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22 November 2005

Price: 13.5p
Real Estate Sector

Medsea Estates Group (MEA)

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Initiation Report

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We certify that this report represents our own opinions.

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While the companies we cover sponsor our research, it is always written on behalf of our readers. It is of the essence of our research that it be **independent** — that is opinions, estimates and valuations be solely those of Objective's analyst; **objective** — that is based upon verifiable data; and **transparent** — that is based upon explicit assumptions.

Our research complies with all FSA recommendations as may arise out of CP172 and CP176, i.e., that it be independent of any broking or trading interests; and CP205, i.e., that it comply with standards for objectivity.

Key Points

Medsea acts as a specialist agent for property developers in southern Spain. After addressing recent operational problems we believe that it is better placed to take advantage of demographic and legislative changes regarded as positive to the market for retirement and holiday homes in its target area. Current plans include extending its marketing reach in and beyond its traditional base of UK and Ireland to Germany and the Benelux countries.

KEY POINTS

- **Medsea's recent history has suffered a catalogue of problems.** The downturn in demand from Medsea's core UK and Irish markets was compounded by operational weaknesses and difficulties in Medsea's agent network. We believe Medsea has learned from and acted upon these issues.

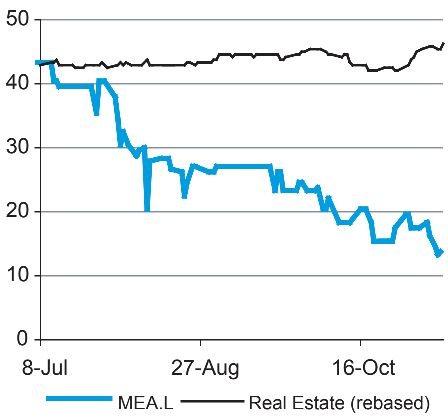
- **The changes implemented address three principal areas**: corporate structure and systems; product development and routes to market. We believe that it is now better placed to develop from its traditional market where competitive pressures are building. Crucially Medsea has overhauled staffing and systems to address the weaknesses highlighted earlier this year.

- **The new corporate structure recognises three main business areas:** the traditional market for selling new developments; the secondary market for holiday homes; and the higher margin business from exclusive distribution agreements with developers. Medsea has established a separate subsidiary, Euromed, to develop the business of exclusive agreements.

- **Medsea has introduced new product areas.** Its traditional product is units in new developments along Spain's southern coast. New product areas include exclusive marketing agreements with developers. Such deals allow Medsea some control over the development better to reflect its understanding of the taste of its clients. Exclusive deals typically offer higher margin and Medsea has established Euromed as a subsidiary company to develop this product area. It has already signed two exclusive deals. Other plans include geographic expansion to take Medsea's business model into new territories both within and outside Spain, potentially outside the Iberian Peninsula.

- **Medsea is developing new routes to new markets.** It has traditionally marketed through small local agents in its principal markets of the UK and Ireland. The route to market was arguably inefficient although closure rates have always been high (see later in this report). It is developing a new marketing channel via relevant professional bodies. In the UK those include Independent Financial Advisers who will include Medsea's products within the range of advice they offer their clients. We expect a significant announcement soon in this area. Such professional bodies will be encouraged by the recent award to Medsea of ISO 9001: 2000, an internationally recognised award for attention to detail and customer service. Medsea has now expanded its marketing reach to include buyers in Germany and the Benelux countries.

Price chart – MEA.L



Our valuation

Entity value:	£13.4m
Value per share:	19p

Company details

Quote	London AIM Market
Ticker (shares)	MEA.L
Hi-Lo last 12 mths	90.5-12.5p
Shares issued	70.629m
Fully diluted	70.629m
Market Cap	£9.5m
Management ownership	91.0%
Broker	Midas Investment Management Ltd
Public Relations	Weber Shandwick Square Mile
Website:	www.medseaestates.com

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Overview

Medseas's annus horribilis is coming to an end. The warnings given in April unwittingly understated the degree of Medsea's problems. The softening market conditions exposed weaknesses in Medsea's management model. In particular the system of non-refundable client deposits was exploited by the manager of the Almeria branch. Mutiple purchases became multiple cancellations. Medsea believes that all financial consequences have been provided at the interim stage. The manager responsible has been sacked, management systems have been reviewed and a Financial Controller has been appointed. Recent cuts in personnel and "tour" costs (those of showing facilities to prospective clients) are estimated to have reduced breakeven property sales by about a third.

Medsea has acted to strengthen its historic business model. Traditionally the company has acted as an agent for property developers in southern Spain. It was established by Tony Gatehouse in 1998 and now has offices in four towns along that coast. Historically it has marketed to buyers in the UK and Ireland through a network of small local agents. More recently it has implemented a corporate structure to reflect its drive to strengthen that model. It is developing new products, new market areas and new routes to market.

Long term market prospects are encouraging. In November 2003 Alliance and Leicester bank estimated that over the next ten years, 2.3 million people aged over 50, one in eight of the population, would be leaving Britain to retire abroad. By 2020 one in five older people would be living outside the UK, the vast majority of these in Spain. An update in June 2004 estimated that, by 2020, a further four million British people would have retired abroad and two million would be working abroad. Proposed changes to UK pension legislation, allowing the purchase by personal pensions of overseas property, are likely to encourage that trend.

Against that potential demand, the supply of new properties has also been large. In 2004 there were 48,000 new starts in the Murcia province and 97,000 in Valencia, for example. Those figures for a small part of Spain should be compared with the 2004 UK total house build figure of 158,000 properties. New housing starts for the whole of Spain were 700,000, not only a multiple of the UK level but also more than in France and Germany combined.

Medsea is introducing new regions into its product mix. The traditional products for the company are units in new developments along Spain's southern coast. It has offices in Torrevieja, Vera, Calpe and in Almunecar covering the coastal regions of Granada, Almeria and Murcia. It has plans to open two new offices – one to cover the Costa de la Luz to the west of Gibraltar, and one on the Orange Blossom coast (Valencia and Castellon), at the northern end of its current area of operations.

Medsea has plans also to develop its business model outside Spain and indeed outside the Iberian Peninsula. Earlier this year it signed an agreement with Barca & Boom, based in the Netherlands, to act as agents for the Netherlands, Germany and the Benelux countries. Its first exhibition took place in Amsterdam in October. The results were encouraging, with the number of potential buyers being more than 10% of a typical good month for Medsea as a whole.

Medsea is introducing new product areas by contract type. Typically the company has acted purely as an agent for local developers. More recently it has entered into exclusive marketing agreements with developers and has established a subsidiary company, Euromed SL, to develop such deals. As well as enabling it to influence design, construction methods and pricing, exclusive contracts allow higher commission rates to Medsea. Euromed has already signed two exclusive deals. Although exclusivity normally requires an investment in the developer by Medsea, its future involvement will typically be no more than a 5% stake.

