December 2004

HSBC Trinkaus & Burkhardt

Deutsche EuroShop

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Initiating coverage

Deutsche EuroShop

Better than a REIT

Year to	Revenue (EURm)	EBITDA (EURm)	Reported PBT (EURm)	HSBC PBT (EURm)	HSBC Net profit (EURm)	HSBC EPS (EUR)	HSBC EPS gwth (%)	PE (HSBC) (x)	PE rel	Yield (%)	EV/ EBITDA (x)	EV/IC (x)	ROIC (%)	REP (x)
12/2003a	49.3	36.4	6.5	6.5	-0.5	-0.03				5.3	20.1	1.0	-0.7	
12/2004e	50.5	39.7	12.5	12.5	5.0	0.32		113.4	436.2	5.3	18.4	1.1	0.3	21.1
12/2005e	56.8	44.0	18.2	18.2	6.3	0.40	26.4	89.8	375.1	5.5	16.5	1.1	0.8	8.2
12/2006e	58.8	45.8	21.6	21.6	8.5	0.54	34.5	66.7	312.4	5.5	15.7	1.1	1.2	5.4

- **Pure play on German shopping centre real estate**
- **Efficient tax structure makes DES 'better than a REIT' at present**
- **HSBC T&B fundamental analysis approach gives rating of 3.36**

HSBC T&B fundamental rating approach

As outlined in the *Company Analysis and Valuation* section, we have analysed our peer group of German real estate companies according to five main weighted criteria – country and category exposure, rent expiry profile, G-REIT potential and a miscellaneous position comprising other relevant factors.

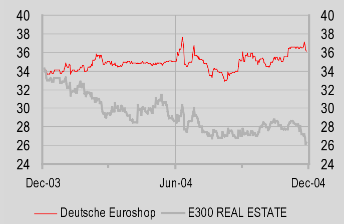
As DES concentrates strongly on the German market, which is in fact our least preferred market, within our peer group its rating is unfavourable at 2.36 (5 is good). Due to its focus on the retail segment, with a particular concentration on shopping centres, DES' category exposure is very favourable – a rating of 3.49, effectively the highest category rating in our peer group. Due to a very low level of rent expiries in the coming years, we have awarded DES the highest possible rating of 5.0 in this criterion. Among other factors, we have accounted for the extremely favourable tax structure of DES, which makes the company unique in our peer group, so we have awarded DES a miscellaneous rating of 5.0.

Below we describe DES' potential to benefit from a G-REIT structure other than increased investor interest, analyst coverage etc.

Potential to benefit from G-REIT

Given its portfolio and strategy, we think DES would make a perfect G-REIT under almost all possible scenarios. DES has expressed its intention to become a G-REIT at some point in the future, but we believe there is little need to rush the process. Currently the company effectively pays no tax at a corporate level, due to existing tax loss carry-forwards of more than EUR60m, putting the company in a situation comparable to REITs, which are tax-exempt at corporate level. In addition, DES' dividends are tax exempt for investors due to a special tax structure, which is more favourable than the full taxation that we would expect for G-REIT dividends. Thus, converting DES into a G-REIT would currently be a change for the worse, warranting a low rating of only 1.0.

Relative price



Source: HSBC

Company report

Country	Germany
Sector	Real Estate
Bloomberg	DEQ GR
Reuters	DEQGn.DE
Mkt cap (EURm)	565.6
Mkt cap (USDm)	756.3
Free float (%)	79

Price

	1M	3M	12M
Absolute	35.55	36.02	34.10
Absolute (%)	1.8	0.5	6.2
Relative (%)	-5.0	-5.2	-22.8

Relative to	E300 Real Estate
Index level	1015.1

Current (EUR)
36.20

Research team*

Analysts
Peter Barkow
Ireneus Stanislawek

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Conclusion

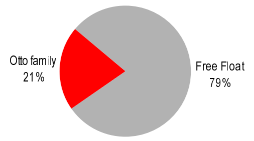
Our fundamental analysis approach gives an overall rating of 3.36 for DES, the best rating within our peer group. At the same time, the company trades at a discount to NAV of c15%. We initiate coverage on DES with this report.

