

28 December 2011

Caledonian Trust PLC

Audited Results for the year ended 30 June 2011

Caledonian Trust PLC, the Edinburgh-based property investment holding and development company, announces its audited results for the year ended 30 June 2011.

Introduction

The Group made a pre-tax loss of £925,000 in the year to 30 June 2011 compared with a loss of £294,000 last year. The loss per share was 7.78p and the NAV per share was 157.6p compared with 165.4p last year.

Income from rent and service charges was £704,000 compared with £672,000 last year. Rental income was increased mainly due to higher rental income from St Margaret's House, Edinburgh. Other operating income was £43,000 compared with £81,000 last year, which included £33,000 judicial expenses recovered on settlement of a property dispute. Administrative expenses were £896,000 compared with £889,000 last year.

Net interest payable was £260,000, an increase of £66,000 on last year, reflecting higher margins on renewal of certain loans. The weighted average base rate for the year was 0.5% and the average Libor rate, on which most of our loans were based, was 0.86%.

Review of Activities

The Group has continued to invest in enhancing the value of its development properties by working towards or gaining valuable planning consents. Some limited development work has also been undertaken to facilitate disposals and to protect existing consents by commencing development. We have also realised some of our major assets.

For several years we have been realising the Group's New Town investment portfolio when development opportunities were achieved or when the investment value had been optimised. Two sales in the Spring of 2011 have almost completed this programme. This time last year we were completing the conversion of the basement of 57 North Castle Street which was marketed in the Spring of 2011 and sold for £350,000 in May. The second New Town investment portfolio sale was of 9 South Charlotte Street let to La Tasca. Retail investment property yields had fallen substantially in 2010, but they were expected to rise. Prospects for rental growth were deteriorating as retail sales growth had fallen and Government fiscal policy seemed likely to curtail leisure spending, factors likely to impair the perceived quality of the covenant. Such poorer prospects coincided with higher expected holding costs as refinancing offers in 2011 required high fees, very high margins, burdensome covenants and a very low LTV together with high amortisation. In these circumstances realisation of the investment appeared more attractive than refinancing it.

Following the sale of South Charlotte Street, the basement of 61 North Castle Street is our only remaining New Town investment, acquired, as indeed was that whole portfolio, in the late 1980s, just before the office rents in Edinburgh more than doubled! Planning and listed building consent were granted in January 2011 for its re-conversion to the more valuable residential use.

St Margaret's House, London Road, a 92,000ft² office building on the A1 about one mile east of the Parliament and Princes Street is our largest individual property, for which we have short and long-term objectives. The building has been wholly let at very modest rents to charitable causes for several years. Since 1 November 2010 it has been let to a single charity, Art's Complex, who have reconfigured and sub-let all the space to over 250 "artists" and "artisans" and "galleries". Very

surprisingly, especially in the current depression, tenant turnover is minimal, and there is a lengthy "waiting list". Almost all the parking spaces are let to our neighbours, the Registers of Scotland, on a short-term lease. Thus we hold the building with very limited outgoings and we expect to be able to raise the current "very modest" rents year by year.

Our long term objective is to effect a larger scale redevelopment of the site, a programme on which we have been working for over five years. As long ago as June 2007²⁰¹ our Architects produced an "Urban Analysis Report" and in July 2007 Draft Development Proposals from which the City of Edinburgh Council suggested that a Development Brief be prepared for the triangle covering St Margaret's House, the adjacent 125,000ft² Meadowbank House, owned and occupied by the Registers of Scotland, and all the smaller varied properties lying between the A1 and "Smokey Brae". The "Brief" required detailed preparation, and months of consultations, often very constructive, followed by long negotiations before the Brief was eventually adopted by the City of Edinburgh Council in August 2009, so providing a "Master Plan" for the whole area within the triangle. In July 2009 we lodged an application for Planning Consent in Principle for a 231,000ft² mixed use development of residential and/or student accommodation, an hotel, and offices and other commercial space, together with parking for 225 cars. This proposal was approved in November 2010, subject to completion of a Section 75 agreement, which was signed earlier this year. The consent was issued in September 2011.

The consented proposal allows for a street frontage to London Road (A1) and direct vehicular access from it and an "at grade" pedestrian plaza which will transform the area.

A significant and immediate improvement to the urban realm and the street frontage will be evident shortly when the redevelopment of the adjacent Meadowbank House is completed in Spring 2012. The current poor quality 'drawbridge' walkway leading to the recessed entrance will be replaced by a new contemporary glass building. This new extension or wing will provide a new public entrance directly accessed from the street. This has the real benefit of providing a positive street edge for Meadowbank House which will encourage pedestrian interaction. The new wing will visually improve the existing tired monolithic building and will screen the adjacent untidy mixed uses properties. St Margaret's will benefit significantly as its outlook will be greatly enhanced and a new enclosed urban courtyard will be created.

For many years we have considered several proposals for our large development site at Waterloo, London SE1. Previously we have attempted to negotiate with Lambeth Council to purchase the contiguous garage site owned by them or to enter an agreement with them to our mutual benefit by realising the marriage value, but no agreement could be reached. Because of the high holding costs we have agreed a sale of our own site for £3.0 million subject to a small overage if the adjacent site is developed. Contracts have been exchanged and a non-refundable deposit paid, and settlement is due within three months.

We have also sold our investment property at 100 West Street, Tradeston, Glasgow for just over £3.0m which completed in June 2011. West Street benefited from planning consent for the development for 191 2/3bed-roomed flats and c10,000ft² of commercial space, but the present value of that consent was considered to be minimal by surveyors. Their view is based on the assumption that the current very low value of land for flatted development will persist for a very long time and there is little reversion. In contrast the current investment value is high, as 15 years of the lease remain. The costs and conditions attached to the loan associated with this investment were also about to become much more onerous and, as with South Charlotte Street, realisation at the current price appeared preferable.

Higher finance costs and lower LTVs reduce the return on investment and will cause a reduced demand for investments which will further reduce their value. Already it appears to have been a good time to have completed the disposal of virtually all our investment properties, a policy we initiated in 2005.

We have three development sites in or near Edinburgh on which we delayed development in 2007 because of the worsening economic conditions. In Belford Road, Edinburgh, a quiet cul-de-sac, less than 500m from Charlotte Square and the West End of Princes Street, we have a long-standing office consent for 22,500ft² and 14 cars where, by completing necessary road works, the consent has been implemented. We have a separate residential consent for 20,000ft² and twenty car parks which has recently been extended for three years. We continue to consider engineering changes in order to

identify a design that maximises profitability. An increase in the area of the more valuable upper floors may also be possible.

We have a consent for eight detached houses in Wallyford, Musselburgh, at a site which is within 400 yards of the East Coast mainline station, near the A1/A720 City Bypass junctions and contiguous to a completed development of 250 houses by two national house builders. We consider that the market for smaller houses there has improved relative to larger houses and we await confirmation that an application to replace the two largest detached houses with a terrace of four, providing ten houses altogether with a larger saleable area of 12,496ft², is acceptable. The existing consent has been implemented by the construction of the foundations of two of the detached houses. The environment at Wallyford, one of the many former East Lothian mining villages, is improving as a result of recent and current development.

In east Edinburgh at Brunstane Farm, adjacent to Brunstane railway station, we hold a consent to convert the listed stone-faced Georgian steading, and to reconstruct a cottage attached to it, to form ten houses of various sizes over 14,648ft² altogether. East of the steading lies a detached stone building on which consent has been granted for conversion to a detached house extending to 3,226ft². This house sits on open ground with views to the Forth estuary. The steading together with five stone Georgian cottages is served by a private road from the west which passes behind the terraced cottages, three of which have been vacant for many years.

Commercially it is preferable that the cottages are improved before the steading is reconstructed and the single detached house built. The need for improvement has become more urgent as some of the services to the occupied cottages and to the separately-owned neighbouring mansion house are malfunctioning. Accordingly we have agreed an external works contract for these services and for other works including car parking, hardstanding and redesign of the gardens prior to the improvement of the cottages. A separate building⁶ contract, including essential repairs to the two let cottages, for the renovation of the three vacant cottages is likely to be let in mid-2012, provided there is no significant further deterioration in economic conditions. The stonework, guttering and slate roof of all five cottages will be reinstated as necessary. An original Georgian cottage, south facing with French doors to the garden, near a railway station and within the City but with a country atmosphere will be a desirable property.

The Company owns fifteen separate rural development opportunities, nine in Perthshire, three in Fife, two in Argyll & Bute and one in East Dunbartonshire, all set in areas of high amenity where proposals for any change are almost invariably opposed, endowing them with a "rarity" value. As these small sites are less important to local authorities the support and priority given to them is often "patchy". Moreover as Councillors are now elected by proportional representation, they are much more influenced by local lobbying. Thus gaining planning consent for small well-located developments has become increasingly more difficult and tortuous, including a requirement to be outside the 1 in 200-year flood plain, and in some cases the scale of development has been unreasonably restricted. Paradoxically, the greater the restrictions, the more supply is reduced, the more valuable achieved consents become.

In spite of these difficulties I am pleased to report continuing success with our planning applications. In Perthshire at Tomperran, a smallholding in Comrie on the River Earn, we hold a consent for twelve detached houses over 19,206ft² issued in July 2009. Tomperran includes approximately one acre zoned for industrial use adjacent to the settlement which is being promoted for a housing allocation in the emerging Local Plan. We promoted a further larger area for housing, but the Finalised Local Plan is expected to allocate an infill area in the south of Comrie instead.

At Chance Inn we hold a consent for ten houses over 21,836ft² in the farm steading and for two further detached houses over 3,366ft² near the modern detached farmhouse. In July 2010 approval was gained to convert the integral garage of the farmhouse into a semi self-contained "guest suite" and to upgrade the house, including adding an en-suite bathroom and all this work is almost complete. The upgraded house and the separate house plots will be marketed in the Spring. Nearby at Carnbo we expect the paddock of the former farmhouse to be included in the village settlement in the new Local Plan and so gain a presumption for a small development of four houses. At Strathtay, where we already hold consents for two large detached houses over 6,040ft² we have just been granted consent to build a

mansion house, two ancillary dwellings and a service block over about 10,811ft² in a secluded garden and paddock near the River Tay.

At Myreside Farm, in the Carse of Gowrie between Perth and Dundee, we have made two unsuccessful applications. Using guidance from the planning department we are finalising proposals that meet the requirements of the Housing in the Countryside Policy 2009. At Camghouran, on Loch Rannoch in northern Perthshire a consent for three houses over 2,751ft² next to the Allt Camghouran stream was issued in March 2011.

In Fife we have made good progress in two attractive rural sites near St Andrews. At Larennie, adjacent to the Michelin-starred Peat Inn, five miles from St Andrews, a consent was gained in April 2011 to renovate and extend an existing stone-built cottage, to convert stone buildings to four houses and to build four new houses over 19,325ft² for the nine dwellings. At Frithfield, six miles from St Andrews, a site with stunning views, we will shortly apply for consent for 12 houses over 20,326ft².

The potential for planning gain differs between the specific sites already discussed and the large land holdings at Gartshore near Glasgow at Kirkintilloch and at Ardpatrik on West Loch Tarbert, Argyll and these in turn differ between each other, although both offer very considerable opportunities in the medium term.

Gartshore comprises the nucleus of the large estate recently owned by the Whitelaw family and includes 120 acres of agricultural land, 80 acres of policies and parks surrounded by mature trees, a designed landscape, including a magnificent Georgian stone pigeonier and an ornate 15,000ft² Victorian stable block, cottages and disused buildings and a huge walled garden. Surprisingly, Gartshore is only seven miles from central Glasgow, two miles from the M73/M80 junction, seven miles from the M8 (via the M73) and three miles from two Glasgow/Edinburgh mainline stations (Croy and Lenzie) and from Cumbernauld commuter station. Gartshore's central location, its historic setting and its inherent amenity are features particularly suited for development of a high-quality landscaped business park, including an hotel, and a destination leisure centre created from the restoration of paths, avenues, woodlands, the walled garden and the other built landscape features. Informal discussions continue with East Dunbartonshire Council on appropriate uses.

Ardpatrick has very considerable medium-term potential for high quality residential property, compatible with the environment. Restoration provides the key to reinstate the attraction of Ardpatrik, masked by neglect, and provides a framework within which appropriate development can be created. The ongoing restoration represents a huge commitment in money, time and skill and some particularly difficult tasks remain. Much of the residential property has now been restored including two houses within the house curtilage and four outlying cottages which have been sold. Restoration is also taking place of the built and designed landscape of Ardpatrik whose enlightened earlier design and execution is being recovered wherever improvements in functionality and amenity value permit.

The immediate development prospects at Ardpatrik were determined either before or after the 2009 North Kintyre Landscape Capacity Study. In 2006 a consent was gained at South Lodge to double the size of the dwelling and to add a large garage. The existing building has been fully restored and is being marketed with the benefit of the consent. In late 2006 we gained consent to change the use of the Kennels situated among the Achadh-Chaorann group of cottages and to extend the building to form a three bedroom house, conditional on putting in a new access road. This road was completed in the spring and we are now seeking consent for a more attractive property. Consents have recently been renewed to divide Ardpatrik house into four, to build one new house nearby, to convert the stone garden shed to a house, to make the existing coach house and flat into two dwellings, to build a further house, which complements and completes the existing design of houses within the curtilage, and to undertake certain residential extensions.

There are a number of practicable development opportunities within the areas designated in the Capacity Study. In September 2011 we secured consent for a 1,670ft² house and double garage on the Shore Road south west of South Lodge and in April 2011 consent for two 1½ storey houses of 2,200ft² each at the north end of the estate on the B8024 Kilberry Road.

Most of the potential new sites and many of the conversion sites are commercially difficult to realise. Current market conditions are unhelpful, but major continuing constraints are the high cost of

conversion, and the overall cost of upgrading the inadequate infrastructure notably road costs, partially due to the required enhancement of the public services. Considerable effort has been expended on minimising the costs of reinstatement and development by operational efficiencies, but the current burdens and restrictions will curtail earlier plans, unless some relaxations become available or other development opportunities emerge.