One of its earliest exclusive deals was with Promilorcorci SL covering the Frondoso Valley development. By the time of the interim results, although the show home had still not been completed, Medsea had already sold 72 properties off-plan at an average price of €185,000. More recently the company announced an exclusive contract for the Torre del Obispo development of up to 578 properties in Aguilas, also in the Murcia region. Prices for the new homes will start at €135,000 for maisonettes and €240,000 for the semis. Both of these are significant contracts in the context of Medsea's size and we expect Euromed to generate a significant proportion of Medsea's revenues from 2006 onwards.

Medsea is also looking to expand its range of properties outside its traditional Spanish market. It has recently announced an exclusivity arrangement to market an initial range of 110 low priced beach front properties in Calabria, in Southern Italy. The properties start at £30,000. Elsewhere we understand that Medsea would like to buy a letting company should the right opportunity emerge. We believe that the budget for any such acquisition would be in the order of £250,000.

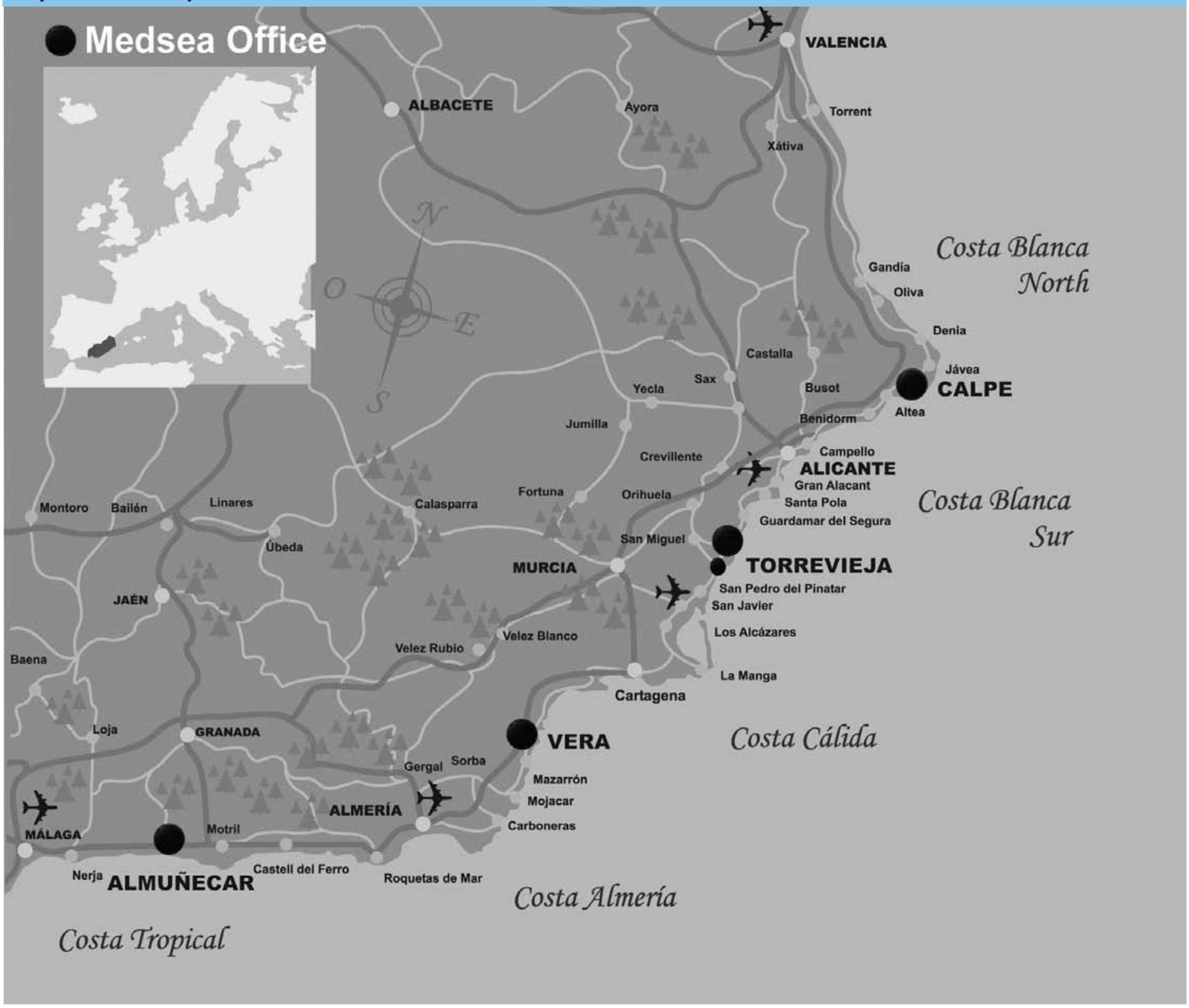
The company also has a secondary market business, based in Torrevieja and serving UK/Irish buyers and sellers. While the main operations have suffered this year, this business has prospered and is thought to be responsible for up to 30% of the properties currently being sold in the region.

Medsea is developing new routes to market. Historically Medsea has marketed properties through a network of small, commission-sharing, local agents in the UK and Ireland. Today it is developing marketing agreements with professional intermediaries and is seeking buyers in new countries. We expect a number of announcements in this area over the next few months. Throughout the changes, it is determined to maintain its reputation for the quality of service it provides to its agents and its clients. That combination plus a "pre-screening" of prospective clients by the agents leads to a high closure rate of some 50-65% of introductions.

The recent award to Medsea of ISO 9001: 2000 is an internationally recognised award for attention to detail and customer service. It will be an important source of encouragement for professional intermediaries. In the UK we understand that Medsea is in the advanced stages of agreement with a significant IFA group which would include Medsea's products in its portfolio of offerings to its own clients.

The company has also started a parallel marketing development, announced on 12 August. It has paid 12 NHS trusts a relatively small sum for authorised access to their employees, numbering about 125,000. Medsea's latest plans on exploiting this access involve working with IFA's and targeting the more highly paid staff.

Map of Southern Spain coastline



See Appendix 1 for descriptions of the different areas

Examples of typical Medsea properties

Jardines de Almanzora

Townhouse, 2 bedrooms, 2 bathrooms in Albox, Costa Almeria
Prices from: 123,750 euros to 132,222 euros

Collado Golf

Apartments, 2 bedrooms, 2 bathrooms in Aguilas, Costa Almeria
Prices from: 140,000 euros to 150,000 euros

Mirador de Polop

Detached villa, 3 bedrooms, 2 bathrooms, Polop, Costa Blanca North
Prices from: 279,000 euros to 290,000 euros

Florida Golf

Apartments, 2 bedrooms, 1 bathroom, Villamartin, Costa Blanca South
Prices from: 129,000 euros to 142,000 euros

Las Kalendas

Detached villa, 3 bedrooms/2 bathrooms, Fortuna, Costa Calida,
Price: 180,000 euros

Hacienda San Cayetano

Apartments, 2 bedrooms, 1 bathroom, Torre Pacheco, Costa Calida
Prices from: 134,000 euros to 139,000 euros

Arenal Marina Golf

Apartments, 2 bedrooms, 2 bathrooms, near Malaga, Costa Tropical
Price: 282,883 euros

Frondoso Valley

Townhouses, 2 bedroom, 2 bathroom
Prices start at 169,600 euros for the two bedroom terraced townhouse

Valuation

Since listing Medsea has suffered from a series of operational issues, and to a lesser extent, market weakness. While these are in many ways a natural part of the risks of smaller businesses operating in niche markets they have highlighted areas that Medsea has needed to strengthen. We believe management has identified the issues and is taking the appropriate steps to address them.