Group strategy

A pure play shopping centre investor

Deutsche EuroShop (DES) is a real estate investment company exclusively focused on shopping centres that are predominantly located in Germany. Its investment strategy profile makes DES a unique play of the German shopping centre sector. The company was founded in 2000 by DB Real Estate, a subsidiary of Deutsche Bank, which injected its shopping centre portfolio into DES. DES then went public in January 2001. In the meantime, Deutsche Bank has sold down its remaining stake, so that the Otto family is the only remaining large shareholder with a combined holding of 21%. DES estimates that of the 79% free float, c55% belong to private investors with only c24% being institutional investors. Such a high concentration of private investors is quite unusual for an MDAX company (DES joined the German Mid-cap Index in September 2004) but can be explained by the history of the company. The company was set up as a tax-optimised dividend pay-out model, a structure from which the company is still benefiting at present. This structure is highly attractive for private investors as dividends are free of tax payments. DES's c6% net of tax dividend yield in the past was therefore much more attractive than yields of open-ended real estate funds (average total performance of 3.9% for the last three years), which were seen as an investment alternative.

DES shareholder structure



Source: Company data, HSBC Trinkaus & Burkhardt

All lateral processes outsourced

DES is structured very efficiently, as all lateral processes such as property development, financial feasibility studies for investments (although due diligence is undertaken and decisions are taken by DES's management), centre management etc. are outsourced so that the company is currently run by five employees (please see following pages for the special relation and dependence on ECE in this regard).

Ambitious growth plans require rights issue…

In the past, DES has mentioned ambitious growth plans, intending to become the no.5 retail RE investor in Europe. The gap between it and current no.5 listed retail property stock, Eurocommercial, is cEUR250m, or 36% of DES' market cap; we think closing this gap will require a rights issue. The company has already stated it intends to increase its capital base if suitable investments are found and It plans to present three specific projects for raising equity capital to investors. In its most recent conference call at the release of the Q3 figures in November, however, it became much more cautious on near-term growth perspectives postponing the utilisation of its EUR30m war chest into 2005. We attribute this to the high competition for shopping centre investments currently. The timing of a rights issue therefore seems elusive at present.

…but timing is elusive

The staff situation at DES is quite tight, with the company stating that it can handle only two to three investment projects annually. We therefore believe DES will need until the end of 2005 to fill its project pipeline in preparation for the SPO.

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Change over to IAS scheduled for FY 2004 figures...

...should have positive impact on revenues and profits...

...but no impact on cash flows and tax payments

Structured as a dividend pay-out model, DES' financials are optimised in order to prevent tax payments. As a consequence, the company is aggressively using all tax accounting measures available in order to minimise reported profits. In turn the company is maximising its free cash flow, which is also the basis for dividend payments. The change to IAS, which is expected for the FY 2004 figures, should lift the company's revenues and profits (without affecting cash flows of course). IAS will mean that the five properties, which are currently held as joint ventures and accounted for at cost, will have to be consolidated on a pro rata basis. This is likely to lead to higher group sales but reduce the financial result. The net impact on the company's bottom line is difficult to forecast given the lack of information on individual property's financials. On the other hand, IAS requires that a higher share of development expenses will have to be capitalised relieving the group P&L. This is unlikely to have any impact on effective tax payments, as these are contingent to DES's tax balance sheet which will not be affected.

Clear investment criteria

Precisely formulated investment approach

DES invests according to concrete investment criteria, of which we have listed the most important in the table below. DES tries to invest in shopping centres at an early stage – significantly before the opening of the centre. Thus, DES is exposed to development risk, which is alleviated by a required pre-let rate of more than 50%. The company stated that the main reason for this is to avoid buying from property developers, who in order to maximise their profits, try to build cheap and maximise rents at the time of the sale. DES is acting as a majority or minority investor (the latter predominantly in order to increase diversification but also to reduce development risk). At present the equity stakes range from 33-100%.