Economic Prospects

Greek myths are spellbinding. Europa, the beautiful daughter of the King of Tyre, played by the sea from which arose a magnificent white bull, a manifestation of Zeus. Carrying her, Zeus swam to Crete where she bore him a son, Minos, whom Poseidon later assisted in gaining the kingdom of Crete, by dispatching a sacrificial bull which Minos foolishly spared. In revenge Poseidon caused Minos's wife Pasiphae - to become infatuated by the bull to whom she bore the Minotaur, a creature with a man's body and a bull's head, which was kept securely in the Labyrinth with Daedalus, the Athenian master craftsman who designed it and where it was supplied with ritual sacrifices of Athenian youth. That the continent of Europe is named after such a potent mythological heritage is fitting given its long history is redolent with war, suppression, deceit, chance and fantasy.

The concept of Europe, a united Europe has a long lineage. The Roman Empire at its acme in 117AD under Trajan did not extend throughout Europe, the north eastern march in Northern Europe being the Rhine, a dividing line of continuing historic significance. Charlemagne's 9th century European empire extended east into Russia, but excluded the Spanish Emirate and at the treaty of Verdun in 843AD there was a tripartite division – Charles the Bald inheriting the West, Louis the German the East and Lothair the middle kingdom, straddling the Rhine, but stretching from Friesland to Calabria. Lothair, including Lorraine, was to become the battleground of Europe for over 1,000 years. Latin-speaking Christendom extended over practically the whole of Europe in the Middle Ages and continental Europe briefly came under the secular control of the Hapsburgs under Charles V, who was also Holy Roman Emperor in the 16th C and of which it is said was neither Holy, nor Roman, nor an Empire. Singularly, the short-lived French Empire under Napoleon in 1812 occupied a similar area as did the Nazi powers in WWII. The Eurozone could be regarded as the most recent and most peaceable standard bearer for a United Europe, the dream of centuries. The latest concept of Europa is threatened by its inherent contradictions, but it is not the unity of Europe that creates concerns but the diversity of its constituents.

The financial position of the Eurozone is distinct from that of its 17 constituent countries which have very disparate economies. The Eurozone has a surplus on its current account and a manageable public debt. The problem is the distribution of funds within the Eurozone, as for instance Germany had a current account surplus of \$183bn, but Italy had a deficit of \$78bn, the five largest surpluses exceeding the five largest deficits and overall the position is in surplus.

The Eurozone's actual and projected fiscal position is considerably better than the US's and the UK's and as a percentage of GDP the OECD shows it to be at 6% in 2010, smaller than the UK's 10% and the US's 11%. By 2012, the Eurozone will have a budget deficit of only 3% compared with 7% for the UK and 9% for the US. On the underlying basis, after allowing for the effect of a cyclical downturn on their economies, the Eurozone's fiscal position relative to these countries is even more favourable. The Eurozone is estimated to have no structural deficit this year while the UK has a deficit of 4.4% of GDP and the US one of 6.9%. Indeed when M Trichet was Chairman of the ECB he repeatedly asserted that the Eurozone's position is more favourable than America's.

Unfortunately for the Eurozone as a whole, although its debts and deficit may be sounder than the USA, it lacks the key central financial institutions to redistribute income and absorb economic shocks, such as a co-ordinated fiscal service and a Central Bank would provide. The Eurozone is not a single entity politically, economically or culturally, as, although the currency is common and there is a common monetary policy, there is no redistribution basis between countries and each country runs its own treasury. With its Federal position the US has sufficient community of interest to make it politically possible for Congress to agree to get Californian tax payers to "save" Wall Street bankers in the national interest, and as the least unpleasant option, but the prospect of Mittelstand Germany rescuing Greeks "*dona ferentes*" or philandering Italian politicians is remote, although very recent events render such previously unlikely behaviour less improbable by the day. In general, however, each of the 17 Eurozone members jealously guards its own treasury and protects its own economy.

The strength of the Euro is further evidence of the strength of the Eurozone overall. When the Euro became the sole Eurozone currency in 2002 the £ bought €1.6264 and the \$ bought €0.9523. By 2010/11 the Euro had strengthened and the £ bought only €1.1779 and the \$ only €0.7582. Thus the € has appreciated 38.1% against the £ and 25.6% against the \$.

The creation of the Euro was motivated by the long-term goal of political integration. The adoption of a common currency represented a step towards, and a means of gaining, that overall strategy. It was the ultimate expression of the policy that established and then developed the European concept as devised by "Europe's godfather", Jean Monnet, who stated his policy as Europe "will not be built at once, or as a single whole: it will be built by concrete achievements which first create de facto solidarity". He believed in European unification through discreet projects administered by technocrats, with the ultimate aim left ambiguous. So far it has been remarkably successful.

The Euro started well, contradicting its detractors, in spite of being composed of countries with wildly differing economies. Fortunately it developed during a period of easy credit conditions and low interest rates which in some of the Eurozone Countries permitted misallocated investment, deficit financing, declines in external competitiveness and external deficits. For some considerable time easy credit masked the growing malaise and the growing difference in the performance of the economies within the Eurozone. When the Euro was established it was hoped that the single currency would bring about an endogenous convergence as it allowed the factors of production to move even more freely around the Euro area. However, instead of converging, a broad divergence developed between northern and southern members of the Eurozone (with Ireland as a special case in the north). Inside the Eurozone, with no apparent exchange rate risk, and, with a central bank committed to low inflation, interest rates fell to all time lows, which in Spain and Ireland produced spectacular, but ill fated, property booms. Elsewhere in the southern bloc Governments dropped the fiscal austerity measures required for Eurozone entry to run deficits benefiting from the windfall lower funding costs on their debt. One of the risks of such policies was masked by the flattering effects such economic booms had on the public finances – in Spain for instance the budget was in surplus by 1.9% of GDP in 2007, but by 2009 this had become a deficit of 11.1%.

The expansion of the economy was not matched by equivalent rises in productivity, particularly in the traded sectors. In consequence, compared to Germany unit labour costs rose by a staggering 30-35% in Greece, Italy, Ireland and Spain, resulting in current account deficits in 2007 of 10% of GDP in Spain, 12.2% in Portugal and 16.3% in Greece and lesser but significant deficits elsewhere. These deficits were largely matched by the surpluses of the Northern economies like Germany and the Netherlands of 7.6% and 9% of GDP respectively. Thus the Eurozone project, far from leading to economic convergence, perversely led to divergence.

The 2008 crisis reduced credit and increased its cost which reduced asset values and the ability to finance deficits and in turn collapsed both the property and deficit-led economic booms. The ensuing economic contraction led to higher deficits, and higher borrowing requirements at ever enhanced risk, further increasing borrowing rates, margin requirements and risk in a self-perpetuating negative feedback. Thus, as Martin Wolf writes, for the Eurozone launched on a wing and a prayer, the wing has fallen off and the gods are not responding.

Greece was the first of the Eurozone economies to which a bail-out or rescue attempt was made in 2010: others have followed! The extent of Greece's problems is illuminated by comparison with Argentina's default in 2001. Greece's current account and fiscal deficits as a percentage of GDP far exceeded that of Argentina when it defaulted. Argentina defaulted on \$81bn in 2001 paying only 35c in the \$ and effected a massive devaluation of 70% against the US \$ while the price of gold rose from 300 Peso to over 1,100. In 2001 Argentina had a fiscal deficit of 3.2% of GDP compared with Greece's 10.5% of GDP and Argentina's sovereign debt was 54% of GDP at default, compared with Greece's current 150%. Argentina's debt was tied to the US\$, Greece's is tied to the Euro.

Since the devaluation, Argentina's economy has grown by 8%, a growth rate favoured by the world economic boom, a huge rise in expected commodity prices, an extensive privatisation programme and a continuing transfer of resources from subsistence agriculture to more productive sectors. If Greece were to devalue now, unlike Argentina, it would not benefit from a world boom, or a rise in

commodity prices, but would have to rely on a more competitive economy allowing increased exports, import substitution and a growth in services, particularly tourism. The Greek public sector accounts for a staggering 40% of its economy whose reform and part privatisation would increase output, although this possibility exists independent of devaluation.

The circumstances of the Argentine default and devaluation were, to say the least, unsavoury. In 2001, prior to the default, 50% of the population were estimated to be below the poverty line, there were eight general strikes, banks were barricaded and looting and protest were widespread. Over ten days five different Presidents took office before the fateful devaluation. The recent protests in Greece appear very mild in comparison!

The Argentinian devaluation contrasts with one much nearer home. It is 44 years since Harold Wilson, previously an Economics don at Oxford, announced a devaluation of the £ from \$2.80 to \$2.40, saying, disingenuously, "It does not mean that the pound here in Britain, in your pocket or purse or in your bank, has been devalued". Chillingly prophetic, as we have since learned to our great cost, he said the devaluation would allow Britain to "break out of the straightjacket of boom and bust economics". Unlike Argentina the UK devaluation did not take place against a background of public riot but in the face of speculation against the £, an uncompetitive economy, balance of payments problems and foreign exchange controls and despite 20 denials of devaluation in three years! The UK devaluation was very "mild" compared to Argentina's and the major qualitative difference was that there was no default. Argentina's debt was Dollar denominated and when the Peso was devalued the Dollar cost in Pesos would have risen proportionately – the real burden on the economy would have been the same. The UK debt was almost exclusively Sterling denominated so the value of the debt to foreign holders was devalued by 14%, a default by another name.

The Eurozone has therefore had two direct malign effects. First, rather than facilitating convergence, as was originally hoped, and although there is no economic reason or explanation of why it should do so, as it was primarily a political decision it has created divergence. Second, because the diverging countries in the Eurozone have the same currency and debts in that currency they cannot devalue or "default" in the style of the UK in 1967. Additionally the structure and operation of the Eurozone puts individual countries at a disadvantage compared with other monetary entities: the individual countries have no Central Bank and the European Central Bank does not act as a central bank.

Italy now suffers from the contagion from Greece and shares many of its economic problems. However, prior to the current crisis the margin for Italian debt over Bunds was modest, even although public debt was 120% of GDP; the average maturity was seven years and the fiscal deficit was 4% of GDP. Martin Wolf, writing in the FT, observes that to pay interest and capital requires about 20% of Italy's GDP per year, a fact well known to all creditors. These same creditors would know that if the Italian Government was unable to raise the sums by rolling them over and had to meet these payments out of reserve it would precipitate a crisis. If the Government slashed spending by 20% to meet the interest and principal payments, then a huge recession would be triggered and government receipts would fall dramatically, obviating the possibility of making the payments the slash in spending was designed to provide. As every professional creditor is aware of the consequences of the credit not being renewed, it follows that the willingness of any one creditor to lend depends on the perceived willingness of others to do so, now and in the future. However, from time to time all such markets depending on the actions of others are exposed to self-fulfilling runs – doubt gives rise to lower prices, gives rise to enhanced doubt, gives rise to even lower prices and so on *ad infinitum*. Such markets can only be stable when there is a credible buyer of last resort: a Central Bank. The UK has a central bank and, even although the UK's borrowing profile is worse than some other Eurozone countries, the UK rates of interest are lower. The Italian sovereign debt, like the debt of all other sovereign Eurozone nations, is issued in Euros, but there is no Central Bank operating to guarantee these bonds.

Political and monetary union tends to co-exist within the same boundaries. In the past currencies were re-ordered as national boundaries were redrawn, for example coming together in the unification of the Netherlands, of Italy and of Germany in the 19th century and growing apart following the collapse of the Russian, Ottoman, Austrian and German empires during and after the First World War; and the break-up of the Soviet Union in 1991 which gave rise to 15 separate currencies. But not all empires had uniform coinage: the pre-biblical Persian empire had none; the Roman Empire took centuries to spread a uniform coinage; and the £ Sterling was not in issue throughout the British Empire.

Not all political unions involve a monetary union, but the minting of coins is closely connected with the power of the state which it augments and consolidates. In the 8th century Charlemagne established a new currency "*livre Carolinienne*"(sic!); in England in the 10th century King Athelstan decreed "There shall be one coinage over all the King's dominion"; the Byzantine empire introduced a common gold coinage accepted from Scandinavia to India and China; and the US monetary union occurred only after the Civil war. Tellingly, in the 1940s, the Third Reich planned that conquered states' individual currencies would become part of a monetary union beneath the Reichsmark. A cynic might observe "*plus ça change plus c'est la même chose*"

In contrast to, and in spite of, the shortage of precedents of monetary union leading to political union Jacques Rueff, a distinguished adviser to President Charles de Gaulle, as early as 1950 said "*L'Europe se fera par la monnaie ou ne se fera pas*". The most successful past monetary unions without political union have been those based on gold, notably the Gold Standard first operated by Britain in 1821.

The Gold Standard linked the separate currencies of the then great trading nations of the world including Britain, France, Germany and the US. The gold supply determined the monetary policy in each country, those with trading deficits losing gold so deflating the economy, reducing prices and re-establishing the trade balance. The rules of the Gold Standard required countries with trading deficits to supplement this inbuilt "balancer" by raising interest rates so deflating the economy further and encouraging the holding of interest earning currency deposits rather than gold. Thus there was a degree of political co-operation to give effect to the monetary union. Schemes based on acceptance of a common coinage operated in the Latin Monetary Union and in Scandinavia from the late 19th century until the 1920s when they faded when France and Italy issued non-convertible paper money and when domestic monetary concerns took priority in Scandinavia. The Gold Standard lasted until the outbreak of WWI when Britain, France and Germany severed convertibility. A Gold-based system was progressively reintroduced from 1925, but Britain and the US left in the Great Depression starting in the early 1930s, although Germany and France continued, forming a wider Gold Bloc with several European nations. At that time the Governor of the Banque wrote to the President of the Reichsbank "... in the present chaos nothing is more important than to maintain monetary stability ... It is infinitely precious to receive from you a new testimony of the perfect concord that exists between the monetary ideas of the Reich Government and those of my Government". A premonition, perhaps!