For investors, the key issues for valuation are:

- **Network of agents:** Medsea has historically been reliant on relatively few agents to source qualified potential buyers. While initial steps seem positive, it has yet to be seen if Medsea's moves to strengthen its agent network will lead to a more stable flow of buyers.

- **Move to exclusives:** Medsea is seeking to improve margin and exercise more influence over the type of product that it sells through exclusive arrangements. While Medsea's first steps have proved to be successful, Medsea has only a limited track record acting as exclusive promoter.

- **Internal controls:** Medsea has significantly tightened its internal procedures. It has yet to be seen if these are sufficient to stop a repeat of the issues that were seen at its Almeria branch - particularly as it expands its branch network outside Spain.

- **Expansion of product range:** Medsea has significant experience working with predominantly English language buyers in the Spanish property market. While reducing Medsea's reliance on the attractiveness of the Spanish property market, it is not clear that Medsea will enjoy the same success selling non-Spanish properties and with buyers from other parts of Europe.

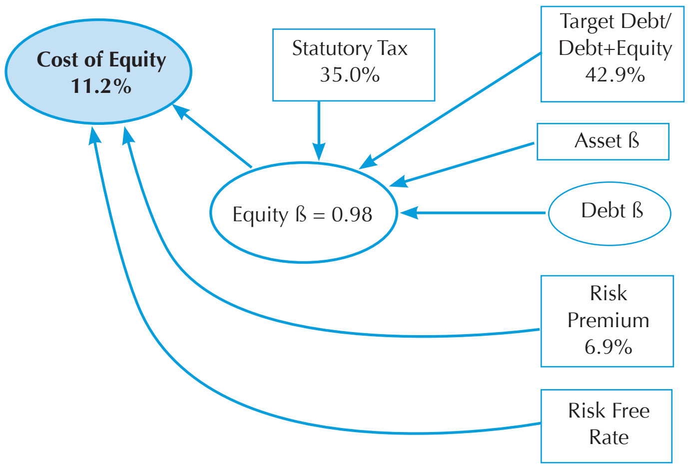
Our base case value assumes no increase in average selling price for the forseeable future, a modest increase in average margins as exclusives form a greater portion of Medsea's sales and slow recovery in demand from Medsea's core markets. Our base value for Medsea is 19p per share.

We also present an alternative scenario for a more optimistic assumption on the effectiveness of Medsea's strategic steps.

Valuation Summary (£m)

Total Expected Operating Value	**12.2**
Add: Listed Investments	0.0
Add: Unlisted Investments	0.5
Add: Tax Benefits	0.0
Add: Cash	1.2
Less: Distributions	0.0
Total enterprise value	**13.9**
Less: Bank & Other Debt	0.6
Less: Traded Debt	0.0
Less: Convertible Debt	0.0
Less: Minorities	0.0
Total Value for Equity Claims	**13.4**
Less: Warrants + Options	0.0
Value Attributable to Equity Holders	**13.4**
Oustanding Shares (m)	70.6
Value per share (£)	0.19

Weighted Cost of Capital



WACC = 10.0%

Scenarios

Base case scenario

Value £13.4m
per share 19p

No. of properties	2005 H2	2006	2007
Barca & Boom	20	50	70
Frondoso	70	280	320
Obispo	20	190	200
Other, via agents	140	120	150
Secondary sales	80	240	240
IFA's & Italy	-	60	150
	330	940	1130
2005 H1	394		
	724		
Frondoso & Obispo	27.3%	50.0%	46.0%
Secondaries	20.3%	25.5%	21.2%
Gross profit	30.3%	31.0%	31.0%
Operating profit	5.6%	14.1%	16.1%

More effective strategic steps

Value £22.8m
per share 32p

No. of properties	2005 H2	2006	2007
Barca & Boom	25	70	110
Frondoso	70	280	320
Obispo	20	200	240
Other, via agents	140	140	170
Secondary sales	125	240	240
IFA's & Italy	-	80	170
	380	1010	1250
2005 H1	394		
	774		
Frondoso & Obispo	23.7%	47.5%	44.8%
Secondaries	31.7%	23.8%	19.2%
Gross profit	30.4%	31.0%	31.0%
Operating profit	7.2%	18.4%	20.2%

Comparatives

	Countrywide plc	Savills	DTZ Holdings	Colliers Cre	Medsea
	CWD.L	SVS.L	DTZ.L	COL.L	MEA.L
Share price (p)	379.5	874	412.25	142.5	13.5
Listing	LSE	LSE	LSE	AIM	AIM
Year end	31-Dec	31-Dec	30-Apr	31-Dec	31-Dec
Market cap (£m)	465.9	403.4	153.4	32.9	9.5
P/E 2004	22.8	14.2	20.8	13.2	6.4
P/E 2005e	27.5	15.3	14.9	9.7	28.8
EV/EBITDA 2004	21.4	10.0	8.3	7.3	5.2
EV/EBITDA 2005	13.4	9.6	7.9	6.8	21.2
EV/Sales 2004	1.4	1.6	1.1	1.0	0.9
P/Book 2004	n/a	5.7	4.1	1.2	3.0
Gross yield	1.6%	2.6%	2.0%	2.9%	-
Op profit margin 2004	9.8%	12.5%	7.6%	9.5%	17.5%
Debt/equity 2004	n/a	-0.73	-0.11	0.42	-0.16
2004 net income/equity	-228.7%	33.8%	18.2%	7.2%	34.9%

Sources: Reuters, Objective Capital estimates

Key Risks

Moves to strengthen its business model have yet to prove themselves

The major risk is undoubtedly that the transition from Medsea's historic business model fails in one or more areas. Competition is intense in its traditional product markets and major developers, such as Polaris, have shown a willingness to by-pass intermediaries. At the demand end of the food chain, Medsea has had limited control over the sourcing of leads. Agreements with IFAs will go a long way to redressing that balance but, on the flip side, they have to if Medsea is to shift significantly into a new gear. And of course the new management structure and systems have yet to prove they can manage continuing growth.

Reliance on limited markets and product base

A downturn in European property markets, particularly those of the UK and Ireland, could lead to a fall in demand for second homes in Spain. Similarly a fall in the Spanish property market may encourage prospective buyers to defer purchase. Increasing competition could force Medsea to accept reduced sales commissions. In general Medsea is vulnerable to adverse swings in demand in client countries, their associated exchange rates and in adverse supply/ competition swings in southern Spain.

Corrections in the price of Spanish properties

There is some suggestion of speculative build in the rush to anticipate demand. The possibility of any burst in the speculative bubble is hard to quantify. However the governor of the Spanish central bank has suggested that house prices may be about 20% overvalued – a correction of which would take them back to a little under those of a year ago. By way of a more extreme example we note the 60% collapse in prices in the Hong Kong property market in the late1990s. The fall was relatively abrupt and prices did not begin to recover for several years.