Prime retail in second-tier German cities

Regionally DES invests in so called regional centres, avoiding the high competition for real estate and related low yields of leading German cities. In order to increase revenues, DES is also investing in international properties (currently five out of 14 centres representing 22% of invested equity), which typically offer net rent yields ranging from 6.5-8%, compared to 5.5-6% for Germany. We see the point to spicing up revenues by adding international properties, nevertheless, we would caution that the international experience and market expertise of a company consisting of only five people is limited almost by definition. The dependence on the centre manager is therefore even higher than in DES's domestic market. We would therefore regard it as a better strategy if the company restricted itself to countries where its trusted centre management partner ECE has a proven track record.

International portfolio to be aligned:

CEE investments to replace Southern Europe

Overall strategy remains 'Buy and Hold'

DES is currently in the process of re-aligning its portfolio (a process that started with the disposal of its stake in the centre in Udine). This process is likely to continue with the sale of its French and Italian assets, which are still a legacy of the initial portfolio injected by DB Real Estate. The company already stated that these centres would not match its current strategy anymore (with a high tax rate being one of the reasons). Coincidentially (or not) these centres are the only ones not being managed by ECE, which would underline our above-stated view. Additional non-domestic investments are likely to be within the CEE area, according to the company's CEO, which matches the countries that ECE currently covers. Despite the above-mentioned strategy to sell assets, DES considers itself as a Buy and Hold investor, as disposals are driven by portfolio optimisation efforts.

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Deutsche EuroShop main investment criteria
Investment only in shopping centres (predominantly in Germany but also abroad)
>10,000 lettable space, of which no more than 15% office space or non-retail usage*
Shopping centre in development only with pre-let rate > 50%
Trading area >100,000 inhabitants
Shopping centre feasibility studies have to be audited by external real estate agents/advisors (eg Feri and GfK Prisma for Germany)
Well-established contractor

*Note: * eg cinemas*
Source: Company data, HSBC Trinkaus & Burkhardt

Development and Centre Management outsourced to ECE

Centre management outsourced to market leader ECE

DES is increasingly co-operating with ECE in terms of shopping centre development and management. ECE is also one of the main providers of new investments for DES. ECE is owned by DES' largest shareholder group, the Otto family. With 77 shopping centres under management, ECE is the German and European market leader in shopping centre management. Geographically it covers Germany, Austria, Hungary, the Czech Republic, Poland, Turkey and Quatar. Some 12 of 14 shopping centres currently owned by DES are managed by ECE (only the centres in Tuscia and Annemasse are managed 'externally').

DES/ECE revenue agreement

Centre Management Phase	Revenue agreement*
Development phase	15-20% of investment volume
Initial letting phase	40% of annual gross rents
Management phase	8% of annual gross rents

*Note: * HSBC estimates*
Source: Company data, HSBC Trinkaus & Burkhardt

ECE tenants outperform...

The success of ECE can be seen not only in its market dominance, but also in the sales development of its tenants. The chart on the following page (top left) indicates that shopping centres managed by ECE consistently outperformed the German retail market in terms of revenue development per square metre.

Although we do not question the success and professionality of ECE, we are, however, of the opinion that an analysis of the revenue development of ECE's tenants has to be treated with caution for the following reasons:

...partly due to success of shopping centre format...

- Shopping centres have been the customer's retail format of choice. Thus, a large part of the outperformance can be attributed to the shopping centre format and not to excellent centre management

...but degree of outperformance has declined...

