

31 March 2009

China Real Estate Opportunities

Year End	Net Revenue (£m)	PBT* (£m)	NAV/share (£)	Disc. to NAV (%)	DPS (p)	Yield (%)
12/07	8.8	60.5	8.34	75	0.0	N/A
12/08	25.3	(90.6)	13.24	85	0.0	N/A
12/09e	26.4	(21.3)	11.41	82	0.0	N/A

Note: PBT is normalised and adjusted for unrealised changes in valuations & NAV is EPRA, ie adjusted for def. tax & non-cash items, ie MTM change in the value of interest/forex derivatives.

Investment summary: Portfolio under spotlight

A share price 85% below historic NAV discounts significant bad news, but two factors overhang the shares. Firstly the uncertain outlook for China's property markets and secondly the need for cash generation, to ensure that a relatively young company still building its portfolio can meet its future capital commitments. We discuss various strategic options in this note. Strong FY08 NAV growth was mainly driven by a 47% fall in the pound versus the yuan, although at constant exchange rates the portfolio was still ahead 6%, post new lettings and tenant renewals at higher rents. Management focus for 2009 is on cash control and active portfolio management to support revenues.

FY08: Non-cash items widen headline loss

Non-cash items make up much of FY08's headline loss, including forex and interest rate hedges. Occupation rates held up well, but Shanghai's office and retail markets are increasingly competitive, ie tenant demand under pressure as new developments hit the market. CREO has put construction on hold pending pre-lets in Beijing and revision of proposed construction phasing in Qingdao.

Strategic focus on cash and active asset management

There is sufficient cash in place to cover commitments to mid 2010, assuming steady exchange rates. The £30m cash element of the performance fee will be paid over 12 months. Plans to bolster the balance sheet may include asset sales.

PRC stimulus should maintain GDP growth above 6% pa

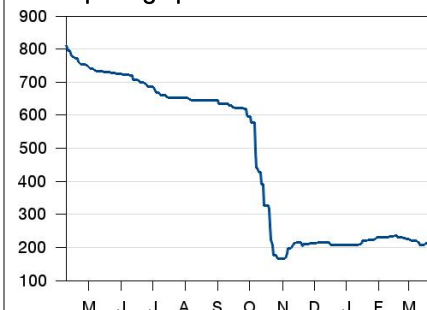
The Chinese government has shown its intention to stabilise the economy, encourage domestic consumption and bank lending to re-energise the residential property market. These actions are expected to keep GDP growth at above 6%.

Valuation: 85% discount to FY08 NAV

The shares dropped sharply last autumn as the Chinese economy slowed. CREO is at 85% below historic NAV, insulated against possible falls in portfolio value. We have assumed 10% falls for illustration, but clarity on cash flows is key to closing the gap.

Price 205p
Market Cap £97m

Share price graph



Share details

Code CREO
Listing AIM
Sector Real Estate
Shares in issue 47.26m

Price

52 week High 819p Low 165p

Balance Sheet as at 31 December 2008

Debt/Equity (%) 54
NAV per share (£) 13.24
Net borrowings (£m) 260

Business

CREO actively manages a portfolio of commercial real estate investments and developments in key Chinese cities such as Shanghai, Beijing and Qingdao.

Valuation

	2007	2008	2009e
P/E relative	11%	N/A	N/A
P/CF	N/A	8.9	N/A
EV/Sales	26.6	15.1	16.4
ROE	12%	N/A	N/A

Revenues by geography

	UK	Europe	US	Other
0%	0%	0%	0%	100%

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Results for FY08: Profit and loss

The FY08 outcome included an organic 23% increase in gross rent for the year to £26m, vs administrative expenses of £66m, the latter including a £44m performance fee. An all-in pre-tax loss of £91.6m included a number of large, non-cash items discussed below. As far as portfolio performance is concerned, there was an eye-catching 61% increase in the appraised, Sterling value of the portfolio to £1.02bn, which stands out relative to the performance of most of its sector peers.

