

7 September 2009

China Real Estate Opportunities

| Year End | Revenue (£m) | Adjusted PBT* (£m) | EPRA NAV/ Share (p) | Disc.to NAV (%) | DPS (p) | Yield (%) |
|----------|--------------|--------------------|---------------------|-----------------|---------|-----------|
| 12/07 | 8.8 | (10.9) | 834 | 66 | 0.0 | N/A |
| 12/08 | 25.3 | (113.5) | 1,324 | 79 | 0.0 | N/A |
| 12/09e | 26.9 | (4.3) | 1,027 | 72 | 0.0 | N/A |

Note: *Adjusted PBT excludes goodwill amortisation and unrealised movements in portfolio valuations. EPRA NAV excludes deferred tax and MTM changes in derivatives.

Investment summary: Managing the assets

Stabilising the business was the theme for H109 and beyond. Intensive asset management is key in an uncertain market, with the focus on defending existing revenues. That means re-signing existing tenants at lease renewals and CREO's strong asset management skills should provide a source of differentiation valued by a tenant list heavy in international companies. We expect those entities to negotiate hard for improved terms in a buyer's market, but CREO to retain the majority of its occupiers. The underlying resilience of the portfolio was recognised in the mid year revaluation. Investment values were down just 1.2% and the bulk of the H109 NAV fall was due to a hefty 13% CNY/£ adjustment.

Active portfolio management also the theme for 2009/10

H109 saw asset sales, tenant renewals, new lettings and news of progress refinancing the first part of CREO's Shanghai investment portfolio with a local bank. These and a revised management fee arrangement will help preserve cash flows. We expect more such news in H209 to add revenue certainty in an uncertain market and would particularly look for evidence of strong support from local banks.

Steady investment portfolio performance

The portfolio's reversionary nature is reflected in increases in average rents achieved on reviews in the first half, despite overall falls in market rents. New development in Beijing and Qingdao is effectively on hold, although plans for construction of the City Centre 3 retail development in Shanghai are progressing.

Sensitivities

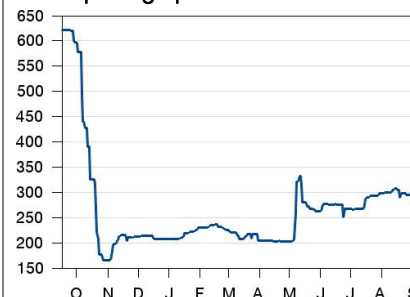
China's real estate market is relatively immature and opaque, with market information confined to the top end. The PRC economy has responded to the stimulus package, but Shanghai's office market has oversupply issues, as new schemes coincide with less demand currently from international tenants. The dynamics are underpinned by Shanghai's pricing advantages vs Asia's other financial centres.

Valuation: 72% NAV discount

The shares sit at a 72% discount to NAV. That more than discounts the risks and should continue to reduce as news flow confirms further progress during 2009/10.

Price 284.5p
Market Cap £141m

Share price graph



Share details

Code CREO
Listing AIM
Sector Real Estate
Shares in issue 49.53m

Price

52 week High 635.0p Low 165.0p

Balance Sheet as at 30 June 2009

Debt/Equity (%) 62
EPRA NAV per share (p) 10.62
Net borrowings (£m) 249

Business

China Real Estate Opportunities actively manages a portfolio of commercial real estate investments and plans to undertake developments in key Chinese cities such as Beijing and Qingdao.

Valuation

| | 2007 | 2008 | 2009e |
|--------------|------|------|-------|
| P/E relative | N/A | N/A | N/A |
| P/CF | N/A | N/A | N/A |
| EV/Sales | 26.6 | 15.1 | 14.0 |
| ROE | N/A | N/A | N/A |

Revenues by geography

| UK | Europe | US | Other |
|----|--------|----|-------|
| 0% | 0% | 0% | 100% |

Analyst

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Investment summary: Managing the assets

Company description: Property investment in China's key cities

CREO is a property investment fund focused on commercial property investment in Shanghai and development in Shanghai, Beijing and Qingdao. The strategy is to add value via active management of a portfolio of rent-producing commercial property in high-growth, tier-one cities. The group's investment portfolio currently comprises three commercial properties (office and retail) in Shanghai. The manager is Treasury Holdings China Ltd (THCL), a subsidiary of Treasury Holdings, a global property company. THCL has an experienced management team and depth of asset management infrastructure in China.