The collapse of one or more developers would leave Medsea exposed to reputational risk. To the extent of its own, currently modest, investment in certain developments such collapse would raise financial implications also. Even without collapse the strategy exposes Medsea to a greater development risk.

Dependence on small agent network

Medsea depends on qualified prospects from a relatively small number of agents for a large part of its revenues. If one or two of these ceased to trade, or chose not to work with Medsea, this would impact Medsea's profitability. This event did occur in 2005 and contributed to the company's poor performance. The company is responding by working to increase the number of active agents and looking for other sources.

Changing climate

The southern coast of Spain has suffered poor rainfall this year. If water shortage becomes a serious problem in the future then the area would become blighted. Steps to rectify the situation, such as re-routing rivers and/ or building desalination plants would themselves compound the problem by reducing the visual attraction of the area, not to mention the major infrastructural disruption they would represent.

Liquidity of the shares

Following the acquisition of Medsea UK by Medsea Estates on 23 July 2004, the nine percent of the company not owned by management was owned by Catalyst Investment Group Limited, two financial institutions and four individuals. In addition, 29,412 shares (0.04%) were issued to an adviser on 26 July 2004 in relation to professional fees.

There was no placing of shares at the AIM listing on 4 August 2004. Since then share turnover has been low, in all amounting to less than 2% of the total issued share capital.

Stock overhang

Tony Gatehouse owns over 77% of Medsea shares. His involvement is expected to reduce over time and with it may be expected also a reduction in his shareholding. Any abrupt change would lead to digestion problems in a hitherto illiquid market.

Dividend Policy

At the time of the listing on AIM the company said that, for the immediate future, it would retain all profits to provide a base for further expansion. Longer term, particularly if the shareholder base had been extended, it would consider implementing an appropriate dividend policy. This remains the company's policy.

Foreign Exchange

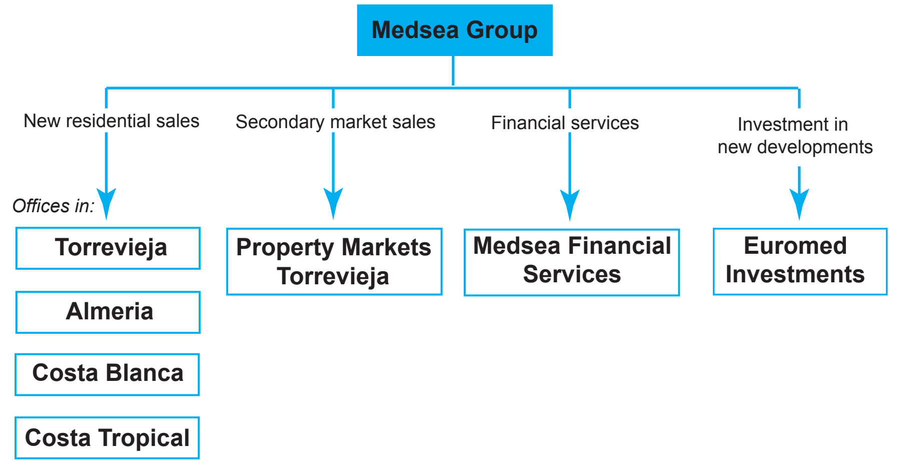
Almost all of Medsea's transactions are in euros, and there is therefore translation risk when these are converted into sterling to produce the consolidated accounts. In addition, a large majority of the buyers of properties that it markets are based in the UK and therefore view the attractiveness of Spanish properties through the euro/sterling exchange rate. The chart below shows the exchange rate for the euro against sterling over the last five years.

Exchange rate for the euro against sterling (5-year)

Source: Reuters

Corporate structure

Organigram for Medsea



Tony Gatehouse moved to Spain in 1984 after building up and selling a UK-based mortgage brokering business. In Spain he acted as an intermediary between Spanish developers and UK agents, and started Medsea Estates SL (a private company registered in Spain) in 1998, which subsequently established subsidiary companies for its different businesses. Tony Gatehouse also started Medsea Estates Almeria SL ("Almeria") in October 2001, which was run in parallel and along similar lines. In 2004 the various entities were brought under the same UK roof and shares issued to various advisers and associates involved in the subsequent AIM listing.

Following a series of transactions the group now comprises the UK parent company, a UK holding company (Medsea UK Limited) and seven Spanish subsidiaries, with separate companies for each of the four regional operations, a specialist in the exclusivity contracts, the secondary property agency, and the financial products specialist. The structure is designed better to represent Medsea's corporate ambitions (see elsewhere).

The board intends at some stage to introduce a share incentive scheme for other employees, subject to shareholder approval. It will not cover more than 5% of the company. There are no options or warrants in issue.

As at 30 September company employed 110 people, including the directors, down from 142 at end-2004. Of these, 48 are in Torrevieja, 30 in Vera, 10 in Calpe and 4 in Almunecar. In addition 8 work in the secondary market, 3 work in Euromed and 7 are employed at the group holding level. By function 41 are salesmen, 19 are after-sales consultants and 50 (including all of group holding) are administrative.

Medsea directors' shareholdings

	No. of shares	
Shares in issue	70,629,412	
Directors' holdings		
Tony Gatehouse	54,602,746	77.3%
Juan Carlos Rodriguez Martinez	9,636,194	13.6%
Alberto Gil	-	-
Ken Burrage	-	-

Industry background

It is well known that Spain has experienced a huge construction boom over the last decade. As well as all the infrastructure, office and factory developments, it is a less emphasised aspect that Spanish families have also been buying holiday homes extensively, and these have tended to be on or near the coast. The proportion of properties in the Spanish coastal region acquired by Spaniards is estimated at around 40%.

At the same time Spain's entry into the EU and subsequently the euro have further stimulated the purchase of retirement or holiday homes by foreigners, led by the British and, in second place, the Germans. In recent years the large increases in Spanish property prices (+140% since 1997) have provided another kicker, encouraging buyers further to buy off-plan.

For British and Irish buyers (Medsea's main catchment area), Spain remains "nearby" in travel terms, is well supported by local airports and flights and enjoys a highly desirable climate (outside the summer peaks). The Spanish people are generally welcoming and the cost of living is generally lower than in the clients' country of domicile.

Some commentators believe that the recent increases in demand represent only the beginning of a longer trend. In November 2003 Alliance and Leicester bank estimated that, while 700-800,000 people from the UK had by then already bought homes in Spain, within the following 10 years 2.3 million people aged over 50, one in eight of the population, would be leaving Britain to retire abroad. That is 230,000 a year. Furthermore, by 2020 one in five older people would be living outside the UK, the vast majority of these in Spain. An update in June 2004 estimated that, by 2020, a further four million British people would have retired abroad and two million would be working abroad.

The supply of new properties has also been on a large scale. In 2004 there were 48,000 new starts in Murcia province and 97,000 in Valencia, for example. These figures for a small part of the Spanish territory should be compared with the 2004 UK total house build figure of 158,000 properties to give some idea of the scale of construction. New housing starts for the whole of Spain were 700,000, not only a multiple of the UK level but also more than in France and Germany combined.