Exhibit 1: Summary P&L

£'000s	2007	2008
Gross rental income	9,076	26,121
Operating costs (including PRC tax)	(15,847)	(14,672)
Net operating income	(6,771)	11,449
Finance expenses	(8,950)	(22,951)
Net revenue	(15,721)	(11,502)
Valuation gains on investment properties	71,355	22,911
Management fee	(3,418)	(8,524)
Net taxable income	52,216	2,915
Tax (excluding PRC tax)	(18,059)	(7,842)
Net income after tax	34,157	(4,927)
Share of loss of joint venture	(175)	(1,022)
Exchange gain/(loss)	10,705	(49,847)
Performance fee	(3,588)	(43,773)
Net profit/(loss)	41,099	(99,569)

Source: CREO Final Results Announcement

In order to put these figures into context, however, it is necessary to appreciate how the headline result was skewed by unusual factors:

- (1) The impact upon the reported, sterling value of the portfolio and deferred tax of the 47% appreciation of the Chinese yuan renminbi versus sterling. This is in part compensated by a similar affect on group debt, although borrowings are mainly in US dollars and euros.
- (2) A £60m fall in the mark-to-market value of the group's currency and interest rate hedges.
- (3) The £44m performance fee to the manager for 2008, £30m of which is payable in cash, the balance in shares. The fee is based upon growth in sterling NAV, which in 2008 was largely driven by currency movements, rather than underlying portfolio performance. Forex driven NAV growth does not produce a matching improvement in rents or cash flows to finance performance fees, unless the properties are sold or refinanced.

In order to mitigate the impact on group cash, the manager THCL (via concert parties a 57% shareholder in CREO) proposed that the cash element of the fee be paid in instalments over 12 months. Group cash is potentially vulnerable to further falls in sterling's value in 2009, so the intentions of the manager are an important consideration. THCL's stake in CREO gives it an interest in preserving the value of its investment, but as it is a private company, it is hard to assess its strategic intentions or cash needs.

- (4) The increase in sterling property values produced a parallel increase in investment management fees to £5.3m (FY07 £2.4m). Development management fees were £2.5m (FY07 £1m), reflecting the increased scale of the group's activities.

Balance sheet: 45% LTV on investment portfolio

Year end 2008 net assets were £485m (FY07 £331m) and EPRA NAV (adjusted for deferred tax and mark-to-market movements on hedges) £660m, up 51% y-o-y. As discussed, the sterling figure benefited from currency gains, but it was also enhanced by improvements to the properties due to refurbishment and active management of tenancies. Their relative influences are set out in Exhibit 2.

Exhibit 2: Impact of fair value/foreign exchange adjustments on property portfolio

	Investment properties £'000	Development properties £'000	Total portfolio £'000	Increase in portfolio value
Balance 1 January 2008	497,133	87,280	584,413	
Additions	1,508	2,156	3,664	0.6%
Foreign currency adjustments	241,267	45,877	287,144	49.1%
Fair value adjustments	23,650	14,484	38,134	6.5%
Balance 31 December 2008	763,558	149,797	913,355	56.2%

Source: CREO Final Results Announcement

Portfolio: 92% occupancy of investment properties

CBRE's external appraisal of the investment portfolio put its value at £764m. This portfolio of office and retail property in Shanghai was valued at a 5.75-6.25% yield on estimated rental values (ERV). In local currency terms, the portfolio grew by 6% (FY07: 17%), adjusted for a 2% fall in value in H208. That is, nonetheless, a material outperformance of most other global real estate markets.

Intensive asset management of a well-located, quality office and retail property portfolio in Shanghai has generated results ie 35 new lettings and 76 tenant renewals. A third element was share buybacks, which added 7% to EPRA NAV.

Exhibit 3: Asset management – FY08

	Occupancy	Number of new lettings	Number of rent renewals	Average rental increase (%)
Office				
Central Plaza	80.8	4	9	18.7
Treasury Building	92.6	3	0	N/A
City Center	91.6	15	26	22.9
Retail				
Central Plaza	85.2	0	8	3.8
City Center	98.9	13	33	10.5
Total	91.8	35	76	16.8

Source: CREO Final Results Announcement

CREO has carried out upgrades and refurbishment of existing space, the last of which, at City Center is close to completion. Historically the group has retained over 85% of tenants on lease expiry and remains confident that it can maintain this level.

It is already in discussion with tenants with leases due to expire in the period to September 2009 and indications are that most intend to renew. CREO has not so far had to offer unusually high

incentives (eg rent free periods, fit out costs) to either achieve that level of retention or attract new tenants. The portfolio has performed in line during Q109 thus far. In common with sector peers, it reports that renewal rates are benefiting from the deferral of relocation decisions by a number of tenants, in the face of a more uncertain economic outlook.

Debt management: An area of focus for FY09

Bank borrowing at the year end was £344m (FY07 £247m), which again reflects movements in sterling during the period, as the figure includes no new or additional debt facilities. The earliest debt maturity is April 2010 and the weighted average maturity for the debt portfolio 1.8 years. Loan-to-value for the investment properties is 45%, or 36% for the portfolio overall, including development properties.

