

# CHINA REAL ESTATE OPPORTUNITIES

24 March 2009

## Bedding down for tougher times

### Financial Results for the 12 Months ending 31 December 2008

Whilst CREO's NAV is likely to decline in 2009, we believe that the share price (at an 84% discount to NAV) is overly discounting the risks. Even if the NAV were to decline 40%, it would take the discount to NAV to 75% and to trade at a 50% discount to the reduced NAV, the share price would need to rise 91%.

- Over the reporting period, currency and property appreciation drove China Real Estate Opportunities (CREO) asset value up 59% to £13.24 per share. However, during the second half of the year a 36.9% appreciation in the RMB/GBP rate masked a 1.9% decline in the value of CREO's assets; precipitated by a slowdown in the Chinese economy and corporate expansion plans. Shanghai vacancy rates have increased substantially over the period ending at 13% in Shanghai overall and at 6.5% in Puxi.
- During 2009, we anticipate that CREO's rent roll will increase as the rental levels (RMB 4-5 per sqm per day) on CREO's expiring contracts (mainly office accommodation) are significantly below the current market average (cRMB 8.0 – all grades) and thus, facilitated by the refurbishment programs, should be renewed at a premium to existing levels. Treasury Holdings indicated that a 10% increase was possible.
- MCC concur with Jones Lang LaSalle's view that rental and assets values will decline in 2009 and we do not believe that we will see additional significant RMB strength. MCC anticipate declines of 10%-20% in the RMB property valuations during 2009, which translates in to an NAV decline of 15-30%; assuming constant FX rates.
- MCC estimate CREO's net cash position at £35 million (i.e. £85 million net of restricted cash and the cash element of the performance fee) against an estimated reoccurring cash burn of £25 million. CREO has a number of non-core assets (£22 million) and the manager has agreed to the phased payment on the performance fee to facilitate the management of the Company's cash position.
- The development opportunities within the portfolio provide basis for future NAV growth that will be crystallised over time as normal levels of economic activity resume.

Rating	CORPORATE
Price	£2.17
Market Cap (m)	£102.8
EPRA Diluted NAV per share	£13.24
Discount	84%
IFRS Diluted NAV per share	£9.94

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## Summary and Outlook

Currency and property appreciation drove China Real Estate Opportunities (CREO) asset value up 59% over the year to £13.24 per share. During the second half of the year a 36.9% appreciation in the RMB/GBP rate masked a 1.9% decline in the value of CREO's assets; precipitated by a slowdown in the Chinese economy and corporate expansion plans. Shanghai vacancy rates have increased substantially over the period ending at 13% in Shanghai overall and at 6.5% in Puxi.

The key surprise in the results was CREO's cash position, which was less healthy than most anticipated. This combined with the economic outlook will hinder NAV progress over the next 18 months. Whilst CREO's NAV is likely to decline in 2009, we believe that the share price (at an 84% discount to NAV) is overly discounting the outlook. We highlight that even if the NAV were to decline 40% it would take the discount to NAV to 75%, and to trade at a 50% discount, the share price would need to rise 91%.

We believe that CREO is attractively priced. The initial return to investors will be a function of discount narrowing, on the back of enhanced investor risk appetite, followed by capital growth; as the development opportunities are progressed and the Chinese growth story re-establishes itself.

## Operational Environment

Despite the macro environment, the operational environment and asset management initiatives will provide support. CREO has maintained and advanced its refurbishment programs with a view to maintaining/improving the attractiveness of the assets to potential and existing tenants. Treasury highlighted that Corporate CAPEX budgets have been cut (i.e. there is no money finance office moves) and expansion plans have been cancelled; thus tenant turnover will be naturally curtailed.

During 2009, we anticipate that CREO's rent roll will increase as the rental levels (RMB 4-5 per sqm per day) on CREO's expiring contracts (mainly office accommodation) are significantly below the current market average (cRMB 8.0 – all grades) and thus, facilitated by the refurbishment programs, should be renewed at a premium to existing levels. Treasury indicated that a 10% increase was likely but not guaranteed.

## NAV Development

MCC concur with Jones Lang LaSalle's view that rental and assets values will decline in 2009 and we do not believe that we will see additional significant RMB strength. MCC anticipate declines of 10%-20% in the RMB property valuations during 2009, which translates in to an NAV decline of 15-30%; assuming constant FX rates.

**Table 1: Sensitivity Analysis – FX and Changes to Asset Values**

Change In	Sterling - Yuan FX rate						
	1,324	-20%	-15%	-10%	0%	10%	20%
Investment							
Values	-20%	683	735	791	920	1,078	1,275
	-15%	767	822	883	1,021	1,190	1,401
	-10%	851	910	974	1,122	1,302	1,504
	0%	1,020	1,086	1,158	1,324	1,503	1,706
	10%	1,188	1,261	1,342	1,502	1,683	1,908
	20%	1,356	1,431	1,502	1,664	1,862	2,110

Source: Matrix Corporate Capital

Table 1, shows our estimate of the NAV sensitivity to changes in the GBP/RMB FX rate and property values.

Even if CREO' NAV declines 40% over the next 12 months (10% FX and 20% property values) to £7.91, the Fund will be trading on a 74% discount and offering 91% upside if the company re-rates to a 50% discount to NAV.

## Property Valuation

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Discussing the valuation process, Treasury highlight that it is being driven by a combination of comparable open-market transactions, in an immature market, and DCF models. They acknowledge that rental growth rates in the DCF models have been significantly reduced for the next few years. CBRE reports that the rental yields on the investment portfolio were estimated to be in the 5.75%-6.25% range, the portfolio running yield is about 4.5%. We understand that the manager will be publishing additional information on the valuations.

## Financing

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In the current environment CREO is looking to conserve cash. Due to a decline in the leasing environment, CREO halted development on the Beijing Logistics site and is, with SIIC's cooperation, revisiting the phasing on Tangdao bay. Treasury China continues to advance the design and planning aspects of the programs but do not anticipate being on site during the next 12 months.

CREO's LTV on investment properties is currently 45% and its first debt refinancing (\$38mn) is due at the end of March 2010 (Treasury building), the other outstanding loans are not due until late 2010 and may be extended per the contact. Treasury, commenting on the banking environment, highlighted that the offshore banking environment (where CREO operates) remains tough.

In the accounts, CREO is shown as having £92 million of liabilities due in 2009. The major components of the £92 million are: debt interest (£23 million), the performance fee (£35 million) of which the cash element is subject to phased payments and tenant deposits (which get rolled).

MCC estimates CREO's net cash position at £35 million (i.e. £85 million net of restricted cash and the cash element of the performance fee, see below) against an estimated cash burn in estimated in 2008 at £25 million. Whilst free cash is tight, phased payment of the performance fee (see below) will assist in managing the company's cash position and CREO has a number of non-core assets (£22 million) that could be disposed off.

We do not anticipate that CREO will repurchase shares during the year and Treasury China highlights that CREO needs to raise external equity capital (asset sales, JVs etc) in order to start construction on any of the major developments.

## Performance Fee

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The strong NAV performance has generated a substantial performance fee (c£60 million), to be paid 50% in cash and 50% in CREO shares valued at NAV. Reflecting the relevant accounting standards, the value of the payment in CREO shares is shown in the accounts at £14.0 million (based on the average price during the year) and has a market value of £4.8 million. Treasury Holdings have agreed to the phased payment of the cash element (£30 million) of the fee over the next 12 months.

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Company	Disclosure
China Real Estate Opportunities plc (CREO)	MCC acts as NOMAD and Broker

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