That a German-Franco alliance exists and has persisted in spite of the most violent and costly wars between them appears a great anomaly. A possible explanation is that the alliance has been continued because of German strength and of French weakness, a role reversal established in the middle of the 19th century. In a step that eerily foreshadows the establishment of the EEC and its customs union in the 1957 Treaty of Rome, which separately pledged to "ever closer union", and, in Articles 103 to 108, refers to a common monetary policy, Germany created a Zollverein (Customs Union) in 1834 and later a widely-accepted but not exclusive common currency, the Vereinstaler. This was the catalyst to unite Prussia and a mishmash of small weak factionalised states sprawled across the remains of the Holy Roman Empire or its part successor, the 1815 Geneva Confederation. It was on this emerging power, whose Prime Minister was Count Otto Von Bismarck, that France declared war on a specious *casus belli* in July 1870. After a *blitzkrieg* type of attack the French forces were trapped at Metz and defeated at Sedan, where Emperor Louis Napoleon and 100,000 soldiers were taken prisoner. With Paris besieged, and taken over by revolutionaries, Bismarck used this triumph to obtain agreement from other southern German states to create the German Empire under the King of Prussia including conquered lands from France's eastern boundary, part of the medieval kingdom of Lothair. This was proclaimed in January 1871 at the gilded palace of Versailles: PR is not a modern invention.

The 20th century saw these countries have two further trials, World Wars with a European epicentre. The causes of the First World War lay in the imperialistic, territorial and economic rivalries among the Great Powers. Since 1871 Germany had continued to consolidate and expand its heartland in central Europe with a strong sense of nationalism and to gain a colonial empire. France, deprived of Alsace and Lorraine in 1871 had its own nationalistic culture. Elsewhere the growing power of Germany together with the Austro-Hungarian Empire brought it into conflict with the Great Powers over the colonisation of Africa, the opening of links to the Persian Gulf, a staging post to British India, the rapid expansion of its navy and, in particular, over Russian influence over the Balkans. The fuse was lit when the Central Powers declared war on Serbia and then on Russia, after it unexpectedly mobilised. It detonated in the west when Germany, convinced that France was about to make a pre-emptive strike, declared war on France. von Schlieffen's plan for a western flanking of the French

forces and a rapid victory over France, similar to 1870, so allowing the German forces to concentrate on the Eastern Front, failed, because of the withdrawal of forces from the western flank, the rapid build-up of Russian forces and the unexpected entry of Britain into the war, nominally in support of Region neutrality. A *blitzkrieg* strike into France relapsed into an appalling war of attrition in the mud of Flanders.

The seeds of the second World War were sown at the Treaty of Versailles in 1919 which stripped Germany of territory in the east and west, restricted military activities and imposed draconian reparation payments of 132bn marks. Germany was unable to meet the payments and undertook a vast expansion of the money supply, a policy resulting as Keynes predicted: "there is no subtler, no surer way of overturning the existing basis of society than to debauch the currency". The subsequent social unrest gave rise to socialism and extreme Nationalism. The breakdown in the existing hierarchical social order facilitated the regeneration of industry while the perceived intrusion by foreigners and others into the "legitimate rights" of Germany focused social unrest and opprobrium on them like a lightning conductor. In the *blitzkrieg* at the start of WWII France was quickly overrun and capitulated. France suffered the further insult of having a portion of the country run by the Pétain Government an apparent collaboration that publicly shamed France. However, just as the Schlieffen plan was not implemented in WWI, so Hitler hesitated before Dunkirk where he stayed a final assault and paused thereafter. The subsequent inability to conquer the UK, due partly to the deficiency of the Luftwaffe, allowed time for the allies to gather and reform.

Post-WWII there were no penal reparations comparable with post WWI, although the Soviet Union effectively expropriated Eastern Germany. However for the first few years the Allies plundered German intellectual property and destroyed much of its industrial capability. The reparation costs and the occupation costs, about \$2.4bn per year, were partially offset by the salaries and the expenses of the 150,000 – 250,000 troops in West Germany at any one time. The Marshall plan assisted economic recovery, arguably altruistically, but also to pre-empt the conditions of the 1920s and, more importantly, to build a strong ally at the frontier of the new threat to the East, the now much enlarged Soviet bloc.

In spite of the great deprivations of the people and the devastation of the country and the destruction of the industrial base, the German economy rebounded quite remarkably. A symptom of the recovery was that, while in 1950 the central bank, Bank Deutscher Lander had no gold reserves, by 1956 its gold reserves outstripped those of France. In Germany social cohesion, low inflation, a transfer of resources and existing skills into more productive areas, a flood of displaced skilled workers, and the exchange rate stability of the 1944 Bretton Woods agreement resulted in the "*Wirtschaftswunder*", or economic miracle. The miracle produced rapid economic growth reaching 6% in 1959, and increased inflation, the spare capacity and increased productivity of the economy having been already exploited. This point represents the key inflexion point for German economic policy, where a decision between opposing views led to a policy that has been continued since then and overshadows the present adjustment process within the Eurozone. The independent Bundesbank maintained that inflation was a domestic phenomenon primarily caused by "overheating" in the construction industry, but Emminger, later President of the Bundesbank, argued that the inflation was caused by excessive exports to the "sick man of the world, the US economy" and proposed a 7.7% Deutschmark appreciation. Backed by Ludwig Erhard, the father of the *Wirtschaftswunder*, the Chancellor, Konrad Adenauer, agreed to a 5% revaluation in February 1961. It was then the Bundesbank learned how to harness the counter inflationary power of an appreciating currency.

The contrast between the economic performances of Germany and France is marked. Between 1950 and 1999, the birth of the Euro, the D-Mark appreciated by 102%, but the Franc was devalued by 37.4%. Three times Germany had dealt military defeats on France, in 1870, 1914 and 1939, from which France was rescued by its Allies in both World Wars but the Germany economy "rose from the dead" and eclipsed the victor. French, British and American leaders enunciated their analyses:

de Gaulle 1969: "France has a certain hesitancy and caution regarding Germany's economic strength, as it does not wish to be invaded by German "industry" and" Germany has been a large industrial country for a long time. As a result, with its entrepreneurs, its population and its infrastructure it is best equipped for production, trade and especially export. That is the nature of Germany, that is the German reality. France went into the phase of large-scale industrialisation much later. It has been an agricultural country for much longer, with far fewer large cities and large corporations. In France there

is nothing to compare with the enormous complex of the Ruhr or the former Silesia in industry and trade Germany is in the lead". In 1978 Valery Giscard d'Estaing said "I want France to ensure that there are in Europe at least two countries of comparable influence" and later, 10 years after he left office, he touched on the truth of the position: "we need an organised Europe to escape German domination"

Macmillan, the patrician British Prime Minister, a prescient student of history, as early as 1960 observed "shall we be caught between a hostile (or at least less friendly) America and a boastful but powerful Empire of Charlemagne – now under French, but later bound to come under German control?"

Paul Volcker, Chairman, US Federal Reserve Board, observed: "They [the French] learned over a period of years a rather ironic lesson: that in order to stand up to the Germans, you had to be subservient to them....."

Powerful but different forces were pushing Germany and France together. However, a fundamental ideological difference as to the mechanisms of monetary union, had arisen in the aftermath of the 1961 D-Mark revaluation the Germans led the "Economists' " group which argued that monetary union should come at the end of a long journey, once countries' economies had achieved convergence. They considered that balance of payments deficits were the sign of excessively expansionist policies in weak countries which were unsuitable as members. The "Monetarists", led by France with the support of the European Commission, felt that the way to convergence lay through a common approach to monetary issues. For them common money would be the means, the instrument of economic convergence; for the "Economists" common money would be the objective of economic convergence. Blessing, the Bundesbank Chairman, told the European Central bankers and Morjolin, the French Commissioner and a fervent advocate of monetary union, that monetary union had to be part of political union, requiring a "transfer of national sovereignty". The Bank of England papers at the time drew attention to the political purpose of EMU and to its implications politically for the participating countries:-

"Apart from the overtly federalist vision of a united Europe the object [of the EMU plan] was to create a Europe that could stand up to the economic might of the US and thus command for itself a powerful voice in world affairs A major objective is to develop a role for European currencies with which to oppose the monetary dominance of the US dollar" and "The plan for EMU has revolutionary long-term implications, both economic and political. It could imply the creation of a European federal state, with a single currency. All the basic instruments of national economic management (fiscal, monetary, incomes and regional policies) would ultimately be handed over to the central federal authorities". Tellingly, an addendum said: "It would be very difficult, if not impossible, for a member, by its own policies, to correct a "balance of payments" deficit which might emerge between it and the rest of the community Deficit regions could easily become depressed areas."

Eventually, whatever the contrary arguments, the "Monetarists" triumphed, a position settled at Maastricht in 1991, the German finance minister, Theo Waigel, representing "we are bringing the D-Mark into Europe". Events have shown that the "Economists" were at least correct, the current position more aptly described as "bringing Europe into the Drachma".

The Monetarists encompassed a wide range of views. Monetary union was an end in itself. Alternatively it would lead to greater consolidation, Monnet style, facilitating later integrations. For some the difficulties of economic and political union were considered so great that this ideal was not worth pursuing directly but monetary union was an attainable goal or, as a variant of this, if the difficulties envisaged by the Economists were realised, any ensuing crisis might then present the possibility of achieving political consensus which could not otherwise be made: a nice "Machiavellian" position!

Monetary arguments were also advanced as a cloak for political ambitions. Following the collapse of the Bretton Woods fixed exchange rates in 1973, consideration was given to forming a joint monetary bloc primarily to "protect" Europe from a fully floating dollar. UK premier Heath, departing from his script, said ... "There is a time when political leaders come to the point of taking great decisions", (comparing himself to Winston Churchill's offer of UK citizenship after the fall of France in 1940), "and making a great leap. We are near, if not at, that point in relation to European Monetary affairs".

That political initiative lost momentum, but one of a very different order arose when the Berlin Wall fell in 1989. Western Germany was no longer the frontier with Communism but, unshackled and likely to be reunified, and no longer so dependent on the West for protection from the East, Germany was becoming increasingly independent. Elsewhere in continental Europe the case for monetary union was revived as a measure of controlling the D-Mark, the Bundesbank and diffusing Germany's potential emergence. President Mitterrand, realising the overwhelming importance to Germany of the reunification of the fatherland, fostered disagreement on various technical aspects of the reunion, using these tactics to persuade Germany, so near so great a prize, to agree the EMU timetable of replacing the D-Mark with the Euro.

The UK's stance on the Euro was extraordinarily complex and transcended all traditional political and economic groupings. There was an important and continuing academic argument that, as the concept of the Euro was flawed, the UK should not join. This was reinforced by the UK's recent practical experience - a "flu jab" against the infection of a common currency. In 1990 the UK joined the ERM, having declined membership in 1978, but which it almost immediately left under dramatic circumstances in 1992 (Black Wednesday). The then Chancellor, Lamont, said "We are floating and will set monetary policy in this country to meet our objectives". This brief infection with a monetary union increased the UK's resistance to the Euro project. When the Labour administration took office in 1997 Tony Blair promised a constructive line on European integration. Indeed, the decision to make the Bank of England operationally independent of the Treasury, presented only after the election as a measure to improve economic performance, coincidentally also fulfilled a formal condition for Britain to join the Euro. Robin Cook, Blair's foreign secretary, said that membership of the Euro was "inevitable".

Niall Ferguson, now professor of history at Harvard University, described the inconsistencies of the EMU "Here today gone tomorrow" in an article in *Foreign Affairs* in 2000. He observed that fiscal imbalances between the member states create potentially insuperable problems and that monetary unions can be undermined by such imbalances. He says "History therefore suggests that asymmetric fiscal problems – often generated by war – quickly causes monetary union between fiscally independent states to dissolve. The fiscal problems caused by bloated social security and pension systems could have a similar centrifugal effect on EMU, with welfare substituting for war as the fatal solvent."

Two of the main FT economic writers have consistently emphasised the economic disadvantages of the Euro. On 7 May 2004 Samuel Brittan wrote "I was told by Raymond Barre, when he was France's combative European commissioner, that if the UK wanted a floating rate it could not join the Common Market. I was too shy to say what I would have chosen if pressed. Milton Friedman was told by Edward Heath, then British prime minister, that floating exchange rate was incompatible with the Common Agricultural Policy – no such luck, as it turned out. Indeed, I was myself given friendly advice by a senior figure in the City of London not to jeopardise my own career by embracing floating rates".

At the time of the Maastricht treaty Martin Wolf wrote: "Perhaps future historians will consider Maastricht a decisive step towards the emergence of a stable, European-wide power. Yet there is another, darker possibility ... The effort to bind states together may lead, instead, to a huge increase in frictions among them. If so, the event would meet the classical definition of tragedy: hubris (arrogance); ate (folly); nemesis (destruction)". And on 3 September 2011 "My fears are coming true. The crisis has done more than demonstrate that the initial design of the Eurozone was defective, as most intelligent analysts then knew; it has also revealed – and, in the process, exacerbated – a fundamental lack of trust, let alone sense of shared identity, among the peoples locked together in what has become a marriage of inconvenience".

The failure of the Euro project as originally conceived by the "Monetarists" is outlined by Otmar Issing former chief economist of the ECB as follows:- "A political union worthy of the name cannot be set up by stealth under the guise of fiscal transfers in the cause of common money". David Marsh, author of "The Euro", says "By a heinous inversion of good but poorly implemented intentions, a grand project aimed at stabilising Europe has accomplished the opposite. A currency scheme to forge stability and solidarity instead brought dissent and division".

The FT when edited by Andrew Gowers strongly supported EMU but still published Samuel Brittan's and Martin Wolf's criticisms. Recently the Sunday Times carried his gracious *mea culpa*. "The current Euro mess is not merely a story of incompetence and political weakness at the highest levels in Athens, Rome, Berlin and Paris – though it is certainly that. It is not based exclusively in a failure of technical execution by policy wonks – though it is that, too. More than either of those, it is a comprehensive and devastating failure of political leadership and economic understanding – Europe's worst fiasco since the Second World War. Its roots go back to the origins of the project and, to me regrettably, its consequences now threaten the long-term future of the European Union. In a sense this is Europe's Lehman Brothers moment, with plenty of blame to go round. All of those involved – the political leaders who signed the 1992 Maastricht treaty that created EMU, the central bankers, officials and policy experts who designed the common currency and its institutions, the cheer leaders in the world of journalism, economics and business – bear a share of it. All of us paid too little attention to the arguments of those who opposed the project in principle and of those who worried about its viability."