- The degree of outperformance has declined continuously over time (as shown in the top right chart on the following page)

...and launch of new centres might distort the picture

- The revenue development of ECE tenants is hugely dependent on the launch of new centres that have a strongly positive revenue impact in the second and third year after opening. This is the time usually required by a shopping centre to establish itself as a retail centre. The large number of shopping centres run by ECE may be compensating for

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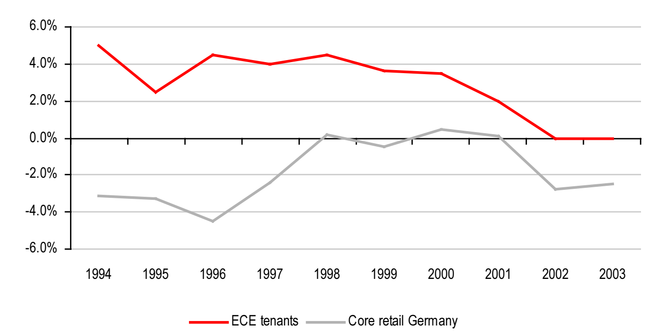
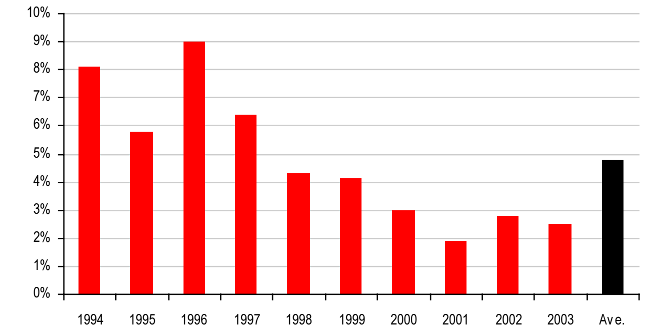
this distortion at present, but we are unsure about what the effect would have been 10 years ago.

ECE tenants outperformed German retail market*...



*Note: * sq m adjusted sales development*
Source: BAG, ECE, GfK Prisma, HSBC Trinkaus & Burkhardt

...but outperformance declined continuously*



*Note: * sq m adjusted sales development*
Source: BAG, ECE, GfK Prisma, HSBC Trinkaus & Burkhardt

We think the tight co-operation with ECE is beneficial for DES, but note two points as a caveat:

Otto family is main shareholder of ECE and DES

- The Otto family is a dominant shareholder in both DES and ECE. In addition, Alexander Otto is a member of DES's supervisory board. This could potentially lead to a conflict of interest, with the natural inclination of the Otto family being to allocate profits in ECE, which is a 100% holding. We have given an overview of the DES/ECE revenue agreement (on previous page) but are admittedly unable to check whether conditions are at arms length. The conditions do not seem completely unrealistic to us

DES dependence on ECE higher than vice versa in our view

- We think the DES dependence on ECE is higher than vice versa. DES is one of ECE's largest, if not the largest, customers (remember that 12 out of 77 shopping centres run by ECE are DES investments). On the other hand, we cannot see how DES could run its business model without ECE

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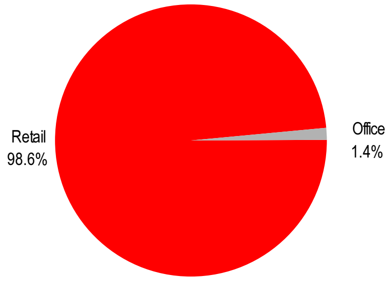
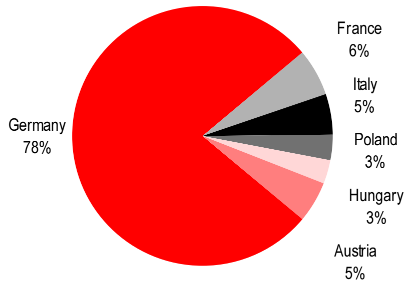
Portfolio analysis

Portfolio by real estate category*...



Note: * as percent of invested equity at end-2003
Source: Company data, HSBC Trinkaus & Burkhardt

...and by country*



*Note: * as percent of invested equity at end-2003*
Source: Company data, HSBC Trinkaus & Burkhardt

Focus on German retail estate reflected in portfolio

The initial capital donation is almost entirely invested at present and the current structure of the portfolio has a strong focus on Germany and retail estate. The company has announced one additional investment in 2004, to replace the sold Udine shopping centre (in Q3). The property is more likely to be located in Germany, according to the management, as a targeted international shopping centre has been swallowed up by a German open-ended fund.