While some developers will only build against firm orders, some have been more speculative. The possibility of any burst in the speculative bubble is hard to quantify. However the governor of the Spanish central bank has suggested that house prices may be about 20% overvalued – a correction of which would take them back to a little under those of a year ago. By way of a more extreme example we note the 60% collapse in prices in the Hong Kong property market in the late 1990s. The fall was relatively abrupt and prices did not begin to recover for several years.

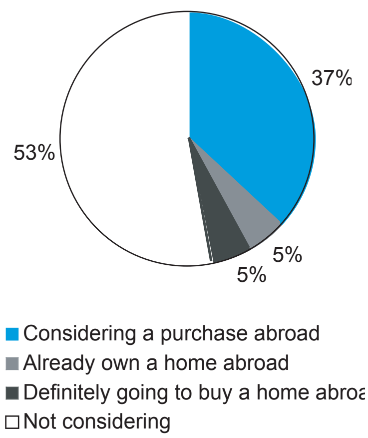
Spanish Holiday Home Market

Location of UK residents' 2nd homes

Spain	27%
France	20%
Portugal	2%
Italy	1%
Other Europe	15%
USA	6%
Other non-Europe	29%
	100%

Source: Office of National Statistics

UK residents considering purchasing

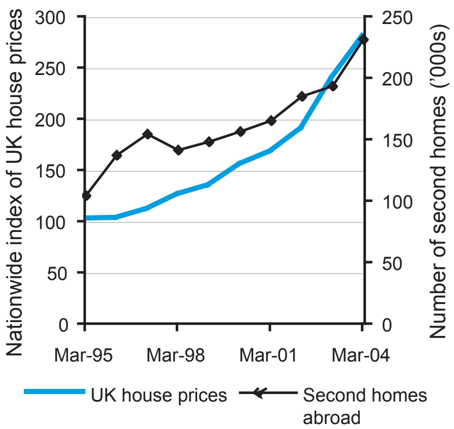


Preferred location for 2nd home

Spain	30%
USA	15%
France	14%
Italy	10%
South Africa	6%
Dubai	5%
Portugal	5%
Bulgaria	3%
Croatia	2%
Morocco	1%
Don't know	9%
	100%

Source: Survey commissioned by Barclays (Nov 2005)

House prices & foreign home ownership



Foreign-property owners in Spain

English	800,000	40%
German	460,000	23%
French	120,000	6%
Scandinavian	Up to 100,000	<5%
Dutch	60,000	3%
Italian	40,000	2%
		<79%
Others: mainly American, Canadian, E. European		>21%

In 2003 foreign nationals bought 150,000 properties in Spain, amounting to 15% of the units sold in Spain that year. By 2007 this figure is expected to rise to 300,000 units per annum. Most foreign purchases are second homes, but 60,000 purchases a year are by foreign nationals who intend to live and work in Spain on a permanent basis.

Source: BBVA, Aug 2005

Our tentative view is that the critical determinant from a UK perspective, so far as it relates to Medsea, will be demand, rather than supply and price. That is to say, UK property owners have learned to take the long view in relation to property prices and a fall in Spanish prices could well lead to a "buy on the dips" reaction in the UK. In the short term demand from the UK and Ireland appears to be strongly influenced by domestic house price trends (driven by 'equity-withdrawal' financing); followed by GDP, employment, interest rates, the exchange rate and consumer confidence, although many of these are inter-related. The trend of Spanish property prices is probably also a factor.

GDP prospects for the UK are broadly positive, even if demand is expected to transfer to some degree from the consumer to the corporate sector. However, pension prospects are discouraging, and the prospect of living in a lower cost environment are likely to seem ever more attractive. Indeed proposed changes to UK pensions legislation may provide a direct boost for Medsea business.

Under the current proposals UK taxpayers are allowed to invest annually up to 100% of their salary (with an upper limit of £215,000) in a Self-Invested Pension Plan, and the range of permissible SIPP investments would be extended to include overseas property for the first time. Against this background we see it as a significant positive that Medsea is now talking to a large IFA business about possibilities in this area and we believe that announcement could be made in the near future on the outcome of such talks.

Competition

Competition is extensive, with agents like Atlas and Parador competing directly with Medsea and very large developers like Polaris World (which has, among its developments, one for a planned 25,000 properties with six golf courses) also selling their own properties and advertising on television.

However a company like Polaris is also happy to use Medsea to sell its properties, to extend its marketing range. Medsea estimates its share of the market as being in single digit percentages. It is therefore required to compete on the quality of its service, its central business theme. We note favourably that Polaris increased its commission rate above its initial level.

In addition we believe that Medsea is right to move in the direction of exclusivity arrangements (referred to elsewhere), particularly where these relate to unusually attractive developments. These will be more profitable and less open to sniper fire from competitors. They may also allow Medsea to develop a distinctive brand in the sub-sector.

The Business

Medsea's core business model is being substantially strengthened following its annus horribilis. We have highlighted elsewhere the principal elements of the changes aimed at reducing its reliance on the traditional model of acting as an agent for property developers in southern Spain, finding buyers in the UK and Ireland.

But the core of its activities will be based around the best practise established by the founder since 1998. Under his formula, a typical property sold by Medsea will be an apartment or maisonette with two to three bedrooms, in the price range of €125-300,000 generally with access to a communal pool, within either walking distance or up to 15 minutes drive of a beach, within 25 minutes drive of the nearest airport and up to the same distance from a golf club. Properties up to €1m plus will occasionally be sold.

Medsea's sales approach can be described as a combination of intensity of focus and winning the trust of the potential buyers. The latter are screened by the agents to produce only customers with a serious intent to purchase. Medsea then pays for them to fly to Spain accommodates them for three nights, determines more closely their requirements and then shows them round a number of properties and local amenities.

Salesmen receive a fixed but fairly low salary (which is unusual in the sector) as well as a relatively high commission on each sale. In return they can put in long hours, remaining with the customer every day until after the evening meal, and are expected to be available seven days a week in busy times. Their closure rate is monitored closely (the target is 70% for each salesman), with a "traffic lights" classification: a fall below satisfactory levels of 50%, say will lead to a review, further training and, if improvement does not come through, to the salesman leaving.

This service-intensive approach, together with the screening by agents, leads to a high closure rate of 50-65%. We believe it also encourages agents to recommend further customers to Medsea and also encourages customers to recommend the company to their friends.

In the case of a typical sale, that is to say for an off-plan purchase, when a purchaser signs a purchase contract (which is with the developer), he pays over to the developer a non-refundable deposit of €3,000. The contract typically requires a further payment of 30-50% of the purchase price within four to eight weeks, but sometimes significantly longer (such as where specified development stages are reached late).

Moving to higher margin exclusive arrangements

Under Medsea's contracts with the developers, when the further payment has been made to the developer Medsea becomes entitled to receive its commission from the developer and the agent becomes entitled to receive his commission from Medsea. If the buyer fails to make this payment, the purchase contracts are typically worded such that they will lapse and Medsea receives no commission, with all accounting entries being effectively cancelled by write-offs. The same applies to its commission payable. In 2004 such lapsing accounted for 6.2% of commissions, and the company sees this as a typical level. In 2005 it increased dramatically for specific reasons (discussed in relation to the interim results, below). At completion of the property (for an off-plan purchase, which most are, typically about 18 months after signing the contract), the balance falls due.