There is an ethereal intangibility about the Eurozone crisis: it seems remote, unreal and abstruse. But it gets worse week by week, politicians plan but the outcome is lost in the PR spin and analysts become more strident, but yet the "phoney war" goes on. The bureaucrats continue to effect the equivalent of rearranging the deck chairs on the Titanic but like the Titanic, "This sucker could go down" as George Bush pithily observed. The overhanging problem is the uncontrollability of such an event. A ship sinking, a run on a bank, a panic in a crowd are not linear events progressing at an even pace to conclusion but self-reinforcing events accelerating at an accelerating rate. At anytime a bank failure, a botched refinancing, a failed auction or a public revolt against austerity could precipitate the break up of the Euro and as Angela Merkel said "Everything is at stake: if the Euro falls, then Europe will fall", or at least the present concept of Europe. Certainly, dismemberment happens much more quickly than accretion, as the Soviet Union discovered after the fall of the Berlin Wall. There is a Japanese saying: "An inch ahead lies darkness".

The most favourable outcome to the present crisis will result in a grave economic crisis in the Eurozone, just not a disastrous one, because of the events that are entrain. In the Eurozone industrial orders fell by 6.4% in September, the steepest decline since December 2008 the PMI fell to 47.2 (below 50 implies contraction) and the EU's index of consumer confidence fell in November for the fifth month running. The Eurozone is experiencing a fiscal and credit squeeze that even without a disastrous outcome to the current crisis, will result in a severe recession. The plans already proposed or presented to the EU alone will result in a 1.25% reduction of output, the impact varying among EU countries. Even Germany will not be immune, as the fall in industrial orders almost certainly presages a fall in demand for capital equipment and for consumer capital items such as cars, a fall expected to reduce GDP by 0.5% in every EU country, including Germany, and Standard Chartered Bank have recently forecast a 1.5% contraction. Even such a recession will prove mild compared to the probable outcome of a failure to resolve the Eurozone crisis. The political changes required in the Eurozone now rest largely on the political will of the German leaders and of their acceptance by the German people. It is a cruel irony that so great an endeavour, nurtured for over half a century, primarily to control Germany within the shackles of a greater European enterprise, should end up so wholly dependant on Germany's will.

The UK's economic performance has been worse, continues to be worse and will be worse than generally expected. Recent revisions of GDP show that the economy entered recession a quarter later than previously calculated in Q2, 2008, but dropped 0.5% more than previously reported for a peak to trough fall of 7.1%, in Q2 2009 a cumulative fall only about 0.5 percentage points less than occurred in the Great Depression in 1930-34. The current depression has already lasted 45 months, only 2 months less than the Great Depression, but the economy's output is still nearly 4 percentage points below the level before output started to decline and, even if output grows at, say 1.25%, for three years, a high estimate as shown later, the pre-recession level of output will not be reached until nearly seven years after the start of the downturn. The extent of the loss to the economy is highlighted by the fact that current GNP is 14% below where it would have been had pre 2008 trends continued.

The UK economy continues to perform badly. In the four quarters to Q3 2010 GDP grew by 2.6% but by only 0.5% in the four quarters to Q3 2011. Growth for the calendar year 2011 depends on the outcome of Q4 for which the prognosis is not good. Recently the OECD has forecast 2011 growth to be just 0.9%, due to a small contraction in Q4. The OBR's recently published estimate is for 0.7% for

2011, implying a larger contraction in the last quarter of 2011. Without doubt the state of the UK economy is deteriorating.

All UK forecasts are based on some variant of "muddling through" the Eurozone crisis. The Bank of England more eloquently states: "but the MPC sees no meaningful way to quantify the most extreme outcomes associated with developments in the euro-area and, as was the case in the August Report, they are therefore excluded from the charts". For 2012 the OECD forecasts a small recession giving only 0.5% growth while the OBR expects a marginally better outturn at 0.7% with a 1 in 3 chance of a recession.

The current OBR forecast of 0.7% growth in 2012 and 2.1% in 2013 is a significant downgrade of its March forecast of 2.5% and 2.9% respectively, due largely to household consumption being 1.7% points lower than previously forecast. Disposable income contracted by 2.3%, a record post-war fall. The OBR's revisions are also due to lower than expected growth in Business Investment and net export trade, the two areas expected to be among the biggest contributors to GDP growth. Both the Bank and the OBR agree that the current economic conditions will delay the reallocation of capital from inefficient activities to more productive ones and this will inhibit investment and delay development of export opportunities. Even cash rich companies may delay profitable investment to conserve cash and reduce the risk inherent in any further deterioration in the economy.

The poor prospects for growth in the economy have severe repercussions. Unemployment is expected to rise from the current 2.6m to 2.8m (8.7% of the workforce) next year, partly caused by a rise in public sector job losses due now to peak at 710,000 by 2017. Borrowing for structural deficits, i.e. those not related to cyclical factors, which was due to be eliminated by 2014-15, is now expected to continue for a further two years during which additional spending cuts of £15bn per year, as yet unspecified, are proposed. As the FT comments, if in 2010 Osborne produced Plan A, in 2011 he has produced Plan A on steroids. However economic conditions could prove much worse, even if the Eurozone "muddles through" as the accuracy of most forecasts, particularly in identifying the timing and extent of secular changes, is low. A recent example is the dramatic reduction in the OBR's forecast in only eight months. The Treasury forecasts leading up to the 2008 recession were particularly at fault, when in each of the previous five years each subsequent forecast downgraded all the previous ones each year and the outcome was worse than any forecast. In John Kay's opinion the large structural deficit with which the UK entered the recession was the direct result of persistently unrealistic official projections made since the turn of the century. The Bank of England severely misjudged the imminence and the extent of the 2008 recession. As late as August 2008, when the economy had already contracted significantly and by 3.2% by the end of September 2008, the Bank identified escalating inflation as the "key risk" and projected economic output to be "flat" and maintained interest rates at 5%. By November 2008 the Bank's greater concern was deflation and then it forecast a peak to trough decline in GDP of 1.9% (actually 7.1%). Of official economic forecasting Martin Wolf said last year "The Chancellor and the Treasury are confident and persuasive. They can point to an array of official organisations that support them. Having written on the UK economy for 23 years, I know it was ever thus. Yet, in retrospect, the government was wrong perhaps half the time. Economics is an art, not a science" As the Chancellor views the economic scene, it may be as well that "beauty is in the eye of the beholder".

The Chancellor has announced several programmes to boost growth. These include an aid programme for the house building industry, an extended enterprise investment scheme, an extension of large scale infrastructure projects and the provision of certain guarantees on lending to small businesses. While all these schemes will expand the economy marginally, they beg the question on why they were not introduced in some form last year. The delay demonstrates at the very least that Plan A last year lacked finesse.

The likely outcome for 2011-12 and the OBR's November projections until 2015-16 show the structural deficit as about 2 percentage points more of GDP than the earlier projection, or about £30bn per year - a marked deterioration. However, in spite of such deterioration the UK retains a AAA rating and UK gilt yields approach those of bunds. This outturn conflicts with the Chancellor's assertion last year that the fiscal tightening then was needed to maintain the AAA rating. The OBR's November forecasts also show that the fiscal tightening increased unemployment and decreased growth, and growth potential, considerably more than he expected but in line with some independent analysts including the NIESR.

I said last year "The IMF has recently shown that a 1% fiscal consolidation reduces real domestic demand by 1% and GDP by 4% over two years, provided at the same time monetary policy becomes more accommodating, an option not realistically available in the UK. The IMF also concludes, helpfully for the UK, that a depreciating currency cushions the impact of a fiscal retrenchment and that spending cuts, 73% of the UK adjustment, are less damaging than tax increases. Finally reduced debt, i.e. following fiscal consolidation, is beneficial for itself but also because it lowers overall real interest rates, but with real interest rates close to 1% such an effect is currently muted. It is concluded that the proposed UK fiscal consolidation would contract GDP at a rate of 1% to 2% per year" - and so it has proved. The FT puts it succinctly "Just as in Greece the additional austerity appears to have made borrowing higher, not lower".

The consequences of the attenuation of the growth achieved in 2011/12 and the expected very low growth predicted by the OBR subsequently leaves an unpleasant heritage. Not only is present debt higher but future debt will be much higher as a result of lower growth. An even more important adverse consequence is that GDP at the end of the recessionary cycle is now expected to be much lower. Previous recent cycles have exhibited a pattern whereby output declines in the recession are compensated by higher than average output increases post the recession, a "catch up process". The OBR now thinks that "catch up" will be more limited leaving an enormous gap between actual output in the year at the end of the depression and the output level expected in 2007 before the crisis. The OBR's GDP estimate for 2013 implies a 3.5% "catch up" and as Martin Wolf says "the growth shortfall is for ever since the economy's potential output in 2016 is estimated to be 3.5% lower than in March [2011] and 13% lower than was forecast before the crisis"

The OBR's assessment of the future growth is modified by a change in the "output gap", the amount an economy could expand without hitting immediate capacity constraints, from 4.7% in March to only 2.5% now. This drop results from a loss in productive capacity – plant, technology, skill and labour – which increases rapidly as these factors of production become scrapped, idle or bypassed. The destruction of productive capacity, first in the recession, then in the long and continuing depression, has been exacerbated not only by the Government's fiscal policy but also by the consequences of the reactions of the banks to the credit squeeze. The Bank of England says "the cost and availability of bank credit remained tight for small business" and states that loans to small business have fallen by 10% in 2011. The FT reports "other areas of credit provision, however, do appear in unstoppable decline – most noticeably for small and medium sized enterprises...". Such enterprises account for 65% of all new jobs created.

Losses from loans made before 2007 and contingent losses from the present Euro crisis constrain the Banks. In order to build their capital ratios they need to gain or retain equity, sell assets or reduce lending: in some measure all three routes are being taken. The low level of equity retention is currently contentious, but is at the discretion of the shareholders who are proving remarkably benign. Asset sales, particularly of high capital low profit, big ticket items, aircraft, shipping and infrastructure are reported to be being bid for "enthusiastically". Bank lending to all business has shrunk by 3% to 10% per annum since 2009 and Barclays Capital estimate that up to a further 10% shrinkage may take place to meet equity requirements. Small businesses are likely to continue to be disproportionately affected by such shrinkage as the capital requirement for loans varies among types – loans to the financial sector require only 6.34% bank capital compared to 14.10% capital to the small and medium sized business. The damage to the economy by credit rationing is likely to be exacerbated by the current requirements of regulators further to increase banks' capital. Patently this cannot be done sufficiently or in time to solve the Euro crisis, it is too late to solve the recent and continuing credit crisis; and it is just in time to exacerbate the current crisis. If one already has a raging fire, the number of hand held appliances to tackle local outbreaks is irrelevant. The European Banking Authority has identified a €114bn equity gap at 70 banks which they require to be closed, prompting the chairman of one large bank to say "The EBA are idiots ... They are causing the credit crunch".

Recession and depression with a consequent fall in living standards is an inescapable consequence of the credit bust. Muddling through the Eurozone crisis, consequent upon the credit boom, but not caused by the credit boom, but by the inherent structural defects within that artificial construct, is a cherished hope beyond the UK's control. However, mitigation of the economic cycle is within the UK's control and there are two main policy errors. The lesser of these is the virtual abandonment of credit policy; the greater of these is the misjudged attempt to effect growth primarily by imposing the deepest cuts for the longest period of any UK Government with limited targeted demand stimulus.

The importance of credit in the propagation of recession and the continuation of a depression were highlighted by Bernard S Bernanke in 1983 who demonstrated that among the major causes of the Great Depression were the cost of credit and its rationing, or non-availability on the current market terms, including credit withdrawal and its non-renewal. In corroboration Carmen Reinhart found that the median of private debt to GDP rises by 38 percentage point in the 10 years before a financial crisis and falls by an equal amount in the 10 years following the crisis. He concluded that deleveraging, repaying credit, is a powerful drag on recovery.

The Government has made a symbolic recognition of its acknowledgement of the importance of the supply of credit by the establishment of project Merlin. However, the Arthurian Merlin, the Prince of Enchanters, was beguiled by the enchantress Nimue, who shut him up in a rock.....! The banks have little incentive and are under little coercion to effect project Merlin. Per contra, to meet their reserve requirements, they have a strong incentive to reduce such loans, and these two objectives are mutually exclusive. Unsurprisingly the November Inflation Report reports a substantial fall in lending. I add, in parenthesis, that the anecdotal evidence available supports the view that credit is arbitrarily rationed. The failure of Merlin is implicitly recognised by the proposed £20bn Government scheme to guarantee bank bonds. However, as the Economist states the "success relies on cautious bankers A small business bank capitalised with £2bn of public money would probably work better". Martin Wolf suggests a better scheme would be for the Government to assume the total risk of such a scheme, so acting as insurer.

Monetary policy has been very expansionary. The delightfully named "quantitative easing" has been used to buy long-dated government debt, the last £200bn of which the Bank estimates has raised GDP by 1.5% to 2.0% effectively by lowering long-term interest rates. However, as credit is effectively being rationed by the UK banks, reducing cost does not increase the supply of credit. Interest rates continue at an all time low but as margins have increased some of the benefit is offset. In Martin Wolf's view the proposed recent extra £75bn will provide only a marginal stimulus, given the existing low yields. A better use of the money, a direct credit supply boost, would be to purchase or support the purchase of private debt, including loans to small businesses. If a fine title matters, this could be termed "credit easing". As Deng Xiaoping said: it does not matter if a cat is black or white; so long as it catches mice it's a good cat.

The second and greater policy error of Government is put by Samuel Brittan as not promoting "the pro stimulus approach of the Obama administration", but promoting "the restrictionist approach of so called technocrats who I believe are fighting the spectre of depression with ever more austerity, as their forefathers did in the 1930s". The UK policy has already resulted in a large increase in the public deficit, which the policy was designed to obviate, but there has been no rise in interest costs which any increase in the deficit was predicted to cause. Samuel Brittan said last year "the deficit should be policy variable rather than targeted to meet a dim accountant's view of balance". The current debt is 97.2% of GDP after the disastrous 2010/11 – but the average over the last 322 years is 112% with long periods above 100%. The current policy will result in a slump that will be longer and more costly than the Great Depression, while the US economy is expected to grow 1.8% this year and 1.9% next year.