Management reports that its lenders are still receptive and willing to support existing borrowers. CREO intends to engage them in discussions regarding the extension of loan maturities at the earliest possibility. A number of other banks, notably those based in mainland China, Hong Kong and Singapore, have also confirmed their interest in entering the Chinese market.

Exhibit 4: Debt repayment schedule

Repayment due	Property	Debt £m	End FY08 valuation £m	LTV %
April 2010	Treasury Building	258.9	614.0	42
October 2011	City Center	2,438.3	5,425.0	45
July 2012	Central Plaza	732.1	1,573.0	47

Source: CREO Final Results Announcement

The above table sets out the group's loan repayment schedule. This assumes that the group exercises its options to extend the due date on two earliest facilities by 12 months. CREO holds an automatic right to do this, if it meets interest service covenants. Although these are not specified, management reports that current indications of tenant renewals suggest that these will be met comfortably at renewal dates. There are no loan-to-value covenants covering any of the facilities.

Prior to payment of the £30m performance fee, CREO held £85m in cash (FY07 £107m). Some £18.4m of the latter figure was 'restricted' cash, ie deposited in interest reserve accounts to repay borrowings as they become due.

Strategic options: Possible asset disposals, development on hold

Although it is not its current intention to dispose of assets, CREO has a number of options available to generate cash. It is worth recalling that the initial strategy, at IPO, was to raise additional equity to fund expansion of the portfolio and capital elements of its developments. That is not currently possible, or arguably desirable, at the current discount to NAV. However, its alternatives are restricted by more limited investor interest in real estate generally.

The group could conceivably dispose of at least part of the properties above without materially affecting the integrity or potential of its investment portfolio. For example, it only holds a 5% stake in the new City Center retail development, which gives it little control over the timing or scope of the

scheme. It is also possible that it would be able to reduce its 50% stake in the Tangdao Bay scheme, yet still retain some influence over elements of the proposed development.

In addition to the possible sale of stakes in the group's investment or development properties, CREO has a number of other, arguably more liquid investments available for sale. These are set out in Exhibit 5, with the book value either the total group investment or for the two HKSE listed entities, their year end bid prices.

Exhibit 5: Financial assets available for sale

Asset	Description	FY08 book value £m
LuxChina Property Dev. Co Ltd	A 9.75% equity interest in a property investment company located in China. CREO injected further capital in FY08.	14.1
Investment in RREEF China Commercial Trust	In November 2008 CREO acquired 33.5m units (7.21%) in this Hong Kong listed REIT at an average of HKD2.58/unit. An option to acquire a further 25.65% stake expired in January at a cost of £1.5m.	7.8
Investment in SJM Investments	In July 2008 CREO purchased 6.3m shares at HKD3.08/share at SJM's HKSE IPO.	0.9
		22.9

Source: CREO Final Results Announcement

Development portfolio: Construction on hold

The group has three principle development properties; in all cases construction is currently on hold.

Exhibit 6: Development portfolio & status

Scheme	Location	Status
City Center Extension	Shanghai	Site cleared and ready for redevelopment. CREO is moving ahead with the Master Layout Planning submission to the government in 2009 and is in discussion with international retailers to anchor the scheme.
City Center Development	Shanghai	Schematic design approval has been achieved on and construction now anticipated to begin in Q209.
Beijing Logistics Park	Beijing	Demand from international tenants in particular has slowed considerably. CREO has decided not to proceed with further construction until the leasing market stabilises.
Tangdao Bay	Qingdao	Master planning submission Q209. Reviewing development phasing programme in light of current market circumstances.

Source: CREO Final Results Announcement

Sensitivities

Chinese economic stimulus and impact on local property markets

The argument for investment in China is currently finely balanced, although the risks appear fully priced into CREO's current valuation. The economy has slowed on the back of the global downturn, but remains on course for GDP growth above 6% pa. The outlook for the Chinese property market, initially residential but also logistics is underpinned by the detail of the government's stimulus package, which identifies both areas as targets for investment.

China's government appears to be in a position financially and indeed temperamentally to provide the investment necessary to maintain growth. Its efforts have already begun to reinvigorate local banking and real estate industries, but the commercial occupational market is still likely to be held back by a less confident tenant, in particular international companies that will inevitably delay decisions on new lettings. This coincides with a development boom likely to deliver substantial space onto the Shanghai and Beijing market during 2009. The performance of CREO's let portfolio will depend upon its ability to maintain occupancy in its established, well-located offices and retail space in Shanghai. Further decisions regarding development work in Shanghai, Beijing and Qingdao will be taken during the current year, depending upon market conditions.