Medsea's current contracts with developers stipulate that they must provide a bank guarantee for the first major payment, so that if the developer collapses the buyer will be able to receive his money back. This was a new arrangement by Medsea and apparently met with some predictable resistance.

In building the business up Medsea has generally operated on a non-exclusive basis with developers, so that both they and other agents have been trying to sell the same properties. However the company has now built up a sufficient track record and local credibility to enter into exclusive agreements with two developers in the last year. In each case it has made investments in the development companies, assuring the developers of its commitment and entitling it to advise on the design of the properties, the methods of construction and pricing.

The company typically sells very few properties in August, and sales in July, December and January are at lower than average levels. Other months exhibit no dramatic seasonal effects, so that Q3 is typically the worst quarter, Q2 the best and Q1 and Q4 intermediate.

Aggregate of sales from companies within the Medsea Group		
	No. of properties sold	**Average value of properties sold** (€)
2001	362	111,000
2002	714	144,000
2003	1,304	157,000
2004	1,048	168,000
2005 H1*	394	178,000

** In H1 2004 the company sold 847 properties.*

Secondary market sales and financial services

The company has an office selling secondary properties on behalf of and to UK/Irish customers, which was responsible for about 20% of group sales in 2004. Commission rates are also high by UK standards, typically 7.5 – 10% (in line with local standards), and this is a good business in its own right. It also adds credibility to Medsea's standing with developers as Medsea can claim to be close to the market and to have a good understanding of current trends in prices and demand. Medsea has also set up a small office to provide financial services such as assisting with arranging mortgages and insurance, but this is currently a very small contributor to the group.

Agents

Medsea relies heavily on the quality of leads provided by its network of agents. Changes to the agent network are key to Medsea's future success. Although again the core elements follow the best practise established at the outset of Medsea's existence.

Agents have typically been small, single office operations, marketing through a combination of the internet, mailshots, specialist magazines and exhibitions. They typically also work with other companies in Spain.

While Medsea has agreements with over 170 agents in the UK and Ireland, the overwhelming proportion of introductions comes from a couple of dozen (a concentrated version of the 80:20 rule). It is this concentration which led to problems in recent results when its most important agent ceased to operate after one of the two partners became incapacitated and the partnership collapsed (we understand that the other partner has since started up a separate business and is once again working with Medsea).

Medsea is considering making its relationship with the agents more effective by changing its agreements so that agent commission is scaled up depending on performance, allocating more of the total agent commission to the top performers.

Medsea continues to develop new agents, with a new head of sales also tasked with focusing more closely on existing business-generating agents. Beyond that however Medsea is developing links with professional intermediaries to include its products along with others in the advice given to clients. In the UK, Medsea is, we believe, at an advanced stage in negotiations with a major IFA group. In addition the company has started a parallel marketing development, announced on 12 August. It has paid 12 NHS trusts a relatively small sum for authorised access to their employees, numbering about 125,000. Medsea's latest plans on exploiting this access involve working with IFA's and targeting the more highly paid staff.

Operational issues

The company warned in April that sales were below expectations in part due to the stuttering property market in the UK.

However the position was even worse than the company realised at the time of its announcement. The manager of the Almeria branch, in an effort to increase sales and in disregard of company policy, was working with customers who purchased in order to trade the position by selling before completion. As the same total deposit of €3,000 was required whether the buyer acquired one or three properties, and given the ability to cancel at the cost of the deposit only, not surprisingly many of these buyers signed up for more than one property. The company noticed the multiple purchases with some mystification, but only realised there was a problem when the cancellation rate tripled. The company has replaced the manager, performed a full review and believes that all related existing and possible future cancellations have been provided against in the interim results. It has also reduced staffing levels, the number of associated motor vehicles and "tour" expenses (by selecting less expensive hotels and restaurants for potential buyers). It estimates that it has reduced the number of property sales required to break even each month by a third.

In addition, some contracts were agreed by the company with certain developers under which the first major payment, typically at least 40% of the total purchase price, could be reduced to 30%. In Almeria this lower level of 30% seems to have been applied, with local developers' agreement (the contracts are signed by them and the buyers), to additional developments. Some of these developers have since said that, with these lower levels of first payment, there is no room for the commission to be paid and that it will be delayed until further payments are made by the buyers. As a result the level of accrued commissions in the balance sheet has increased significantly. We understand from the company that it has now stabilised.

Expansion of office network and product range

The changes to the traditional business model include expansion into new territories. Medsea is increasing its coverage in the Costa de la Luz. It has already sold some properties in the region and will soon take over an office there. As it has stayed out of the overcrowded market in the Costa del Sol, this would not be contiguous with its other operations (although it would cover an area next to a future Portugese office) but Medsea may benefit from being a relatively early mover in an area that itself is starting to grow. In addition Medsea has agreed to service the customers of an established operator in the Orange Blossom Coast, in return for passing on those of its own customers who are interested in the western Mediterranean. It is currently working out of the other company's office and will take it over in the near future.

Medsea has spoken of possibly opening an office in Portugal. The buyers would be similar to Medsea's existing buyers and Medsea's local knowledge could extend across the frontier. However it would be a new entrant in a market in which some operators are already established. Development in this area is likely to be deferred until the company is operating more profitably.

But its plans extend beyond the Iberian Peninsula. It has established an exclusive relationship, at little cost, with a Dutch company to market there and in Germany and the other Benelux countries. Scandinavia might be an option for further expansion. Further out in time it believes that there may be opportunities to replicate the exclusivity arrangements on the Frondoso Valley and Torre del Obispo developments in further countries outside Spain. It has recently announced an exclusivity arrangement to market an initial range of 110 low priced beach front properties in Calabria, in Southern Italy. The properties start at £30,000.

Medsea has indicated that it would like to buy a letting company, mainly for strategic reasons. It is not likely to spend more than, say, £250,000, and this would provide an additional after-sales service to buyers (synergies) as well as enhancing the company's knowledge of different parts of the local property market (primary sales, secondary sales, letting), increasing its attraction to buyers/agents and developers.

Accounting issues

Revenue recognition. Under UK GAAP, which is the basis for the consolidated accounts, commission is treated as receivable from the moment that the buyer signs a legally binding contract and the initial deposit has been paid. There is therefore a timing difference between this date and the date that, under the typical contract with the developer, Medsea is entitled to its commission. As a result Medsea holds on its balance sheet commission earned (and commission payable to agents) from an accounting point of view but to which it is not yet legally entitled, and this commission is also reflected in turnover for the period. The balance sheet items are significant, amounting to £6.1m accrued income and prepayments and £3.2m accruals and deferred income at end-2004, against shareholders' funds of £4.1m and sales for the year of £14.1m.

In the event that a buyer fails to make the first major payment (ie subsequent to the initial deposit) and the contract lapses, the relevant amounts are deducted from commissions earned, accrued income and accrued payables. This is therefore a significant balance sheet (but not cash) exposure for Medsea. In theory, if the Spanish (or UK/Irish) property market crashed, a significant number of buyers might walk away.