Mr Osbourne said last year "we are going to ensure, like every solvent household in the country: that what we buy we can afford; that the bills we incur, we have the income to meet; and that we do not saddle our children with the interest on the interest on the interest (sic!) of the debts we were not ourselves prepared to pay" and the Prime Minister repeated the mantra this year "The only way out of a debt crisis is to deal with your debts. That's why households are paying down their credit card and store card bills. It means banks getting their books in order. And it means governments – all over the world – cutting spending and living within their means." Martin Wolf observes that the result of such advice would be: "Prolonged stagnation, at best. That is what we have been seeing, after all".

Bernanke described credit limitation, as one of the US policy defects in dealing with the Great Depression. Another major defect, fortunately reversed later, was the Hoover administration's policy that recovery could be achieved if the principles of "orthodox finance" were followed. Randall Parker, "An Overview of the Great Depression", describes such restrictive policies as representing the price that had to be paid for the misdeeds of the previous decade. This is perhaps best exemplified in the well-known quotation of the Treasury Secretary Andrew Mellon, who advised President Hoover to "Liquidate labour, liquidate stocks, liquidate farmers, liquidate real estate" Mellon continued, "It will purge the rottenness out of the system. High costs of living and high living will come down. People

will work harder, live a more moral life. Values will be adjusted, and enterprising people will pick up the wrecks from less competent people". Hoover apparently maintained this advice as the Depression wore on. He continued to reassure the public that if the principles of orthodox finance were faithfully followed, recovery would surely result. Twenty years after his election defeat, Hoover continued to steadfastly maintain that, if Roosevelt and the New Dealers had stuck to the policies his administration put in place, the economy would have made a full recovery within 18 months of the election in 1932 stating "we have to intensify our resolve to stay the course" and all will be well in time "if we just take our medicine". In hindsight, as Parker says, it challenges the imagination to think up worse policy prescriptions for the events of 1929-32.

There is no suggestion that such policy extremes are promoted in the UK, but there appears to be moralistic and non-Keynesian threads to the current policy, or at least in its presentation. The underlying problem is that in a closed economy all parties cannot all save and all maintain their living standards, as income and spending must match. In a benign situation the savings of some sectors might be offset by, say, non-financial institutions and foreigners, as the government hoped, but this is not immediately apparent.

To ascribe errors to the mainstream economic policy makers and to established economic research organisations is usually the lot of partial politicians or deemed eccentrics. One area where over a prolonged period sound economic thought was stifled or traduced was in the promotion of the concept of the Euro as a workable monetary system. Perhaps like the Fed in the Great Depression there will be changes – after all Mervyn King said "of all the ways of organising banking, the worst is the one we have today".

On present indications UK economic growth will be low with a high probability of a recession. Unemployment will rise further and there will be further falls in demand. Inflation seems likely to return to acceptable levels. A major recession would threaten deflation, a far worse outcome than the mild inflation at present, which is a major factor in diminishing real debt and presents a low cost option to reduce it. I conclude as I have done for the last two years, and I suspect I may do next year, quoting Alfred Marshall, the eminent Cambridge economist: "The commercial storm leaves a path strewn with ruin; when it is over there is calm, but a dull heavy calm"

These conclusions are wholly conditional on the Euro "muddling through". A serious infarction could lead to a 1930s style catastrophe.

Property Prospects

In the previous property investment cycle the CBRE All Property Yield Index peaked at 7.4% in November 2001 and fell steadily to a trough of 4.8% in May 2007 before rising in this cycle to a peak of 7.8% in February 2009, a yield surpassed only twice since 1970, on short occasions when Bank Rate was over 10%. Yields fell rapidly from 7.8% and by February 2010 were 6.4% and fell another 0.1 percentage points in May 2010 to 6.3% (5.8% C&W) with only a further fall of 0.1 percentage points since then.

The peak yield of 7.8% in February 2009 was 4.6 percentage points higher than the ten year Gilt, the highest "Yield Gap" since records began in 1972, and 1.4 percentage points higher than the previous record in February 1999.¹⁰¹ From the 1970s until the late 1990s, except for one year, the 1993/94 downturn, the position was reversed – "the Reverse Yield Gap" - and the Gilt yield exceeded the property yield, The "Yield Gap" was re-established in 1997 and has persisted since then, except very briefly, at the 2007 property peak. The current "Yield Gap" of 4.0 percentage points, is much higher than the average over twenty years partly because 10 year Gilts yield only 2.3%.

The All Property Rent Index which, apart from a brief fall in 2003, had risen consistently since 1994 fell 0.1% in the quarter to August 2008 and then fell substantially for four consecutive quarters by 12.3% altogether. From August 2009 rents rose for four consecutive quarters, due wholly to a rise of 6.9% in office rents, and the index rose by 0.9% in August 2010 since when a further rise of about 1.0% has taken place due to a 4.7% rise in office rents and a 1.1% rise in shop rents.

Property Investment, as measured by the IPD All Property Index returned 8.70% in the year to 31 October 2011, of which 80% of the return was income, as capital growth slowed during the twelve

months to only 1.7%. In the year to 31 October 2010 the return was 20.4% compared with minus 14.0% in the year to 31 October 2009 and minus 22.5% in the year ended 31 December 2008, a month that produced a record fall of 5.3%. As the IPD total return figures include about (plus) seven percentage points of return from Income, the negative total return figures disguise an even greater capital loss than indicated by the return. The Bank notes that the Commercial Property prices fell by about 44% in late 2008 but recovered last year to about 35% below the 2007 peak, and with the small capital growth of 1.7% recorded this year will be about 34% below the peak. The total returns to property to 30 September 2011 were 8.66%, considerably better than the total return to equities of minus 4.36%, but much worse than the return to 20yr gilts of 11.22%.

Total Property returns in 2011 are widely forecast at about 8.0% (Colliers 8.0%, Cluttons 8.8%, IPF 7.5%) and the mean return based on derivatives is 8.1%. Forecasts for 2012 have been downgraded since last year, when Colliers forecast 12.0%, Cluttons 8.6% and IPF 9.2%, to 8.2%, 6.9% and 4.5% respectively this year. Last year the return implied in 2012 by the derivatives market was 3.7%, but this year that forecast has dropped to a paltry 1.2%! All these forecasts were made before the OBR November report and the Chancellor's autumn statement, both of which substantially downgraded previous forecasts of economic growth. Low economic growth, which may relapse back into a recession, will reduce demand for occupational property and so reduce rents and increase vacancies, both of which will reduce investment values.

Present and prospective economic conditions have already reduced the quality of tenants' covenants which has had a dramatic effect on tertiary property values. Since the peak the difference in yield between primary and tertiary property has widened from the 2007 lows of between 1.8 percentage points and 2.8 percentage points, depending on the category of property, to between 3.5 percentage points and 6.2 percentage points. The highest gap of 2 percentage points represents the yield difference in office yields between prime and tertiary investments both outside London. Cluttons consider that, although a record yield gap exists, it will widen further.

I see no recovery in the investment property market until there is a prospect of "normal" economic growth. In due course there will be a cyclical recovery. However, the investment property market will continue a secular erosion caused by the factors previously enumerated, before the Group embarked on a policy of property disposals particularly, technical obsolescence, loss of locational primacy and competition from new formats. A practical example makes the point succinctly. A charming New Town office is currently for sale, un-refurbished but in good order, for offers over £650,000. We sold that office in good decorative order to an owner occupier in 1989 for £970,000. Adjusting for inflation the present value of the sale price is £1,880,000 a drop of an amazing 65% in real terms. Rising yields, increased vacancies and tighter credit conditions have caused many property based loans to be delinquent or non-refinanceable, estimated at c£100bn. Most loans are being "managed" by the lenders, but if conditions require these properties to be refinanced at short notice, a large supply of mostly secondary property will erode investment values further.

This time last year predictions of house price changes in 2011 ranged from -5.1% Capital Economics, to "flat" or "steady" except for prices derived from the Halifax House Price Derivatives which indicated a steep fall of 8.5%. The outturn to November 2011 varies amongst the index providers and for England and Wales is between - 3.1% Land Registry to +1.6% Nationwide. The widely used Halifax Index records -1.0%, almost the same as the much more comprehensive LSL/Acadametrics Index. Of the indices the Land Registry(-3.1%) is the only one that tracks solely properties previously sold and uses geometric means so reducing the influence of "outlying" prices. Scottish house prices show a narrower range to September 2011 from about -1.5% LSL/Acadametrics, -1.0% Nationwide and Halifax and nil Registers of Scotland. LSL/Acadametrics adjust their figures for seasonal variations and for "mix" variations e.g. standardise the number of small flats and mansion-houses, but Registers of Scotland use the actual data unadjusted.

There have been significant differences in price changes among the regions and among house types. In England and Wales, prices have risen only in London by 3.1%, but falls of about 4.0% have occurred in Yorkshire and Humber, West Midlands and the North West and of 7.2% in the North. Anomalously the overall price of flats has increased by 2% in the three months to October 2011, due to high prices in London, but flats in the North have fallen by 12% over the year, the largest fall of any category.

Interestingly recent house transactions have increased from only 58% of long term transactions from 1995-2010 in January 2011 to 66% in November 2011, probably because, according to LSC/Acadametrics the cost of mortgages has recently fallen and they have become less unavailable. Poorly performing areas such as the North only show a 5% rise in transactions while London and Southern areas show a 12% increase. Similarly terraced houses, traditional in industrial areas, show only a 7% rise in transactions but transactions in detached houses are up 14%. There appears strong positive correlation between transaction number and price.

In Scotland annual price changes of about -1% have been similar to England and Wales as a whole but price falls have been less than Wales and in the northerly regions of England. The Halifax showed prices peaked at £199,600 in August 2007. Inflation to September 2011 has been 14.5% and the average price adjusted for inflation would be £228,540. The Halifax House Price of £161,131 in September 2011 implies a fall of 29.5% in real terms.

House price predictions for 2012 vary in a similar range to those of 2011 reported a year ago. The average for those forecasts reviewed by HM Treasury is - 0.13%, with the average of recent forecasts at -0.92%. The three most pessimistic forecasts are around -5.0%, including notably Capital Economics, but there is one optimist, Beacon Economics, forecasting growth at 5.0%. The specialist house price surveys are generally pessimistic - Nationwide expects prices on the "downside", Hometrack expects an "acceleration of price falls", and LSL says "the outlook for transactions in 2012 is that they might weaken slightly in the light of reduced confidence, tighter household budgets and restricted lending". Similar views seem to be held by the Bank who comment that "forward looking indicators of housing market activity have remained weak", while David Miles, an external member of the MPC, said that the housing market was in transition and that it might "never look quite the same again" while the OBR in November suggested that house prices would fall slightly in 2012 and that transactions would remain subdued. Savills forecast for 2012 has changed over the last few months. In the summer of 2011 they predicted UK house price growth of 1.5% in 2012, 3.0% in 2013 and 5% in 2014, but these predictions have been revised down to -2.0% , 0.5% and 1% respectively, based on lower GDP growth of 1% and higher unemployment. The Economist argues that UK prices may not have reached a "floor" and, even if they have, they may go lower by undershooting fair value as occurred by 33% in the mid 1990s. The Economist calculates indices of prices against rents and disposable income and shows that index compared to the long-term average of such indices. Current prices are still 28% higher against "rents" and 20% higher against "disposable income". By comparison France is +58% and +39% respectively and Germany is -36% on both.

Undoubtedly prices depend on the balance between the supply and demand for houses but are subject to slightly differing constraints in the long term from the short term. The long-term supply of houses is relatively inelastic and slow to respond to changes in demand largely due to the long cycle time of acquiring planning and then constructing and also due to restrictions imposed by institutional factors. The long-term demand for houses, according to the currently used econometric models, is likely to continue to grow at a rate which may be reduced but is unlikely to be appreciably altered, even by a depression of such continuing length as is currently being experienced. Cumulative supply shortage as estimated by Savills will be 1.4m in 2022 and 400,000 in Scotland. Demand also grows with increasing affluence as time, convenience, amenity and quality of location all become more valued. While the current fundamental imbalance persists between the supply and demand prices will be higher in the long term.

The short-term market is supplied by recycling existing houses and by new houses increasingly built for established demand. Existing house supply is derived from owners exercising their discretion to move house – larger, smaller, smarter, relocation – who buy other such houses so effectively recycling them. Another supply source, but a "non-discretionary" one, is from estates, from household "breakups" and from repossessions. The volume from the first two should be relatively fixed, although the depression which at first appears to have reduced "breakups", has now increased them, but the supply from repossessions will vary considerably with interest rates and with economic activity. While interest rates are likely to remain low, effects of the fiscal tightening on economic activity, particularly on unemployment is likely to be severe. Already unemployment has risen steeply, employment levels are down and the jobless rate up from 7.9% in July to 8.3% in September. Importantly, the FSA estimates that 5-8% of all the UK mortgages would be in arrears if the banks chose not to exercise forbearance. A change in policy or a rise in numbers might cause a large scale flood of repossessions. These factors will cause a rise in the short-term supply.

Short-term demand will be determined primarily by mortgage cost and availability. Fortunately mortgage costs are likely to remain low but credit for house purchase seems likely to continue to be restricted and subject to rationing, so restricting demand, when supply may be increasing. Thus the short-term outlook for the housing market is unfavourable and I expect further price falls in 2012.

The housing market is a paradox: demand rationed by credit is the major influence on short-term prices and supply rationed by institutional factors is the major influence on long-term prices. In the short-term credit rationing together with deteriorating economic conditions is likely to depress prices. Credit rationing is a major contributory factor to the current house price falls and, when it eases, probably coincident with stronger economic growth, then supply will again become limiting. Thus the key determinant of the long term housing market will be the restriction of supply which will result in higher prices

Future Progress

The Group shall shortly complete three major objectives. Our investment portfolio has been realised apart from two high yielding multi-let retail parades, which will be retained. Sales have taken place primarily when development or special opportunities occurred or when the investments "matured". Bank loans have been paid down and expensive new facilities declined. The directors expect that the two remaining small bank loans will be paid off early in 2012 when the Group will then have no bank debt. In our development portfolio a very high proportion of sites now have excellent planning consents, many of these gained in the last three years. Our several strategic land sites have been extensively promoted for inclusion in Local Plans and we have secured bridgeheads there. The investment in these long planning processes has been considerable but is already providing a return on investment with the prospect of very considerable future returns. The investment in planning will be greatly reduced next year.

