



December 3, 2009

Dear Investor:

This brief cover letter and the attached individual property reports serves as our annual report and look-back on various investments.

In 2009, we focused on minding our "stores", that is each property that we own, operate and manage. Despite the persistent economic recession, our buildings have remained well-leased at an average occupancy of 90%. However, we have had to reduce rental rates, so net income is down. Given the additional job losses that are forecasted for next year, we expect more vacancy in our projects. In any event, maintaining occupancy remains our primary focus.

We have not purchased any properties in 2009, but we did make a couple of attempts. In general, the disconnect between buyers and sellers has just been too great to consummate a transaction.

It's fair to say that every smart investor is trying to understand where the economy is headed. No segment of the economy has been spared by the Great Recession -- just about every company in every industry is being forced to revise its capital structure, many by deleveraging. Because the real estate investment business is so capital intensive, the deleveraging process is especially painful.

In commercial real estate there's distress in every facet of the business: weak leasing markets with declining rents and rising vacancies; decreasing property values such that many properties are underwater (the value of the property is below the outstanding mortgage amount); and virtually no real estate financing is available to replace existing loans as they come due or to help finance new acquisitions.

There have been some property sales -- sellers needing to raise cash and/or get out from under heavy debt loads, and in some cases bankruptcy or bank-owned sales. But there has not been the vast number of "distressed sales" that many were predicting for 2009. Unlike in the early 1990's when banks were quick to foreclose on borrowers, take back the properties and sell them at hugely reduced prices, this time around banks are not required to "Mark to Market" the loans or assets they carry on their balance sheets. Instead banks are working with the borrowers to "Blend and Extend" loans or they are taking back the properties, holding them, collecting whatever income there is and waiting for a better sale market in the future.

Think about this scenario: a borrower bought a property three or four years ago on a 7% current return on the purchase price (let's say \$10,000,000 purchase with \$700,000 NOI). They borrow 75% of the purchase price at an interest rate of 7% (\$7,500,000 loan with payments of \$525,000). The recession hits, tenants vacate and rents go down leading to an actual return on cost of 4% (\$400,000). The borrower cannot sell the property for the value of the loan (a property with \$400,000 of NOI selling on a 7% cap would be worth just \$5,700,000) and they cannot service the loan payments of \$525,000 with \$400,000 of NOI and so they "give" the property back to the bank. From the bank's point of view they are earning \$400,000 on the loan balance of \$7,500,000, or 5.3%. Since the bank's costs of funds in today's low interest rate world is about 0-1% they are actually making a reasonable spread on their invested capital. Why sell at \$5,700,000, a discount of \$1,800,000 to the loan, and have to report a loss? Better to hold and collect the income.

There are new players in the market, known as "Master" and "Special Servicers". Many of the loans made in the last cycle were CMBS loans that were packaged and sold off in tranches. These CMBS loans are administered and managed by Master Servicers and are often times then kicked to what is known as a Special Servicer once the loan becomes a problem. Many times, the Special Servicers are the very same institution that lent the last dollar or are the holders of the riskiest tranche of the CMBS loans. When the Special Servicers take back a property, they have very little incentive to sell at a discount since they would be wiping out their own tranche of the loan. Instead they can manage the property and receive fees from all the other tranche holders, and like the banks, collect whatever income there is and wait for a better sale market in the future.

Consequently, the buying and selling of real estate investment assets has been at a relative standstill. We do think there will be more opportunities in 2010, but probably not at the deep discounts many are hoping for or dreaming about.

We are evaluating various capital structures in order to take full advantage of future buying opportunities. Ideally, we would like to use private funds with friends and family investors and continue to operate as we have in the recent past -- one investment at a time, utilizing financing and some combination of private and institutional equity as appropriate for the each deal. If the buying opportunities turn out to be incredible and we require more capital, we may have to consider a format that's more scalable. This might entail raising a significant private fund or a programmatic relationship with an institutional partner or utilizing some sort of public vehicle.

Earlier this year, we launched our real estate stock investment fund with twenty two investors and just over \$1 million in initial capital. We began purchasing stocks in September. We are about 50% invested to date and are up just a little. We would be delighted to accept additional investments from existing partners and of course, we would welcome new investors. (Additional investments or new investors can be accepted prior to the beginning of each quarter.)

As always, we appreciate your interest and support. Please feel free to contact us anytime with any questions concerning your investments with us or the real estate markets, or your interest in other real estate investments.

Sincerely,

**DAVENPORT PARTNERS**

Enclosures