Strategy focused on cash management and revenue generation

CREO does retain strategic options, a number of which we have reviewed above. However, the current environment puts the focus on its ability to generate cash flows to cover operating overheads and interest, and meet its capital commitments. The latter includes debt maturities, refurbishment and development costs, plus other amounts that may fall due in connection with site acquisition and improvement. We set out an outline schedule of possible calls on CREO's finances in Exhibit 4. The original strategy at IPO included further equity and supporting debt to finance an accelerated development programme. This has been revised in less receptive market conditions.

We estimate the group would consume around £12-15m of net cash annually, assuming no further development work at either Beijing or Tangdao Bay. This contrasts with the near £100m pre-tax loss announced for FY08, some £97m of which comprised non-cash items.

The outlook for underlying portfolio performance is negative as China's economy slows and its property markets cope with surplus space, reduced tenant demand and a shortage of bank finance. The latter may not be as acute as that afflicting Western markets, depending upon the success of the government's stimulus package.

The relative weakness of the UK economy could result in further Sterling declines that may compensate for falls in renminbi valuations. We have commented on the manager's willingness to ease the impact of its performance fee on group cash resources, ie by taking its £30m performance fee in instalments over the next 12 months. Its 57% stake in CREO equity (together with concert parties) gives it a strong interest in preserving the value of its investment. THCL is, however, a private company, which makes it quite hard to assess its strategic intentions.

Exhibit 7: Financials

Year end 31 July	£000	2007 UK GAAP	2008 IFRS	2009e IFRS
PROFIT & LOSS				
Revenue		8,745	25,295	26,350
Cost of Sales		0	0	0
Gross Profit		8,745	25,295	26,350
EBITDA		(9,319)	(40,910)	7,500
Operating Profit (before GW and except.)		(9,319)	(40,910)	7,500
Intangible Amortisation		0	0	0
Exceptionals		(175)	(1,022)	(1,000)
Other		71,355	22,941	0
Operating Profit		61,861	(18,991)	6,500
Net Interest		(1,564)	(72,613)	(28,750)
Profit Before Tax (norm)		60,472	(90,582)	(21,250)
Profit Before Tax (FRS 3)		60,297	(91,604)	(22,250)
Tax		(19,198)	(7,965)	0
Profit After Tax (norm)		41,274	(98,547)	(21,250)
Profit After Tax (FRS 3)		41,099	(99,569)	(22,250)
Average Number of Shares Outstanding (m)		31.7	50.9	50.9
EPS - normalised (p)		130.3	(193.5)	(41.7)
EPS - FRS 3 (p)		129.7	(195.6)	(43.7)
Dividend per share (p)		0.0	0.0	0.0
Gross Margin (%)		100.0	100.0	100.0
EBITDA Margin (%)		N/A	N/A	28.5
Operating Margin (before GW and except.) (%)		N/A	N/A	28.5
BALANCE SHEET				
Fixed Assets		606,738	955,704	867,000
Intangible Assets		497,133	763,558	700,000
Tangible Assets		87,280	149,797	125,000
Investments		22,325	42,349	42,000
Current Assets		111,105	117,111	61,000
Stocks		2,567	22,860	17,500
Debtors		11,542	9,255	9,000
Cash		79,210	66,640	16,000
Current Liabilities		(47,064)	(90,316)	(56,000)
Creditors		(47,064)	(90,316)	(56,000)
Short term borrowings		0	0	0
Long Term Liabilities		(339,470)	(497,238)	(500,000)
Long term borrowings		(246,635)	(344,080)	(345,000)
Other long term liabilities		(92,835)	(153,158)	(155,000)
Net Assets		331,309	485,261	372,000
CASH FLOW				
Operating Cash Flow		(24,917)	11,787	(21,960)
Net Interest		(4,514)	(16,932)	(28,800)
Tax		(689)	(7,410)	(800)
Capex		0	0	0
Acquisitions/disposals		(341,015)	(16,773)	0
Financing		230,990	(1,960)	0
Dividends		0	0	0
Net Cash Flow		(140,145)	(31,288)	(51,560)
Opening net debt/(cash)		27,380	167,425	277,440
HP finance leases initiated		0	0	0
Other		0	(78,687)	0
Closing net debt/(cash)		167,525	277,400	329,000

Source: Company accounts/Edison Investment Research

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