Our emphasis is shifting to the completion and realisation of development opportunities which can be marketed shortly. Within our development portfolio there are sufficient opportunities to allow several years of such minor sales. As these sales take place other development opportunities will be brought forward to provide replacements for the realisations. This, together with the income from our investment portfolio, will provide stability during the continuing prolonged depression.

We will not commission any major development until market conditions improve, or at least until the probability of another downward lurch in the economy is significantly reduced. We do not depend on a recovery in prices for the successful development of our sites as most of these sites were purchased unconditionally, i.e. without planning permission, for prices not far above their existing use value, and before the 2007 house peak. The main component of the possible development value lies in the grant of planning permission, and in its extent, and is relatively independent of even large changes in house values. For development or trading properties no change is made to the Company's balance sheet even when improved development values have been obtained. Naturally, however, the balance sheet will reflect such enhanced value when the properties are developed or sold.

I have commented on the investment property market over the last few years, concluding that over the cycle real returns were at best poor, that the easing of traditional supply restrictions would reduce values and that values were very volatile, as subsequent price falls and the 2008 crash amply demonstrated. In 2005 I said "Investment property seems fully priced .. ."; in 2006 "a further disadvantage of investment property is that recent price rises are arguably due to a short-term speculative serial correlation – a momentum effect – which ultimately will be susceptible to a long-term reversal"; and in 2007, noting the tendency of homogeneous chemical structures to shatter suddenly, "the behaviour of the commercial property market is consistent with the hypothesis that homogeneity is a prelude to fracture. Returns have been very high; a relatively specialised asset class has been opened up to retail investors who have invested heavily; funds have promoted commercial property investment aggressively; bank investment has increased; more and more complex and more geared investment vehicles have been created; reasonable expectation of returns has diminished progressively and depended more and more on increasing capital values rather than rental growth while financing costs rise".

We will deploy the same care in determining future investment decisions and the policy of the Group will continue to be considered and conservative, but responsive to market conditions and opportunistic. The mid market share price on 21 December 2011 was 110p a discount to the NAV of 157.6p. The Board does not recommend a final dividend, but will restore dividends when profitability and consideration for other opportunities and obligations permits.

Conclusion

I repeat much of last year's conclusion: "Three years ago I concluded: 'The UK economy is expected to experience a major deflationary shock resulting from an unprecedented contraction of credit;' two years ago I concluded: 'Fortunately the recession will pass, but will not leave its passage unmarked;' and last year I concluded: 'This present alleviation (of the recession) comes at a terrible and continuing long-term cost: huge debts; high servicing costs; lower output..... and presages a watershed in economic management, in political power and moral sway and in changing world order... .. The scale of the cost in the UK is becoming evident, a continuing process, as the Euro crisis highlights, and the prospective pain of the remedial measures looms, encompassing lower employment, continuing business failure and a fall in the economy's potential output, now operating up to 10% below capacity. The depression resulting from a financial crisis is the worst since the Great Depression, but, fortunately, severe as it is, the worst consequences of that period appear to have been avoided, largely by improved economic management. However, there will be long-term changes following "The Second Great Contraction" which, although discernible, are not yet evident' ".

The Group is successfully negotiating the worst economic crisis for a century. The implementation of considered strategies now permits us to operate on a cash neutral basis during the long crisis while still affording us the possibility of realising major opportunities even while it persists.

I D Lowe
Chairman
23 December 2011

Group income statement for the year ended 30 June 2011

| | Note | 2011 £000 | 2010 £000 |
|---|------|--------------|--------------|
| Gross rental income | | 682 | 648 |
| Service charge income | | 22 | 24 |
| Dilapidation income | | - | 25 |
| Property charges | | (368) | (305) |
| Net rental and related income | | 336 | 392 |
| Proceeds from sale of trading properties | | - | 370 |
| Carrying value of trading properties sold | | - | (347) |
| Profit from disposal of trading properties | | - | 23 |
| Administrative expenses | | (896) | (889) |
| Other income | | 43 | 81 |

| | | | |
|--|---|----------------|----------------|
| Net operating loss before investment property disposals and valuation movements | 5 | (517) | (393) |
| (Loss)/profit on disposal of investment properties | | (273) | 48 |
| Valuation gains on investment properties | | 175 | 450 |
| Valuation losses on investment properties | | (50) | (205) |
| Net valuation gains on investment properties | | 125 | 245 |
| Operating loss | | (665) | (100) |
| Financial income | 7 | - | 1 |
| Financial expenses | 7 | (260) | (195) |
| Net financing costs | | (260) | (194) |
| Loss before taxation | | (925) | (294) |
| Income tax | 8 | - | - |
| Loss for the financial period attributable to equity holders of the company | | (925) | (294) |
| Loss per share | | | |
| Basic loss per share (pence) | 9 | (7.78p) | (2.47p) |
| Diluted loss per share (pence) | 9 | (7.78p) | (2.47p) |

Consolidated statement of comprehensive income for the year ended 30 June 2011

| | 2011 | 2010 |
|--|--------------|--------------|
| | £000 | £000 |
| Loss for the period attributable to the equity holders of the parent company | (925) | (294) |
| Change in fair value of equity securities available for sale | (1) | 3 |
| Total other comprehensive (loss)/income | (1) | 3 |
| Total comprehensive income for the period | (926) | (291) |

Consolidated balance sheet as at 30 June 2011

| | 2011 | 2010 |
|------|-------------|-------------|
| Note | £000 | £000 |

| | | | |
|--|----|----------------|----------------|
| Non current assets | | | |
| Investment property | 10 | 11,650 | 16,410 |
| Property, plant and equipment | 11 | 35 | 22 |
| Investments | 12 | 4 | 5 |
| Total non-current assets | | 11,689 | 16,437 |
| Current assets | | | |
| Trading properties | 13 | 11,131 | 10,891 |
| Trade and other receivables | 14 | 65 | 134 |
| Cash and cash equivalents | 15 | 577 | 250 |
| Total current assets | | 11,773 | 11,275 |
| Total assets | | 23,462 | 27,712 |
| Current liabilities | | | |
| Trade and other payables | 16 | (512) | (485) |
| Interest bearing loans and borrowings | 17 | (1,497) | (5,673) |
| | | (2,009) | (6,158) |
| Non current liabilities | | | |
| Interest bearing loans and borrowings | 17 | (2,725) | (1,900) |
| Total liabilities | | (4,734) | (8,058) |
| Net assets | | 18,728 | 19,654 |
| Equity | | | |
| Issued share capital | 21 | 2,377 | 2,377 |
| Capital redemption reserve | 22 | 175 | 175 |
| Share premium account | 22 | 2,745 | 2,745 |
| Retained earnings | 22 | 13,431 | 14,357 |
| Total equity attributable to equity holders of the parent company | | 18,728 | 19,654 |

The financial statements were approved by the board of directors on 23 December 2011 and signed on its behalf by:

ID Lowe
Director

Company registration number 1040126

Consolidated cash flow statement for the year ended 30 June 2011

| | | |
|---|--------------|-------|
| | 2011 | 2010 |
| | £000 | £000 |
| Cash flows from operating activities | | |
| Loss for the period | (925) | (294) |

| | | |
|---|----------------|----------------|
| Adjustments for : | | |
| Profit/(loss) on sale of investment property | 273 | (48) |
| Gains on fair value adjustment of investment property | (125) | (245) |
| Depreciation | 9 | 12 |
| Net finance expense | 260 | 194 |
| | <hr/> | <hr/> |
| Operating cash flows before movements in working capital | (508) | (381) |
| (Increase)/decrease in trading properties | (240) | 121 |
| Decrease in trade and other receivables | 69 | 73 |
| Increase/(decrease) in trade and other payables | 26 | (110) |
| | <hr/> | <hr/> |
| | (653) | (297) |
| Interest paid | (260) | (210) |
| Interest received | - | 1 |
| | <hr/> | <hr/> |
| Net cash flows from operating activities | (913) | (506) |
| | <hr/> | <hr/> |
| Investing activities | | |
| Proceeds from sale of investment property | 4,612 | 947 |
| Acquisition of property, plant and equipment | (22) | (10) |
| | <hr/> | <hr/> |
| Cash flows from investing activities | 4,590 | 937 |
| | <hr/> | <hr/> |
| Financing activities | | |
| Repayments of long term borrowings | (4,175) | (1,087) |
| Increase in other long term borrowings | 825 | - |
| | <hr/> | <hr/> |
| Cash flows from financing activities | (3,350) | (1,087) |
| | <hr/> | <hr/> |
| Net increase/(decrease) in cash and cash equivalents | 327 | (656) |
| Cash and cash equivalents at beginning of year | 250 | 906 |
| | <hr/> | <hr/> |
| Cash and cash equivalents at end of year | 577 | 250 |
| | <hr/> <hr/> | <hr/> <hr/> |

Notes to the consolidated financial statements as at 30 June 2011

1 Reporting entity

Caledonian Trust PLC is a company domiciled in the United Kingdom. The consolidated financial statements of the company for the year ended 30 June 2011 comprise the company and its subsidiaries (together referred to as “the Group”). The Group’s principal activities are the holding of property for both investment and development purposes.

2 Statement of Compliance

The group financial statements have been prepared and approved by the directors in accordance with International Financial Reporting Standards as adopted by the EU (“Adopted IFRSs”).

3 Basis of preparation

The financial information set out above does not constitute the company's statutory accounts for the years ended 30 June 2011 or 2010 but is derived from the 2011 accounts. Statutory accounts for 2010 have been delivered to the Registrar of Companies, and those for 2011 will be delivered in due course. The auditors have reported on those accounts; their reports were (i) unqualified and (ii) did not contain statements under Section 498(2) or (3) of the Companies Act 2006.

The financial statements are prepared on the historical cost basis except for available for sale financial assets and investment properties which are measured at their fair value.

The preparation of the financial statements in conformity with Adopted IFRSs requires the directors to make judgements, estimates and assumptions that affect the application of policies and reported amounts of assets and liabilities, income and expenses. The estimates and associated assumptions are based on historical experience and various other factors that are believed to be reasonable under the circumstances, the results of which form the basis of making the judgements about carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates.

These financial statements have been presented in pounds sterling which is the functional currency of all companies within the Group. All financial information has been rounded to the nearest pounds thousand.

Going concern

The group's business activities, together with the factors likely to affect its future development, performance and position are set out in the Chairman's Statement. The financial position of the group, its cash flows, liquidity position and borrowing facilities are described in Note 18.

In addition note 18 to the financial statements includes the group's objectives, policies and processes for managing its capital; its financial risk management objectives; details of its financial instruments and hedging activities; and its exposures to credit risk and liquidity risk.

The group and company finance their day to day working capital requirements through a combination of related party loans and two third party debt facilities (see note 17). Both loan facilities are due for renewal within the next 12 months.

The Directors have prepared projected cash flow information for the period ending twelve months from the date of their approval of these financial statements. These forecasts which demonstrate that the group has sufficient resources to meet the liabilities as they fall due are dependent upon sales which are contractually agreed but have not yet completed. These sales will generate sufficient funds to allow both of the third party debt facilities to be repaid, rather than renewed.

Should these sales not complete the directors are confident that they would be able to sell sufficient other properties within a short timescale to repay the existing facilities in full and generate sufficient funds to meet other liabilities as they fall due.

For these reasons they continue to adopt the going concern basis in preparing the financial statements.

Areas of estimation uncertainty and critical judgements

Information about significant areas of estimation uncertainty and critical judgements in applying accounting policies that have the most significant effect on the amount recognised in the financial statements is contained in the following notes:

- *Valuation of investment properties (note 10)*
The valuation of properties is subjective and based on similar transactions in the market, rental yields and development potential. The company's directors are experienced in dealing with such properties. Valuations at the balance sheet date are based on independent external valuations as at 30 June 2010, updated by the Directors to 30 June 2011. The Executive Directors have respectively over 40 years and 30 years experience in commercial property. RJ Pearson is a Fellow of the Royal Institution of Chartered Surveyors and has practised as a surveyor in Scotland for 32 years during which time he has specialised in commercial property.
- *Valuation of trading properties (note 13)*
Trading properties are carried at lower of cost and net realisable value. The net realisable value of such properties is based on the amount the company is likely to achieve in a sale to a third party which is dependent on availability of planning consent and demand for sites which is influenced by the housing and property markets.
- *Taxation (note 8)*
As noted in note 8, the company has treated a dilapidations payment from a tenant as a capital receipt and accordingly no taxation has been provided in these financial statements. In the event that HMRC do not agree with this treatment the directors will vigorously challenge any such contrary view. The tax that would be payable if the receipt were to be treated as revenue is approximately £615,000.

4 Accounting policies

The accounting policies below have been applied consistently to all periods presented.

Basis of consolidation

The financial statements incorporate the financial statements of the company and all its subsidiaries. Subsidiaries are entities controlled by the group. Control exists when the group has the power to determine the financial and operating policies of an entity so as to obtain benefits from its activities. The financial statements of subsidiaries are included in the consolidated financial statements from the date that control commences until the date it ceases.

Revenue

Rental income from properties leased out under operating leases is recognised in the income statement on a straight line basis over the term of the lease. Costs of obtaining a lease and lease incentives granted are recognised as an integral part of total rental income and spread over the period from commencement of the lease to the earliest termination date on a straight line basis.

Revenue from the sale of trading properties is recognised in the income statement on the date at which the significant risks and rewards of ownership are transferred to the buyer with proceeds and costs shown on a gross basis.

Other income

Other income comprises income from agricultural land and other miscellaneous income.

Finance income and expenses

Finance income and expenses comprise interest payable on bank loans and other borrowings. All borrowing costs are recognised in the income statement using the effective interest rate method. Interest income represents income on bank deposits using the effective interest rate method.