In the event that the buyer makes the first major payment but fails to complete, Medsea will try to convince the buyer that it is in his interests to complete on the purchase and then sell the property. If the buyer chooses not to do this the developer will take possession of the property, which the buyer forfeits, and Medsea and its agent retain their commissions. An exception is typically made where completion does not take place as a result of a death, in which case the buyer (or his estate) receives back the first major payment. Defaults, which are included in the cancellation provision, are estimated by the company at 20 or fewer a year, and discussions with agents have confirmed their rarity.

Deferred taxation. The significant timing difference between the approach under UK GAAP and Spanish taxation, which follows Spanish GAAP, leads to a deferred tax provision which will grow as the company's sales grow. With the advent of IFRS in Spain in 2006 it is likely that Spanish taxation will apply on the same basis as UK GAAP – commission will be treated as earned and taxable from the date the purchase agreement is signed. It may be that Spanish tax authorities will make the transition only in stages. It may also be that Spanish estate agents will persuade developers to accelerate the cash cycle, so that commission is paid over at an earlier stage. However if neither of these occurs, then Medsea's deferred tax will crystallise, with a corresponding impact on its cash balance . In view of Medsea's financial strength this is unlikely to place the company under financial pressure.

Merger reserve. Because Medsea UK Limited, which acquired all the Spanish companies before being taken over by Medsea Estates, issued less than £100 of nominal capital to make its acquisitions, and because Medsea Estates then issued about £7m of nominal capital to acquire Medsea UK Limited, the result of merger accounting these two transactions is that Medsea Estates had, in its end-2004 balance sheet, a merger reserve of £7.058m, only marginally short of its issued share capital of £7.063m. Some such situation was probably inevitable once it was decided to acquire the Spanish businesses for shares, requiring merger accounting of the acquisition, as we would assume that the shareholders' funds of the Spanish businesses consisted more of retained profits than of issued share capital. The company could cancel part of this reserve by using retained profits, but that would reduce its ability to distribute, should it choose to do so, for what could be viewed as a slightly cosmetic exercise. We therefore expect it to remain in the balance sheet for the foreseeable future.

Medsea's Profit and Loss						
Year ended 31 December	**2003** £'000	**2003 Adjusted** £'000	**2004** £'000	**2005e** £'000	**2006e** £'000	**2007e** £'000
Turnover	7,843	12,025	14,082	10,238	13,434	16,136
Cost of sales	–5,666	–8,674	–10,020	–7,133	–9,262	–11,134
Gross profit	2,177	3,352	4,062	3,106	4,161	5,002
Administrative	–1,030	–1,399	–1,595	–2,534	–2,275	–2,411
Operating profit	1,147	1,953	2,467	572	1,886	2,591
Exceptional	–	–	–219	–	–	–
Interest (net)	–18	–18	–6	–10	–10	–10
PBT	1,129	1,935	2,242	562	1,876	2,581
Tax	–397	–678	–822	–197	–657	–903
	732	1,257	1,420	365	1,220	1,678
Minorities	–	–	–2	–34	–34	–34
Net income	732	1,257	1,418	331	1,186	1,644
EPS	1.04		2.12	0.47	1.68	2.33
Properties sold		1,304	1,183	724	940	1,130
Ratios						
Gross profit	*27.8%*	*27.9%*	*28.8%*	*30.3%*	*31.0%*	*31.0%*
Operating profit	*14.6%*	*16.2%*	*17.5%*	*5.6%*	*14.1%*	*16.1%*
Tax/PBT	*35.2%*	*35.1%*	*36.7%*	*35.0%*	*35.0%*	*35.0%*

Notes

1. Almeria, bought on 3 March 2004, generated 50% of group operating profits in 2004 despite being included in the P&L only from the date of purchase. In view of its materiality to the group results, for the 2003 P&L we have included both the comparatives reported in the 2004 accounts and an adjusted comparative, being the pro forma 2003 P&L, included in the accountants' report for the AIM listing, compiled by aggregating the results of Medsea and Almeria. These were provided in euros and we have converted them to sterling using an average exchange rate for 2003 of 1.4450. The intention is to provide a more helpful indicator of like-for-like developments.
2. Future revenues are broadly a function of the number of potential buyers visiting Medsea's offices, the closure rate, the average sale price and commission rates (cancellations also impact). Of these, we see the first as the most likely to change from current levels and the hardest to project. Assuming a steady average property sale price (which we have), and a reasonably consistent closure rate, the key variable then becomes the number of properties sold, which the company reports.
   We believe that the Frondoso Valley and Torre del Obispo developments will be sold almost in line with the company's expectations, since Medsea will be able to sell the through its competitors as well as its own agents, and they have particular attractions. They are projected to account for about half the properties sold in the next couple of years. They have significantly higher commission rates, but we have taken a conservative view of the impact on margins as there may be further marketing costs. We have also projected a contribution from Barca & Boom, which may well be exceeded, and have made a cautious projection for the secondary business.
3. Gross margins have been very consistent, and the reason for this is that agent commissions and salesmen's commissions are both percentage based, while for a steady closure rate and a fixed expenditure on potential buyers per "tour", with a steady property sale price this expense is also relatively stable in percentage terms. The salaries of salesmen and the costs of motor vehicles are relatively low outlays and semi-variable.
4. The exceptional cost in 2004 relates to the expenses of listing on AIM.

Medsea's Balance Sheet

	2003 £'000	2004 £'000	2005e £'000	2006e £'000	2007e £'000
Fixed Assets					
Intangible assets	3	4	3	3	3
Tangible assets	1,017	1,174	1,130	1,130	1,130
Investments	0	92	92	92	92
	1,020	1,270	1,225	1,225	1,225
Current assets					
Stock	–	129	156	156	156
Debtors	3,017	7,500	7,167	8,725	9,682
Cash	1,013	1,229	1,582	2,224	3,401
	4,030	8,858	8,905	11,105	13,238
Creditors (less than 1 year)	–1,800	–4,772	–4,607	–5,369	–5,648
Net current assets	2,230	4,086	4,297	5,736	7,591
Creditors (more than 1 year)	–298	–253	–129	–69	–9
Provisions	–410	–1,042	–983	–1,262	–1,499
	2,542	4,061	4,410	5,630	7,308
Capital and Reserves					
Share capital	3	7,063	7,063	7,063	7,063
Share premium	–	22	22	22	22
Other reserves	120	173	163	163	163
Revaluation reserve	126	98	92	92	92
Merger reserve	–	–7,058	–7,058	–7,058	–7,058
Retained profits	2,293	3,761	4,092	5,278	6,922
Minority Interest	–	2	36	70	104
	2,542	4,061	4,410	5,630	7,308
Ratios					
Debtors/sales	*38.5%*	*53.3%*	*70.0%*	*65.0%*	*60.0%*
Creditors/sales	*23.0%*	*33.9%*	*45.0%*	*40.0%*	*35.0%*
NWC/sales	*15.5%*	*20.3%*	*26.5%*	*26.2%*	*26.0%*

Notes

1. Tangible assets include, as well as the freehold of the Torrevieja office, office equipment and motor vehicles, seven investment properties, valued at £436,000 at end-2004 on an open market basis. These were acquired in the past as part of the arrangements for a sale of some land. Medsea can sell these if necessary. In the meantime they are used to provide temporary accommodation for buyers who, for one reason or another, experience an unforeseen delay in completion (eg mortgage not in place) when arriving to take possession. This facility is seen as contributing to Medsea's reputation for customer service.
2. Stock consists of an apartment held for resale.
3. It has been assumed that there is no crystallisation of the deferred tax liability.
4. We have assumed that the company slowly but steadily reduces the proportion of accrued commissions receivable and payable, in the direction of previous levels.