We estimate a net rent yield of 5.4% for the portfolio

The occupancy rate is excellent at a 99% occupancy rate – excluding the centres that are still at a development stage – indicating the quality of DES shopping centres, as well as of the work done by ECE. According to our estimates, the total portfolio generates a net rent yield of 5.4%, with international properties generating higher yields than the German locations. The Rhein-Neckar centre, as well as Wuppertal, are generating disappointing returns at present. The latter has been suffering from two consecutive large insolvencies. As the situation has now been resolved, rental income should rise from H1 2005 onwards.

Portfolio externally rated and valued

The entire portfolio has been rated by GfK Prisma and Feri in 2003 with an average A rating. We think this is a decent outcome given the overall sluggish condition of the German real estate market. Furthermore, DES published an NAV for the portfolio for the first time in March 2004. Market values have been provided by locally leading real state agents (eg Feri and GfK Prisma for Germany). The NAV (before deferred taxes and sales costs) has been calculated at cEUR680m for the portfolio (compared to equity investments of cEUR600m at the time).

Portfolio makes DES an attractive takeover target, in our view

We think that DES's clear investment focus in terms of real estate category and country makes the company an attractive takeover target if large property investors want to play the recovery of German consumer spending.

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DES rent expiry profile*

	2003	2004e	2005e	2006e	2007e	2008e	2009e and beyond
Expiry	2%	3%	2%	5%	3%	2%	85%

*Note: * Still including Udine, not including Pécs, Klagenfurt, Hamburg and Wetzlar as at end-2003*
Source: Company data, HSBC Trinkaus & Burkhardt

At present, favourable rent expiry structure

DES's rent expiry structure looks favourable at present, with expiries totalling 3% in 2004 and 2% in 2005. This reflects the relatively young portfolio in combination with long-lasting rental contracts (c10-15 years). Expiries will accelerate beyond 2009 to above 10% annually. The expiry figures do not include bankruptcies, which the company states range between 1-2% of lettable space annually.

DES' top 10 tenants account for 26% of rental revenues*

	Tenant	Category	Exposure
1	Metro Group	Food & non food retail	6.3%
2	Douglas Group	Personal care and miscellaneous	4.6%
3	P&C	Fashion	2.6%
4	Karstadt Group	Food & non food retail	2.2%
5	Engelhorn	Fashion	2.0%
6	H&M	Fashion	2.0%
7	Palastbetriebe	Cinema	1.7%
8	Ipercoop	Food retail	1.6%
9	Bauhaus	Do-it-yourself	1.5%
10	New Yorker	Fashion	1.4%
Total			**25.9%**

*Note: * Still including Udine, not including Pécs, Klagenfurt, Hamburg and Wetzlar as at end-2003*
Source: Company data, HSBC Trinkaus & Burkhardt

Top 10 tenants account for 26% of rents…

…KarstadtQuelle for 2.2% (3.1% including the Phoenix centre)…

…but overall KQ risk seems limited at present

The table above shows that DES's top tenants account for 26% of rental revenues. The KarstadtQuelle (KQ) exposure at 2.2% (3.1% including the Phoenix centre) is striking. The German retail giant has embarked upon an extensive turnaround programme, putting all of its business units to the test. KQ has decided to exit its small- to medium-sized retail outlets with less than 8,000sq m. In addition, KQ subsidiaries Runnerspoint (running equipment) and Sinn Leffers (fashion) are up for sale. KQ currently rents major retail space from DES in Dresden, as well as in the newly-launched Phoenix centre in Hamburg/Harburg. The latter is not yet included in the table above. In addition, KQ acts as co-investor in Kassel (50%) and owns real estate in the Rhein-Neckar centre. Should these real estates be sold, we think DES would be a logical buyer. Given the pressure mounting on KQ, we think that these properties might represent attractive buying opportunities for DES in the medium term. In a first step, we would, however, assume that KQ would sell its real estate to an opportunity fund in one shot. The fund will then later repackage and sell the acquired portfolio. The rented retail outlets are partly large and/or quite successful, fitting KQ's current strategy. In addition they are subject to long rental agreements (thus exiting them would be costly for KQ). As our retail research team does not see a high risk of insolvency for the KQ group, we think that related rental income seems safe at present. ECE might, however, face the challenge of finding a new anchor tenant for the Phoenix centre in the medium term. Overall, we think that KQ risk is quite limited at present.