Taxation

Income tax on the profit or loss for the year comprises current and deferred tax. Income tax is recognised in the income statement except to the extent that it relates to items recognised

directly in equity, in which case the charge / credit is recognised in equity. Current tax is the expected tax payable on taxable income for the current year, using tax rates enacted or substantively enacted at the reporting date, adjusted for prior years under and over provisions. Deferred tax is provided using the balance sheet liability method in respect of all temporary differences between the values at which assets and liabilities are recorded in the financial statements and their cost base for taxation purposes. (Deferred tax includes current tax losses which can be offset against future capital gains.) As the carrying value of the group's investment properties is expected to be recovered through eventual sale rather than rentals, the tax base is calculated as the cost of the asset plus indexation. Indexation is taken into account to reduce any liability but does not create a deferred tax asset. A deferred tax asset is recognised only to the extent that it is probable that future taxable profits will be available against which the asset can be utilised.

Investment properties

Investment properties are properties owned by the group which are held either for long term rental growth or for capital appreciation or both. Properties transferred from trading properties to investment properties are revalued to fair value at the date on which the properties are transferred. When the Group begins to redevelop an existing investment property for continued future use as investment property, the property remains an investment property, which is measured based on fair value model, and is not reclassified as property, plant and equipment during the redevelopment.

The cost of investment property includes the initial purchase price plus associated professional fees. Borrowing costs directly attributable to the acquisition or construction of qualifying assets are capitalised during the period of construction. Subsequent expenditure on investment properties is only capitalised to the extent that future economic benefits will be realised.

Investment property is measured at fair value at each balance sheet date. External independent professional valuations are prepared at least once every three years. The fair values are based on market values, being the estimated amount for which a property could be exchanged on the date of valuation between a willing buyer and a willing seller in an arms length transaction after proper marketing wherein the parties had each acted knowledgeably, prudently and without compulsion.

Any gain or loss arising from a change in fair value is recognised in the income statement.

Purchases and sales of investment properties

Purchases and sales of investment properties are recognised in the financial statements at completion which is the date at which the significant risks and rewards of ownership are transferred to the buyer.

Property, plant and equipment

Property, plant and equipment are stated at cost, less accumulated depreciation and any provision for impairment. Depreciation is provided on all property, plant and equipment at varying rates calculated to write off cost to the expected current residual value by equal annual instalments over their estimated useful economic lives. The principal rates employed are:

| | | |
|-----------------------|---|---------------|
| Plant and equipment | - | 20.0 per cent |
| Fixtures and fittings | - | 33.3 per cent |
| Motor vehicles | - | 33.3 per cent |

Trading properties

Trading properties held for short term sale or with a view to subsequent disposal in the near future are stated at the lower of cost or net realisable value. Cost is calculated by reference to invoice price plus directly attributable professional fees. Net realisable value is based on estimated selling price less estimated cost of disposal

Financial assets

Trade and other receivables

Trade and other receivables are initially recognised at fair value and then stated at amortised cost.

Financial instruments

Available for sale financial assets

The group's investments in equity securities are classified as available for sale financial assets. They are initially recognised at fair value plus any directly attributable transaction costs. Subsequent to initial recognition they are measured at fair value and changes therein, other than Impairment losses, are recognised directly in equity. The fair value of available for sale investments is their quoted bid price at the balance sheet date. When an investment is disposed of, the cumulative gain or loss in equity is recognised in profit or loss. Dividend income is recognised when the company has the right to receive dividends either when the share becomes ex dividend or the dividend has received shareholder approval.

Cash and cash equivalents

Cash includes cash in hand, deposits held at call (or with a maturity of less than 3 months) with banks, and bank overdrafts. Bank overdrafts that are repayable on demand and which form an integral part of the Group's cash management are shown within current liabilities on the balance sheet and included with cash and cash equivalents for the purpose of the statement of cash flows.

Financial liabilities

Trade payables

Trade payables are non-interest-bearing and are initially measured at fair value and thereafter at amortised cost.

Interest bearing loans and borrowings

Interest-bearing loans and bank overdrafts are initially carried at fair value less allowable transactions costs and then at amortised cost.

IFRS not yet effective

In May 2011 the IASB released three new standards covering consolidation and amended currently existing standards in particular IAS 27 and IAS 28. All consolidation standards have an effective date of 1 January 2013 with early adoption permitted provided all 3 standards are early adopted. These new standards are IFRS 10 – Consolidated Financial Statements, IFRS 11 – Joint Arrangements and IFRS 12 – Disclosure of Interests in Other Entities. The Directors are currently considering the impact of the new standards on the Company.

IFRS 13 – Fair Value Measurements is also effective from 1 January 2013 with early adoption permitted. IFRS 13 replaces the fair value measurement guidance spread throughout various IFRS's with a single source. The standard defines fair value, establishes a framework for measurement and sets out disclosures requirements. The standard does not create any new requirements to measure assets and liabilities at fair value. The disclosures requirements under IFRS 13 are primarily disclosures currently effective within IFRS 7. In a majority of circumstances it is expected that IFRS 13 will not result in significantly different fair value estimates to those obtained under currently effective standards. The Directors are currently considering the impact of this on the Company.

Operating segments

The Group determines and presents operating segments based on the information that is internally provided to the Board of Directors ("The Board"), which is the Group's chief operating decision maker. The directors review information in relation the Group's entire property portfolio, regardless of its type or location and as such are of the opinion

that there is only one reportable segment which is represented by the consolidated position presented in the primary statements.

| | | | |
|----------|---|-------------------|-------------------|
| 5 | Operating profit/(loss) | 2011 | 2010 |
| | | £000 | £000 |
| | The operating loss is stated after charging : | | |
| | Depreciation | 9 | 12 |
| | Fees paid to auditors | | |
| | - audit of the financial statements | 19 | 13 |
| | - audit of financial statements of subsidiaries pursuant to legislation | 15 | 13 |
| | | <u> </u> | <u> </u> |

| | | | |
|----------|--|-------------------|-------------------|
| 6 | Employees and employee benefits | 2011 | 2010 |
| | | £000 | £000 |
| | Employee remuneration | | |
| | Wages and salaries | 380 | 365 |
| | Social security costs | 43 | 42 |
| | Other pension costs | 58 | 58 |
| | | <u> </u> | <u> </u> |
| | | <u> </u> | <u> </u> |

Other pension costs represent contributions to defined contribution plans

The average number of employees during the year was as follows:

| | | |
|----------------|-------------------|-------------------|
| | No. | No. |
| Management | 2 | 2 |
| Administration | 2 | 2 |
| Other | 4 | 4 |
| | <u> </u> | <u> </u> |
| | <u> </u> | <u> </u> |

The directors consider that key management personnel are the company's directors. Compensation is shown below:

| | | |
|---|-------------------|-------------------|
| | 2011 | 2010 |
| | £000 | £000 |
| <i>Remuneration of directors</i> | | |
| Directors' emoluments | 234 | 256 |
| Company contributions to money purchase pension schemes | 52 | 52 |
| | <u> </u> | <u> </u> |

Retirement benefits are accruing to 2 (2010 - 2) directors under money purchase schemes.

The directors who served during the year and their remuneration for the year are shown below:

| | | | | | |
|------------|-----------------|----------|-----------------------|-------------------|-------------------|
| Director | Salary and Fees | Benefits | Pension Contributions | 2011 Total | 2010 Total |
| | £000 | £000 | £000 | £000 | £000 |
| ID Lowe | 110 | 4 | 28 | 142 | 141 |
| MJ Baynham | 125 | 2 | 25 | 152 | 152 |
| AJ Hartley | (15) | - | - | (15) | 8 |
| RJ Pearson | 8 | - | - | 8 | 8 |

| | | | | |
|------------|----------|-----------|------------|------------|
| <u>228</u> | <u>6</u> | <u>53</u> | <u>287</u> | <u>309</u> |
|------------|----------|-----------|------------|------------|

7 Finance income and finance costs

| | 2011 | 2010 |
|--|-------------------|-------------------|
| | £000 | £000 |
| Finance income | | |
| Interest receivable: | | |
| - on bank balances | - | 1 |
| | <u> </u> | <u> </u> |
| Finance costs | | |
| Interest payable: | | |
| - Bank loans and overdrafts | 200 | 132 |
| - Loan stock repayable within five years | 60 | 63 |
| | <u> </u> | <u> </u> |
| | 260 | 195 |
| | <u> </u> | <u> </u> |

8 Income tax

| | 2011 | 2010 |
|--|-------------------|-------------------|
| | £000 | £000 |
| <i>Recognised in the income statement</i> | | |
| UK corporation tax – current period | - | - |
| | <u> </u> | <u> </u> |
| | - | - |
| | <u> </u> | <u> </u> |
| Deferred tax – effect of change in rate | - | - |
| Deferred tax – current period | - | - |
| | <u> </u> | <u> </u> |
| Total income tax charged in income statement | - | - |
| | <u> </u> | <u> </u> |
| Reconciliation of effective tax rate | | |
| | 2011 | 2010 |
| | £000 | £000 |
| (Loss) before tax | (925) | (294) |
| | <u> </u> | <u> </u> |
| Current tax at 26% (2010 : 28%) | (241) | (82) |
| <i>Effects of:</i> | | |
| Expenses not deductible for tax purposes | 40 | 23 |
| Capital gains tax indexation (restricted) | - | (15) |
| Deferred tax asset not recognised | 41 | 74 |
| Other deferred tax charges related to properties | 160 | - |
| | <u> </u> | <u> </u> |
| Total tax charge | - | - |
| | <u> </u> | <u> </u> |

In the case of deferred tax in relation to investment property revaluation surpluses, the base cost used is historical book cost and includes allowances or deductions which may be available to

reduce the actual tax liability which would crystallise in the event of a disposal of the asset.

The Emergency Budget on 22 June 2010 announced that the UK corporation tax rate will reduce from 28% to 24% over a period of 4 years from 2011. The Budget on 25 March 2011 announced that the UK corporation tax rate will reduce from 28% to 26% was substantively enacted on 31 March 2011 and will be effective from 1 April 2011. It has not yet been possible to quantify the full anticipated effect of the announced further 2% rate reduction, although this will further reduce the company's future current tax charge and decrease the group's deferred tax liability accordingly.

Factors affecting the future tax charge

The group received a dilapidations payment from the former tenants of an investment property amounting to £2,100,000 during the year ended 30 June 2005. The payment was made to fulfil the tenant's obligations under the repairing lease held by them. The directors successfully promoted a development brief for the island site of which the property forms part which was formally adopted by the Planning Authority in August 2009. The directors have been progressing an outline planning consent for the site owned by the group which forms part of this island site and this was issued on 12th September 2011. Accordingly the repair work to the property has not been carried out and it is unlikely that it will be undertaken. The receipt was treated as a capital receipt for taxation purposes on which basis no taxation was payable or has been provided. HMRC has queried the tax treatment of this receipt and there is an ongoing dialogue with HMRC local inspector on the matter. The directors continue to be of the opinion that the receipt is a capital receipt and accordingly no taxation has been provided in these financial statements. In the event that HMRC do not agree with this treatment the directors will vigorously challenge any such contrary view. The tax that would be payable if the receipt were to be treated as revenue is approximately £615,000.

9 Loss per share

Basic loss per share is calculated by dividing the loss attributable to ordinary shareholders by the weighted average number of ordinary shares outstanding during the period as follows:

| | 2011 | 2010 |
|---|-------------------|------------|
| | £000 | £000 |
| Loss for financial period | (925) | (294) |
| | ===== | ===== |
| | No. | No. |
| Weighted average no. of shares: for basic earnings per share and for diluted earnings per share | 11,882,923 | 11,882,923 |
| | ===== | ===== |
| Basic (loss) per share | (7.78p) | (2.47p) |
| Diluted (loss) per share | (7.78p) | (2.47p) |

The diluted figure per share is the same as the basic figure per share as there are no dilutive shares.

10 Investment properties

| | 2011 | 2010 |
|----------------------------------|----------------|--------|
| | £000 | £000 |
| Valuation | | |
| At 30 June 2010 | 16,410 | 17,045 |
| Revaluation in year | 125 | 245 |
| Sold in year | (4,885) | (900) |
| Additions in year | - | 20 |
| Valuation at 30 June 2011 | 11,650 | 16,410 |

The carrying amount of investment property is the fair value at the balance sheet date based on external independent valuations at open market value made by Montagu Evans, independent property consultants, at 30 June 2010 updated by the Directors to 30 June 2011. The Executive Directors have respectively over 40 years and 30 years experience in commercial property. RJ Pearson is a Fellow of the Royal Institution of Chartered Surveyors and has practised as a surveyor in Scotland for 32 years during which time he has specialised in commercial property. The properties have been valued individually in accordance with the definition of market value and good practice guidelines set out in the 6th Edition of the Royal Institution of Chartered Surveyors valuation and appraisal manual. In this regard, market value is defined as “the estimated amount for which a property should exchange between a willing buyer and willing seller in an arm’s length transaction after proper marketing wherein the parties had acted knowledgeably, prudently and without compulsion”. The values have taken into account rental values and development potential.

Fair values were calculated having regard to recent transactions for similar properties.

Investment properties comprise a number of commercial properties, some of which are leased to third parties with an initial rental period. Subsequent renewals are negotiated with the tenant.

The cumulative amount of interest capitalised in respect of the group’s investment properties is £684,000 (2010: £684,000).