Valuation

The shares sit at 72% below EPRA NAV/share, which discounts a scenario that is not reflected in the H109 figures or outlook. With some of the development essentially on hold pending pre-lets and secure finance, the focus for the next 18 months will be further underpinning the investment portfolio and capitalising upon its ability to actively manage its portfolio in ways that improve client retention rates and, as the market eases, put it in the front line to attract new occupiers for vacant space.

Sensitivities

CREO specific issues are 1) the potential for increased vacancies, with lease renewals pending on a three-year cycle and 2) the need to refinance group debt over the next two years. The Shanghai office market is facing material oversupply over the next couple of years, unless demand from international tenants picks up faster than anticipated. Overall, the PRC economy has responded to the stimulus package, but confirmation of a reliable, broadly based recovery has yet to emerge.

Financials

The first half performance was relatively steady. Gross H109 rental income of £15.9m was up 33% year-on-year, but adjusted for 27% sterling appreciation was stable. That is still a fair performance in a deteriorating leasing environment in Shanghai, especially as the group achieved average underlying (ie building specific) rental increases during the period of up to 16%. The outlook for 2010 and beyond is heavily dependent upon lease renewals over the next nine to 12 months and discussions are underway with a number of important occupiers. We will extend forecasts to FY10e when there is greater clarity regarding the outcome of these negotiations.

Mid-year debt was manageable at 36% loan to value for the total portfolio, post adjustments in values. Debt/equity was 54%, net of £54m cash. Mid-year debt of £303m was actually below the £344m at end December, but as the majority is denominated in US dollars (forex risk hedged) the figure is heavily influenced by material changes in the £/\$ exchange rate since the last year end. The aggregate portfolio value was similarly affected, in this case by a 13.6% CNY/£ depreciation during H109. The aggregate gross Sterling value of the portfolio at the mid year was £836m, a 17% fall, adjusted for the disposal of the interest in City Center 5 during the period.

Interim results: Steady performance

The first half focus has been 'active management' ie efforts designed to drive portfolio performance in a weak environment for property investment and development. CREO has concentrated on areas under its control to reduce the portfolio impact of difficulties in local real estate markets and particularly, create a more defensive outlook among existing and potential tenants. This has positioned the group to better navigate the next 12-18 months, but management intends to further leverage a key competitive advantage in its sophisticated in-house property management infrastructure.

PRC property market affected by global influences in H109

H109 was a difficult market for real estate worldwide. Although China may well have suffered less than some, the Shanghai office market has still had to cope with a sharp drop in demand for space from international tenants, badly timed post a period of significant new development.

The group portfolio was valued at CNY9.47bn at the mid-year, down 6.2% in aggregate. The investment assets (three office and retail properties in Shanghai) saw just a 1.2% decline. H109 EPRA NAV, adjusted for mark to market (MTM) movements in currency hedges, was £10.62/share, down 20% from FY08, but over 13% of that was due to the pound's appreciation against the Chinese yuan during the period.

Gross rents in line in Chinese yuan, despite weaker letting market

Against the backdrop of a weaker letting market, CREO's first half outcome was relatively steady. Gross rental income was £15.9m in H109, 33% ahead of H108, albeit assisted by 27% appreciation in sterling during that period. On an underlying, local currency basis, rental income was in line year-on-year, a fair performance in a deteriorating Shanghai leasing environment. That reflects the benefits of an emphasis on intensive management of properties, including refurbishments and tenant relationships. The group achieved average underlying rental increases for individual buildings of up to 16% during the period.