Medsea's Cash Flow Statement

Year ended 31 December	2003 £'000	2004 £'000	2005e £'000	2006e £'000	2007e £'000
Operating profit	1,147	2,467	572	1,886	2,591
Exceptional items	–	–219	–	–	–
Depreciation	42	88	54	54	54
Foreign exchange	–	75	–162	–	–
Amortn of intangibles	–	–64	–	–	–
(Profit)/loss on sale of FA	–34	–75	–	–	–
(Inc)/decrease in debtors	–707	–3,102	333	–1,558	–957
(Increase) in stock	–	–129	–27	–	–
Inc/(decrease) in creditors	721	1,295	–49	762	278
Net cash flow from op. activities	1,169	336	721	1,144	1,967
Returns on investment and interest paid	–18	–6	–10	–10	–10
Tax paid	–242	–440	–51	–378	–666
Capex and fin. Investment	34	–81	–80	–54	–54
Acquisitions & disposals	–	277	–4	–	–
Management of liquid resources	–	–92	–	–	–
Financing	–133	222	–240	–60	–60
Increase in cash	810	216	352	642	1,177

Notes

1. Disposals. No disposals have been projected. However the company's investment in two development companies (valued at the lower of cost and net realisable value) involve an underlying interest in the two land banks which have appreciated substantially since planning approval was obtained. The developers may well accept offers for some of the unsold land over the projection period. If this happens and the proceeds are distributed, the net effect on Medsea would be to reduce commission income but increase either dividend income or disposal gains and proceeds (and short term cash balances).

Appendix 1: The Coastline

Below is a brief summary of the various parts of the southern Spanish coastline, moving anti-clockwise or eastwards from the southern border with Portugal. As every part of central London seems to be branded as a "village", so every stretch of the coastline appears to require its own identity, following the long-established ones such as the Costa del Sol and the Costa Blanca. Nonetheless this does reflect significant differences between the different areas, where development is also at different stages and which attract different kinds of buyers.

Costa de la Luz (coast of light). This extends from the border with Portugal to Punta Tarifa, at the southern tip of mainland Europe and to the west of Gibraltar. As it faces the Atlantic rather than the Mediterranean, the seas are cooler and rougher, but the beaches are often broader and cleaner. To date it has been less developed than futher round the Spanish coast, but it is becoming more popular. However most developments are still of relatively low density. Properties are generally cheaper than on the Costa del Sol but more expensive than on the Costa Blanca.

Costa del Sol. This extends 200km from Punta Tarifa to Nerja, a little east of Malaga, and, with 320 days of sun a year, is the sunniest part of Spain and has been the most popular area in Spain for British property buyers. It includes the mass package holiday area running from west of Malaga through Torremolinos, Benalmadena and Fuengirola to the east. Marbella and other more up-market destinations are in the west of the Costa del Sol, and further east of Malaga the coast is less developed but pretty. Medsea has no office in the Costa del Sol, and believes that there are better opportunities elsewhere.

Costa Tropical. This describes the coast of Granada province. The name comes from a small, sheltered plain between Salobrena and Motril that, for centuries, has been used for growing sugar cane and tropical fruit. The coast is relatively quiet, as the Sierra Nevada mountains (with skiing opportunities) come down very close to the shore or fall directly into the sea, leaving small coves between them and limiting the space for high-density development. Almunecar, where Medsea's office is located, is the only resort of any size, and elsewhere there are mostly small villages or isolated beaches.

Costa Calida (hot coast). This is the name chosen by Murcia province, which is also next to the **Costa de Almeria** (no brand name yet). These two regions are the hottest and driest in Spain, and Almeria contains Europe's one true desert, famous for the filming of spaghetti westerns. Much of inland Almeria is devoted to growing winter vegetables. Murcia includes the large La Manga sports resort, next to the Mar Menor, a large saltwater lagoon, and has experienced a dramatic increase in construction in recent years. Medsea's office is in Vera.

Costa Blanca. The coast of Alicante province, like the Costa del Sol has long been popular with the British on holiday and includes at its centre Benidorm, Europe's largest resort. The southern part of the coast, with a climate more like that of the Costa Calida, is one of the fastest growing holiday areas in Spain and Medsea has offices in Torrevieja and Calpe.

Costa del Azahar (orange blossom coast). This is the coast of Valencia and Castellon provinces, distinguished by the large Valencia orange groves. The coastline tends to straight, sandy beaches and properties are mainly owned by Spaniards, with Germans the only foreigners present in any number.

Appendix 2: Personnel

Tony Gatehouse (66), Chairman. Tony Gatehouse's background is described in the main text above. Within the company he is unavoidably the central figure and, although the CEO is involved in developing the company's strategy as well as day-to-day detailed management, we believe that the privileged access to opportunities for exclusivity arrangements, and other possible developments, result mainly from Tony Gatehouse's reputation and longstanding local involvement. He is also well known by the agents, although they deal more with other Medsea staff.

Juan Carlos Martinez (37), CEO, joined in 2000. He was educated in South Africa, where he obtained accountancy and business management qualifications. After working in South Africa he worked briefly with a recruiting agency in London before moving to Spain, where he held positons as operations and finance director of New Restaurants of Spain, chief accountant/manager of Castle Travel S.L. and chief accountant/manager of Regalos Totem S.L. before joining Medsea.

Alberto Gil (43), non-executive finance director, is the financial controller of Catalyst Investment Group Limited. Catalyst specialises in early stage growth companies qualifying for personal tax relief, advising companies and marketing their shares.

Ken Burrage (59), non-executive, is the chairman of Catalyst Investment Group Limited.

The employment contracts of Tony Gatehouse and Juan Carlos Martinez are for two years, with a notice period of 12 months. The non-executive directors' contracts can be terminated by either party on giving 3 months' notice.

We are pleased to bring you this report on **Medsea Estates Group plc**.

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Andy Hartwill – Head of Research
Andy has more than 20 years experience as a technology analyst and UK & Global Strategist at SG Hambros. Prior to this he was UK and European Strategist for Paribas, and Head of Research at Capital House and Spencer Thornton. He is a regular guest on Bloomberg and CNBC.

Tom Gidley-Kitchin – Company analyst
Tom has over 20 years of pan-European experience including coverage of UK & European leisure and property companies. He has previously worked for Theodoor Gilissen Securities, RAB Capital and Robert Fleming.

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