Certain of the company’s investment properties with a carrying value of £6,000,000 (2010: £13,125,000) are secured against bank borrowings and as such on disposal of investment properties a proportion of proceeds are remitted to reduce bank borrowings

11 Property, plant and equipment

| | Motor Vehicles £000 | Fixtures and fittings £000 | Other equipment £000 | Total £000 |
|------------------------|---------------------------|----------------------------------|----------------------------|---------------|
| Cost | | | | |
| At 30 June 2009 | 18 | 48 | 43 | 109 |
| Additions in year | - | 4 | 5 | 9 |
| At 30 June 2010 | 18 | 52 | 48 | 118 |
| Additions in year | 3 | 1 | 18 | 22 |
| At 30 June 2011 | 21 | 53 | 66 | 140 |
| Depreciation | | | | |
| At 30 June 2009 | 17 | 45 | 22 | 84 |
| Charge for year | - | 4 | 8 | 12 |
| At 30 June 2010 | 17 | 49 | 30 | 96 |
| Charge for year | 1 | 2 | 6 | 9 |
| At 30 June 2011 | 18 | 51 | 36 | 105 |
| Net book value | | | | |
| At 30 June 2011 | 3 | 2 | 30 | 35 |
| At 30 June 2010 | 1 | 3 | 18 | 22 |

12 Investments

| | |
|-------------|------|
| 2011 | 2010 |
| £000 | £000 |

| | | |
|---|---------------|---------------|
| <i>Available for sale investments</i> | | |
| At the start of the year | 5 | 2 |
| (Loss)/gain on investments recognised in equity | (1) | 3 |
| Available for sale financial assets | <u>4</u> | <u>5</u> |
| 13 Trading properties | 2011 | 2010 |
| | £000 | £000 |
| At start of year | 10,891 | 11,032 |
| Additions | 240 | 206 |
| Disposals | - | (347) |
| At end of year | <u>11,131</u> | <u>10,891</u> |

Trading properties with carrying value of £nil (2010: £2,546,000) are secured against the Group's bank borrowings.

| | | |
|--|-------------|------------|
| 14 Trade and other receivables | 2011 | 2010 |
| | £000 | £000 |
| <i>Amounts falling due within one year</i> | | |
| Other debtors | 6 | 52 |
| Prepayments and accrued income | 59 | 82 |
| | <u>65</u> | <u>134</u> |

The company's exposure to credit risks and impairment losses relating to trade receivables is given in note 18.

| | | |
|-------------------------------------|-------------|------|
| 15 Cash and cash equivalents | 2011 | 2010 |
| | £000 | £000 |
| Cash | 577 | 250 |

Cash and cash equivalents comprise cash at bank and in hand. Cash deposits are held with UK banks. The carrying amount of cash equivalents approximates to their fair values. The company's exposure to credit risk on cash and cash equivalents is regularly monitored.

| | | |
|------------------------------------|-------------|------|
| 16 Trade and other payables | 2011 | 2010 |
| | £000 | £000 |
| Accruals and other creditors | 512 | 485 |

The Group's exposure to currency and liquidity risk relating to trade payables is disclosed in note 18.

17 Other interest bearing loans and borrowings

The Group's interest bearing loans and borrowings are measured at amortised costs. More information about the Group's exposure to interest rate risk and liquidity risk is given in note 18.

Current liabilities

| | 2011 | 2010 |
|---------------------------------------|--------------|--------------|
| | £000 | £000 |
| Current portion of secured bank loans | <u>1,497</u> | <u>5,673</u> |
| <i>Non current liabilities</i> | | |
| Floating rate unsecured loan stock | <u>2,725</u> | 1,900 |
| | <u>2,725</u> | <u>1,900</u> |

Terms and debt repayment schedule

Terms and conditions of outstanding loans and loan stock were as follows:

| | Currency | Nominal interest rate | 2011 | | 2010 | |
|------------------------------------|----------|------------------------------------|-------------------|------------------------|--------------|-----------------|
| | | | Fair value | Carrying amount | Fair value | Carrying amount |
| | | | £000 | £000 | £000 | £000 |
| Secured bank loans | GBP | LIBOR + 0.95 to 4.5% Base +1.5% | 1,497 | 1,497 | 5,673 | 5,673 |
| Floating rate unsecured loan stock | GBP | Base + 3% | 2,725 | 2,725 | 1,900 | 1,900 |
| | | | <u>4,222</u> | <u>4,222</u> | <u>7,573</u> | <u>7,573</u> |

The bank loans are secured by standard securities and charges over the assets of certain subsidiaries and by an unlimited guarantee by Caledonian Trust PLC.

18 Financial instruments

Fair values

Fair values versus carrying amounts

The fair values of financial assets and liabilities, together with the carrying amounts shown in the balance sheet, are as follows:

| | 2011 | | 2010 | |
|-------------------------------------|-------------------|------------------------|------------|-----------------|
| | Fair value | Carrying amount | Fair value | Carrying amount |
| | £000 | £000 | £000 | £000 |
| Available for sale financial assets | 4 | 4 | 5 | 5 |
| Trade and other receivables | 65 | 65 | 134 | 134 |
| Cash and cash equivalents | 577 | 577 | 250 | 250 |
| | <u>646</u> | <u>646</u> | <u>389</u> | <u>389</u> |
| Secured bank loans | (1,497) | (1,497) | (5,673) | (5,673) |
| Loan from related party | (2,725) | (2,725) | (1,900) | (1,900) |
| Trade and other payables | (512) | (512) | (485) | (485) |

| | | | |
|---------|---------|---------|---------|
| (4,734) | (4,734) | (8,058) | (8,058) |
|---------|---------|---------|---------|

Estimation of fair values

The following methods and assumptions were used to estimate the fair values shown above:

Available for sale financial assets – as such assets are listed, the fair value is determined at the market price.

Trade and other receivables/payables – the fair value of receivables and payables with a remaining life of less than one year is deemed to be the same as the book value.

Cash and cash equivalents – the fair value is deemed to be the same as the carrying amount due to the short maturity of these instruments.

Secured bank loans and other loans – the fair value is calculated by discounting the expected future cashflows at prevailing interest rates

Overview of risks from its use of financial instruments

The Group has exposure to the following risks from its use of financial instruments:

- credit risk
- liquidity risk
- market risk

The Board of Directors has overall responsibility for the establishment and oversight of the company's risk management framework and oversees compliance with the Group's risk management policies and procedures and reviews the adequacy of the risk management framework in relation to the risks faced by the Group.

The Board's policy is to maintain a strong capital base so as to cover all liabilities and to maintain the business and to sustain its development.

The Board of Directors also monitors the level of dividends to ordinary shareholders.

There were no changes in the Group's approach to capital management during the year.

Neither the company nor any of its subsidiaries are subject to externally imposed capital requirements.

The group's principal financial instruments comprise bank loans, cash and short term deposits. The main purpose of these financial instruments is to finance the group's operations.

As the group operates wholly within the United Kingdom, there is currently no exposure to currency risk.

The main risks arising from the group's financial instruments are interest rate risks and liquidity risks. The board reviews and agrees policies for managing each of these risks, which are summarised below

Credit risk

Credit risk is the risk of financial loss to the Group if a customer or counterparty to a financial instrument fails to meet its contractual obligations and arises principally from the Group's receivables from customers, cash held at banks and its available for sale financial assets.

Trade receivables

The Group's exposure to credit risk is influenced mainly by the individual characteristics of each tenant. The majority of rental payments are received quarterly in advance which reduces the group's exposure to credit risk on trade receivables.

Other receivables

Other receivables consist of amounts due from a company in which the group holds a minority

investment.

Available for sale financial assets

The Group does not actively trade in available for sale financial assets. The Group's investments had a fair value of £4,000 at 30 June 2011 (2010: £5,000) and so the Group does not have significant exposure to credit risk in relation to these assets.

Bank facilities

At the year end the company had loan facilities of £1.5 million (2010: £7.6 million) available.

Exposure to credit risk

The carrying amount of financial assets represents the maximum credit exposure. The maximum exposure to credit risk at the reporting date was:

| | Carrying value | |
|--------------------------------|------------------------|-----------------|
| | 2011 | 2010 |
| | £000 | £000 |
| Available for sale investments | 4 | 5 |
| Other receivables | 6 | 52 |
| Cash and cash equivalents | 577 | 250 |
| | <hr/> 587 <hr/> | <hr/> 307 <hr/> |

The company does not have an allowance for impairment on trade receivables as, based on historical experience, management does not consider that such an impairment is required.

Credit risk for trade receivables at the reporting date was all in relation to property tenants in United Kingdom.

The company's exposure is spread across a number of customers.

Liquidity risk

Liquidity risk is the risk that the Company will not be able to meet its financial obligations as they fall due. The Company's approach to managing liquidity is to ensure, as far as possible, that it will always have sufficient liquidity to meet its liabilities when due without incurring unacceptable losses or risking damage to the Company's reputation.

Whilst the directors cannot envisage all possible circumstances, the directors believe that, taking account of reasonably foreseeable adverse movements in rental income, interest or property values, the group has sufficient resources available to it, including additional support from the major shareholder if necessary, to ensure continued compliance with these conditions.

The group's exposure to liquidity risk is given below

| 30 June 2011 | Carrying amount | Contr actual cash flows | 6 months or less | 6-12 months | 1-2 years |
|------------------------------------|------------------------|--------------------------------|-------------------------|--------------------|------------------|
| Secured bank loans | 1,497 | 1,560 | 1,560 | - | - |
| Floating rate unsecured loan stock | 2,725 | 2,822 | 48 | 48 | 2,726 |
| Trade and other payables | 512 | 512 | 512 | - | - |

| 30 June 2010 | Carrying amount | Contractual cash flows | 6 months or less | 6-12 months | 1-2 years |
|------------------------------------|-----------------|------------------------|------------------|-------------|-----------|
| Secured bank loans | 5,673 | 5,766 | 771 | 4,995 | |
| Floating rate unsecured loan stock | 1,900 | 2,034 | 67 | 67 | 1,900 |
| Trade and other payables | 485 | 485 | 485 | - | - |

Market risk

Market risk is the risk that changes in market prices, such as interest rates, will affect the company's income or the value of its holdings of financial instruments. The objective of market risk management is to manage and control market risk exposures within acceptable parameters, while optimising the return.

Interest rate risk

The Group borrowings are at floating rates of interest based on LIBOR or Base Rate.

The interest rate profile of the Group's borrowings as at the year end was as follows:

| | 2011 £000 | 2010 £000 |
|---|--------------|--------------|
| Floating rate instruments – financial liabilities | 4,222 | 7,573 |

The weighted average interest rate of the floating rate borrowings was 3.98 % (2010: 2.80%).

A 1% movement in interest rates would be expected to change the Group's annual net interest charge by £42,000 (2010: £75,000).

19 Operating leases

Leases as lessors

The group leases out its investment properties under operating leases. The future minimum receipts under non cancellable operating leases are as follows:

| | 2011 £000 | 2010 £000 |
|----------------------------|--------------|--------------|
| Less than one year | 222 | 529 |
| Between one and five years | 670 | 1,923 |
| Greater than five years | 501 | 4,093 |
| | <u>1,393</u> | <u>6,545</u> |

The amounts recognised in income and costs for operating leases are shown on the face of the income statement.

20 Income tax and deferred tax

At 30 June 2011, the group has a potential deferred tax asset of £1,007,000 (2010: £866,000) of which £488,000 (2010: £351,000) relates to differences between the carrying value of investment properties and the tax base. In addition the group has tax losses which would result in a deferred tax asset of £519,000 (2010: £515,000). This has not been recognised due to the uncertainty over the availability of future taxable profits.

Movement in unrecognised deferred tax asset

| £'000 | Balance 1 July 09 at 28% | Additions | Balance 30 June 10 at 28% | Additions | Balance 30 Jun 11 at 26% |
|-----------------------|--------------------------------|-----------|---------------------------------|-----------|--------------------------------|
| | £000 | £000 | £000 | £000 | £000 |
| Investment properties | 261 | 90 | 351 | 137 | 488 |
| Tax losses | 409 | 106 | 515 | 4 | 519 |
| | ----- | ----- | ----- | ----- | ----- |
| Total | 670 | 196 | 866 | 141 | 1,007 |
| | ----- | ----- | ----- | ----- | ----- |

| 21 | Issued share capital | 30 June 2011 | | 30 June 2010 | |
|----|------------------------------|--------------|-------|--------------|-------|
| | | No | £000 | No. | £000 |
| | Authorised | | | | |
| | Ordinary shares of 20p each | 20,000,000 | 4,000 | 20,000,000 | 4,000 |
| | | ===== | ===== | ===== | ===== |
| | Issued and fully paid | | | | |
| | Ordinary shares of 20p each | 11,882,923 | 2,377 | 11,882,923 | 2,377 |
| | | ===== | ===== | ===== | ===== |

Holders of ordinary shares are entitled to dividends declared from time to time, to one vote per ordinary share and a share of any distribution of the company's assets.

| 22 | Capital and reserves | Share capital | Capital redemption reserve | Share premium account | Retained earnings | Total |
|----|-------------------------------------|---------------|----------------------------|-----------------------|-------------------|--------|
| | | £000 | £000 | £000 | £000 | £000 |
| | At 1 July 2010 | 2,377 | 175 | 2,745 | 14,357 | 19,654 |
| | Total recognised income and expense | - | - | - | (926) | (926) |
| | | ----- | ----- | ----- | ----- | ----- |
| | At 30 June 2011 | 2,377 | 175 | 2,745 | 13,431 | 18,728 |
| | | ===== | ===== | ===== | ===== | ===== |
| | At 1 July 2009 | 2,377 | 175 | 2,745 | 14,648 | 19,945 |
| | Total recognised income and expense | - | - | - | (291) | (291) |
| | | ----- | ----- | ----- | ----- | ----- |
| | At 30 June 2010 | 2,377 | 175 | 2,745 | 13,357 | 19,654 |
| | | ===== | ===== | ===== | ===== | ===== |

Capital redemption reserve arose in prior years on redemption of share capital. The reserve is not distributable.

The share premium account is used to record the issue of share capital above par value. This reserve is not distributable and can only be reduced with court approval.

The retained earnings reserve is distributable with the exception of negative amounts arising in relation to property revaluations of £643,000 (2010: positive £875,000). Such reserve is only distributable when the revalued assets are sold outside the group.

23 Related parties

Transactions with key management personnel

Transactions with key management personnel consist of compensation for services provided to the company. Details of this are given in note 6.

Other related party transactions

The parent company has a related party relationship with its subsidiaries.

The group and company has unsecured floating rate loan stock due to Leafrealm Limited, a company of which ID Lowe is the controlling shareholder. This is on normal commercial terms, with the key terms being that the loan stock is not convertible, and attracts interest at the rate of 3% over the base rate of the Bank of Scotland. Leafrealm received £60,000 (2010: £63,000) interest in respect of its holding of Floating Rate Unsecured Loan Stock. The balance due to this party at the year end was £2,725,000 (2010: £1,900,000).

The Annual Report and Accounts will be posted to shareholders on or before 31 December 2011 and further copies will be available, free of charge, for a period of one month following posting to shareholders from the Company's head office, 61A North Castle Street, Edinburgh, EH2 3LJ.

The Annual General Meeting of the Company will be held at 61A North Castle Street, Edinburgh EH2 3LJ on Friday 17 February 2012 at 12:30pm.

For further information please contact:

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