Exhibit 1: Interim results – Summary P&L

| | H108 (£m) | H109 (£m) |
|--|-------------|---------------|
| Net rents & related income | 11.7 | 15.2 |
| Valuation (loss)/gain on investment & development portfolios | 48.6 | (27.9) |
| Other income | - | 0.5 |
| Gain on disposal of investments | - | 2.9 |
| Administrative expenses | (26.1) | (9.6) |
| Net operating (loss)/profit | 34.1 | (18.9) |
| Finance income | 5.9 | 32.7 |
| Finance expense | (10.5) | (16.9) |
| Share of (loss)/profit of joint venture | 7.4 | (3.9) |
| Pre-tax profit | 37.0 | (7.1) |
| Tax | (14.5) | 4.7 |
| Profit after tax | 22.5 | (2.4) |
| EPS (p) | 44 | (5) |

Source: CREO FY09 Interim Results Announcement

Administrative expenses fell to £9.6m for H109, from £26.1m in H108, mainly due to a £15m fall in performance fees. A revised management agreement will match future fees to underlying

performance measured in Chinese yuan terms. The gain on disposal of investments relates to the sale of a minority stake in a Shanghai development.

Balance sheet and portfolio

Debt at the mid-year was a manageable 36% loan to value for the total portfolio, post adjustments in values, with £54m gross cash in hand. Mid-year debt of £303m was below the £344m at end December, but with the majority denominated in US dollars (forex risk hedged) the figure is thus heavily influenced by material changes in the £/\$ exchange rate since the last year end.

The aggregate portfolio value was similarly affected, in this case by a 13.6% CNY/£ depreciation during H109. The aggregate gross sterling value of the portfolio at the mid year was £836m, a 17% fall, adjusted for the disposal of the interest in City Center 5 during the period.

Exhibit 2: Interim results – Summary balance sheet

| | 31 December 2008 | 30 June 2009 |
|---------------------------------------|------------------|--------------|
| | £m | £m |
| Investment properties | 764 | 664 |
| Properties under development | 150 | 116 |
| Joint ventures | 40 | 32 |
| Total property assets | 955 | 812 |
| Total non-current assets | 956 | 813 |
| Current assets | 117 | 74 |
| Total assets | 1,073 | 887 |
| Total liabilities | (588) | (486) |
| Net Assets | 485 | 401 |
| Diluted EPRA NAV per share (£) | 13.24 | 10.62 |

Source: CREO FY09 Interim Results Announcement

Portfolio: 85% let at end June 2009

The portfolio was 85% occupied at end H109, down from 92% at the last year end; a steady outcome relative to a year-on-year increase in the Shanghai office vacancy rate from 3.6% to 13.6%. We anticipate a further modest decline in occupancy over the next 12 months.

Increased competition for space has encouraged both potential new tenants and those renewing to push for reductions in rents and incentives, ie rent-free periods and contributions to fit-out costs. However, CREO's gross rental income was stable year-on-year in local currency terms. In addition, average rental uplifts of up to 16% (per square metre) were achieved, reflecting improved tenant mix and, arguably, the group's asset management skills.

Exhibit 3: Average rents achieved on review during H109

| (average rent/sqm, CNY) | June 2008 | June 2009 | % increase |
|-------------------------|-----------|-----------|------------|
| City Centre Office | 4.57 | 5.27 | 15% |
| City Centre Retail | 5.62 | 6.24 | 11% |
| Central Plaza | 5.52 | 6.41 | 16% |
| Treasury Building | 6.18 | 6.19 | 0% |

Source: CREO Interim Results Announcement

Within the above figures is a particularly strong performance by the group's retail holdings, which remain 97% let, with prospects supported by steady enquiries from potential new retail tenants.

One impact of the PRC's stimulus package on consumers has been a 15% rise in retail spend.

