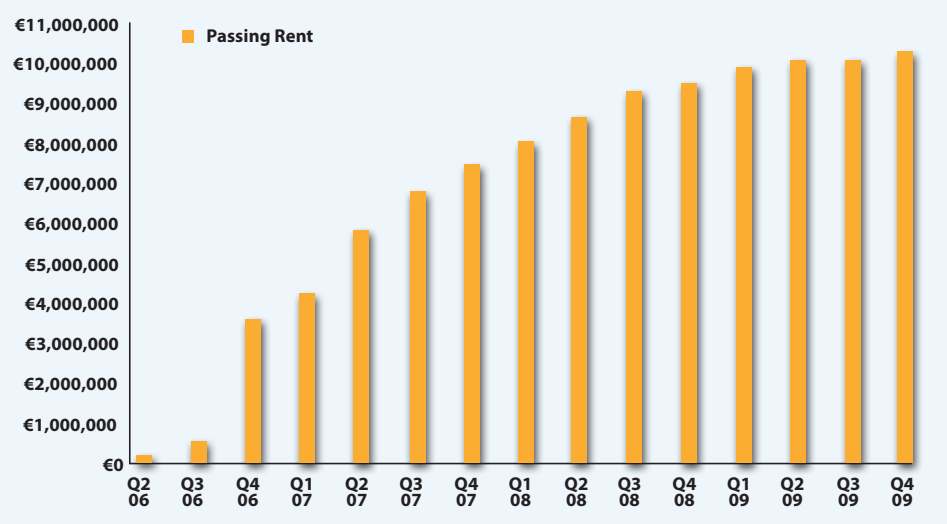
Source: London & Capital

As of November 2009 the Fund holds 46 assets with an aggregate capital value of €541.1 million. The Fund will benefit from the quality of assets, quality of tenants and relatively long lease expiry profile once the recovery takes hold. There has been no significant tenant default to date. Major bankruptcies in the German retail arena eg Arcandor (previously Karstadt) and its subsidiary Quelle did not affect the Fund.

The allocation to the retail sector such as retail warehousing, shopping centres, restaurants and supermarkets is in aggregate 68%. The supermarket sector represents 24.5%, with strong recession-robust German retailers like Lidl, REWE, Plus and EDEKA (see Chart 3).

The weighted average lease expiry is 7.51 years as of November 2009.

## Chart 2: Passing Rent (QoQ)

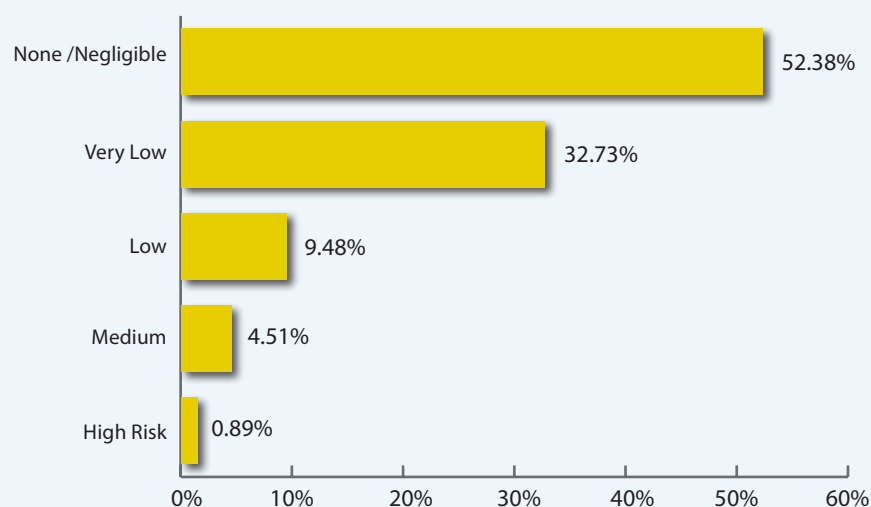


Source: London & Capital

One of the Fund’s strategic priorities was the selection of assets with strong, sustainable covenants in combination with long leases. To illustrate the strength of the rental income profile the 216 leases have been analysed and rated by the Fund Manager in respect of potential tenant default in terms of enforceability of rental payments, covenant strength and financial standing (Chart 3). This shows that tenants providing more than 85.0% of the rental income of the Fund are rated as having either a negligible or very low risk of default. The rating represents the Fund Manager’s view and is not linked to any official, recognised credit rating.

The Board continues to actively review all options available for the best management of the Fund. A detailed recommendation to shareholders will be presented by the Fund in early 2010, outlining a time line for a re-opening of the Fund. For the time being the Board has decided to further postpone a re-opening of the Fund.

Chart 4: Tenant Default Risk Analysis



Source: London & Capital

### Rating Definitions

Default Risk	Definition
None/Negligible	<ul style="list-style-type: none"> <li>➤ highest degree of enforceability of rental payments</li> <li>➤ very strong covenant</li> <li>➤ very strong financial results</li> </ul>
Very Low	<ul style="list-style-type: none"> <li>➤ high degree of enforceability of rental payments</li> <li>➤ strong covenant</li> <li>➤ good financial results</li> </ul>
Low	<ul style="list-style-type: none"> <li>➤ enforceability of rental payments in doubt</li> <li>➤ covenant with uncertainty</li> <li>➤ lack of transparency of financial results</li> </ul>
Medium	<ul style="list-style-type: none"> <li>➤ covenant with a high degree of uncertainty</li> <li>➤ strong volatility of financial results</li> <li>➤ default risk</li> </ul>
High Risk	<ul style="list-style-type: none"> <li>➤ very weak covenant, negative cash flow</li> <li>➤ no rental payments and/or payments in arrears</li> <li>➤ imminent default risk</li> </ul>

Source: London & Capital

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