In contrast, occupancy rates in the office portfolio fell during the year. City Centre ended H109 80% let, from 99% 12 months ago, principally due to the departure of four large manufacturing tenants

(10% of the building). Letters of intent have been signed with Prudential Insurance and Metlife Insurance, each for an entire floor, which would bring occupancy back to 90% during Q409.

Negotiations already underway regarding 2010 lease renewals

The reviews due under the rolling review programme are set out in Exhibit 4. Negotiations are well underway with existing and potential new tenants to secure new agreements for the three-year period from 2010. The new leases are likely to include incentives that are, anecdotally, equivalent to c 15% of the rent over the period of the new letting.

Exhibit 4: Asset management: occupancy and reviews due in 2010

| | |
|------------------------------------|--|
| City Centre, Shanghai | Occupancy: 75% office / 97% retail 26% due for renewal in 2010 |
| Central Plaza, Shanghai | Occupancy: 85% office / 83% retail 30% due for renewal in 2010 Progress to date: Prudential Insurance & Metlife (Q409) |
| Treasury Building, Shanghai | Occupancy: 93% office 86% due for renewal in 2010 Negotiations underway with SPX (58% of space) |

Source: CREO Interim Results Announcement

To put the above into perspective, 43% of rents were due for renewal in FY09. Of this, 80% has already been completed and some 75% of existing tenants have renewed for a further three years.

Those tenants that decided to leave have either found significantly cheaper property or relocated with their own premises. A high percentage of tenants for buildings such as City Centre are local manufacturers' administrative offices and a proportion have moved to their own plants, typically on local business parks. CREO has reported a number of successful renegotiations with existing tenants in H109. One example is Honeywell, which signed a further three-year lease at a 4.5% increase in CNY rents per sqm, despite offers from competing buildings at a significantly lower rent. In such negotiations, the office portfolio's low prevailing rents, relative to Grade A international space, is an advantage. It results in lower short-term savings for tenants considering a move to cheaper space, after estimated CNY2.5/sqm moving/fit out costs are taken into account.

The relatively short, three-year leases typical for PRC office and retail space mean that quite a high proportion of CREO's tenant leases will always be due for review/renewal each year. That puts a high emphasis on asset management skills, such as maintenance of strong tenant relationships and advanced negotiation with existing occupiers in order to maximise retention rates and attract international tenants used to high levels of service.

Development portfolio: Cautious progress

There was further progress on the refurbishment programme in Shanghai during H109, although new development is on hold pending pre-lets (Beijing) and revised planning (Qingdao). In Shanghai, detailed design plans for interior refurbishment of the Central Plaza retail podium and entrances are complete and work is due to commence in November. Detailed design and tenant discussions are underway in respect of the refurbishment and reconfiguration of the retail element of City Centre, due for amalgamation with the extension (City Centre 3) due for completion in 2012.

The pace at which CREO will push the pace of its developments is clearly driven by the market and access to finance. A strong retail market is likely to make extensions to existing space in Shanghai the priority, with reports that retailers may be willing to commit to occupy new space due for

completion two to three years away. In Qingdao, the group is in discussion with PRC government regulators regarding the Tangdao Bay masterplan. Development phasing may be adjusted to reduce the residential component in the earlier stages, until local market oversupply is absorbed.

Debt: Refinancing underway

The first facility to mature is also CREO's smallest, of €18.8m and CNY97m (ie aggregate £24.5m) secured on the Treasury Building, due in March 2010. CREO recently announced that it had received credit approval for a multi-currency five-year loan facility equivalent to £26.6m from the Industrial and Commercial Bank of China (ICBC).

This is a £2m increase over the current loan and will in addition release £1.5m of existing cash reserves committed to the existing lender and not required under the new facility. The interest rate on the new facility is 5.8% pa, from 6.9% pa on the existing loan.

Although this has not yet completed, it does represent a breakthrough for CREO, ie its first facility with a local bank, and conceivably the template for refinancings due October 2010 and July 2011. Management has expressed confidence that these are achievable, from its discussions with ICBC.

Other initiatives help stabilise finances

Two other events in H109 contributed to an improved financial outlook.

- In June 2009 CREO disposed of its 5% stake in the City Centre 5 Development, a luxury retail and office scheme in Shanghai, to Sociedade de Turismo e Diversoes de Macau SA for CNY95m (£8.6m), ie at an 8.6% premium to its end December 2008 valuation.
- The investment advisory agreement between CREO and the investment manager, Treasury Holdings China Ltd (THCL), was revised such that performance fees will now be calculated in local currency rather than sterling, as originally agreed, and exclude any NAV increase resulting from share repurchases. This removes the potential for unexpected impacts on group cash as a result of forex volatility, such as occurred during FY08. Although THCL is still due a £22m payment under the previous terms, it has agreed to defer settlement of this sum over a phased period of more than 12 months to commence when CREO has the available financial resources to settle. This reflects pragmatism on the part of the manager, which is also a major shareholder.

Sensitivities: Market opacity and oversupply issues

The actions taken by CREO over the last six months have helped to stabilise the outlook, although more remains to be done. There has been progress on lease renewals and new lettings, debt refinance, asset sales and a new management agreement. Discussions with management suggest that it is positioned for another tough 18 months, with the key Shanghai office market facing significant oversupply.

Consequently, the next six months will see intensive negotiations with tenants, attention to both completion of the agreed new debt package and discussions regarding other facilities due to mature in 2010 and 2011. Although it remains committed to its development programme, it is clear that these will be paced in line with its access to cash and debt, with development starts phased according to market demand and pre-lets.

China's real estate market is not easy to call. Although efforts are being made to improve the quality of information regarding transactions, these remain relatively superficial and tend to be confined to Grade A properties.

The robust mid-year valuation of the investment portfolio, only 1.2% down in value, reflects investor demand for such assets, still expected to produce growing revenues over the medium term. News that, from October 2009, Chinese institutions, such as insurers and pension funds will for the first time be permitted acquire property for investment provides further intellectual underpinning for the external opinion. Valuation yields on the portfolio, at 5.75-6.25%, were unchanged over the period.

PRC economic outlook

The outlook for the PRC economy appears attractive relative to mature western economies. China achieved 7.1% GDP growth in H109. A CNY4tn stimulus package has already boosted residential property market volumes and retail sales. There are concerns that government pressure on banks to step up lending (CNY7.4tn in H109 is some three times greater than H108) will create an asset price bubble and, for the banks, higher bad debts in future.

That said, the government seeks to manage the local real estate market and the stimulus package has already benefited the residential market in terms of sales volumes, and retail sales are well ahead year-on-year. The office market depends upon broader recovery, ie to encourage domestic and international occupiers to commit to new space. Estimates suggest that there are sufficient vacant offices in Shanghai to absorb 12-18 months of 'normal' demand. Take up rates are well below the norm, so failing a strong global economic rebound there is, conceivably, two to three years' supply in the pipeline.

Valuation

The shares sit at 72% below end H109 EPRA NAV/share, which discounts a worst-case scenario not supported by the group's H109 figures or outlook. A high degree of uncertainty remains the key issue for investors, although there is potential for the next six to nine months of newsflow to provide material reassurance.

With significant new development on hold, in terms of newsflow, the focus is the investment portfolio for the next six to 12 months. The nature of a typical Chinese lease, ie only three years in length, provides little revenue visibility, although the propensity for the group's international tenants to renew during period reflects well on CREO's ability to understand its clients' needs. A strong focus on asset management is designed to maximise client retention rates.

The group's properties represent attractive options for domestic and international tenants, but do not purport to provide the highest specification space on the market. Consequently the impact on rental values due to oversupply (falls of c 40-45% for International Grade A Shanghai offices) is far less pronounced for good quality, mid-market space, such as CREO holds.

Exhibit 5: Financials

| | £000 | 2007 UK GAAP | 2008 IFRS | 2009e IFRS |
|---|------|------------------|------------------|------------------|
| Year end 31 December | | | | |
| PROFIT & LOSS | | | | |
| Revenue | | 8,745 | 25,295 | 26,850 |
| Cost of Sales | | 0 | 0 | 0 |
| Gross Profit | | 8,745 | 25,295 | 26,850 |
| EBITDA | | (9,319) | (40,910) | 6,450 |
| Operating Profit (before GW and except.) | | (9,319) | (40,910) | 6,450 |
| Intangible Amortisation | | 0 | 0 | 0 |
| Exceptionals | | (175) | (1,022) | (5,000) |
| Valuation gains on investment properties | | 71,355 | 22,941 | (30,000) |
| Operating Profit | | 61,861 | (18,991) | (28,550) |
| Net Interest | | (1,564) | (72,613) | (10,750) |
| Profit Before Tax (norm) | | 60,472 | (90,582) | (34,300) |
| Profit Before Tax (FRS 3) | | 60,297 | (91,604) | (39,300) |
| Tax | | (19,198) | (7,965) | 5,000 |
| Profit After Tax (norm) | | 41,274 | (98,547) | (29,300) |
| Profit After Tax (FRS 3) | | 41,099 | (99,569) | (34,300) |
| Average Number of Shares Outstanding (m) | | | | |
| | | 31.7 | 50.9 | 49.6 |
| EPS - normalised (p) | | 130.3 | (193.5) | (59.0) |
| EPS - FRS 3 (p) | | 129.7 | (195.6) | (69.1) |
| Dividend per share (p) | | 0.0 | 0.0 | 0.0 |
| Gross Margin (%) | | | | |
| | | 100.0 | 100.0 | 100.0 |
| EBITDA Margin (%) | | | | |
| | | N/A | N/A | 24.0 |
| Operating Margin (before GW and except.) (%) | | | | |
| | | N/A | N/A | 24.0 |
| BALANCE SHEET | | | | |
| Fixed Assets | | 606,738 | 955,704 | 814,000 |
| Intangible Assets | | 497,133 | 763,558 | 670,000 |
| Tangible Assets | | 87,280 | 149,797 | 110,000 |
| Investments | | 22,325 | 42,349 | 34,000 |
| Current Assets | | 111,105 | 117,111 | 64,000 |
| Stocks | | 2,567 | 22,860 | 14,000 |
| Debtors | | 11,542 | 9,255 | 6,000 |
| Cash | | 79,210 | 66,640 | 30,000 |
| Current Liabilities | | (47,064) | (90,316) | (86,000) |
| Creditors | | (47,064) | (90,316) | (61,000) |
| Short term borrowings | | 0 | 0 | (25,000) |
| Long Term Liabilities | | (339,470) | (497,238) | (405,000) |
| Long term borrowings | | (246,635) | (344,080) | (279,000) |
| Other long term liabilities | | (92,835) | (153,158) | (126,000) |
| Net Assets | | 331,309 | 485,261 | 387,000 |
| CASH FLOW | | | | |
| Operating Cash Flow | | (24,917) | 11,787 | (21,960) |
| Net Interest | | (4,514) | (16,932) | (10,750) |
| Tax | | (689) | (7,410) | (800) |
| Capex | | 0 | 0 | 0 |
| Acquisitions/disposals | | (341,015) | (16,773) | 0 |
| Financing | | 230,990 | (1,960) | (700) |
| Dividends | | 0 | 0 | 0 |
| Net Cash Flow | | (140,145) | (31,288) | (34,210) |
| Opening net debt/(cash) | | 27,380 | 167,425 | 277,440 |
| HP finance leases initiated | | 0 | 0 | 0 |
| Other | | 0 | (78,687) | 37,650 |
| Closing net debt/(cash) | | 167,525 | 277,400 | 274,000 |

Source: Company accounts/Edison Investment research

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