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DES becoming a G-REIT? At present a change for the worse

DES: currently better than a REIT...

DES is strongly in favour of German REIT legislation. Given the companies portfolio and strategy, we think DES would make a perfect REIT under almost all possible scenarios (low gearing, relatively passive portfolio management, limited development exposure, etc). DES has also expressed its intention to become a REIT at some time in the future. We are of the opinion that there is little need to rush this. The company is effectively not paying any taxes at corporate level (the tax charge at group level almost exclusively consists of deferred taxes). The existing tax loss carry-forward of above EUR60m ensures that this will remain so for the foreseeable future (at least seven years according to our estimates). This puts the company in a situation that is comparable to a REIT, which is also tax exempt at corporate level.

...as almost no taxes are paid at corporate level...

In addition, DES's tax strategy involves one other element that makes the company superior to a REIT. Dividends paid out by the company are effectively taken out of DES's reserves and due to a special tax structure are effectively treated as capital repayments for investors. Thus, the investor does not have to pay taxes for DES's dividends, which is a clear advantage over a REIT structure. Whether this concept could be maintained if DES opted for a REIT structure seems uncertain at present. Peer Deutsche Wohnen, which operates with the same tax optimisation model, has already mentioned the likely loss of its tax status when converting to a REIT.

...and dividends are tax exempt at investor level

G-REIT conversion could mean loss of tax status

Deutsche EuroShop – summary financials

Current price (EUR)	36.20	Market cap (EURm)	565.6	Bloomberg code	DEQ GR
		Enterprise value (EURm)	729.6	Reuter RIC	DEQGn.DE

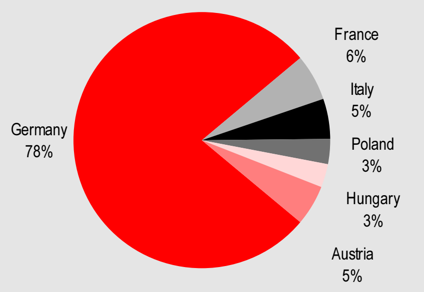
Year to	12/2003a	12/2004e	12/2005e	12/2006e
Per share data (EUR)				
Reported EPS	-0.03	0.32	0.40	0.54
HSBC EPS	-0.03	0.32	0.40	0.54
CEPS	1.40	1.75	1.87	2.05
DPS	1.92	1.92	2.00	2.00
NAV	43.56	44.65	46.13	47.66
P&L summary (EURm)				
Revenue	49.3	50.5	56.8	58.8
EBITDA	36.4	39.7	44.0	45.8
EBIT	14.0	17.3	21.0	22.3
Net interest	-14.1	-15.1	-15.0	-14.8
PBT	6.5	12.5	18.2	21.6
HSBC PBT	6.5	12.5	18.2	21.6
Taxation	-8.7	-11.0	-13.6	-13.8
Reported net profit	-0.5	5.0	6.3	8.5
HSBC Net profit	-0.5	5.0	6.3	8.5
NOPLAT	-4.9	2.1	5.3	8.0
Cash flow summary (EURm)				
Op free cash flow	-9.7	31.1	33.4	40.1
HSBC cash flow	17.7	21.4	24.7	28.4
Capital expenditure	-23.9	0.0	0.0	0.0
Cash earnings	21.9	27.4	29.3	32.0
Change in net debt	57.5	-2.1	-2.5	-7.4
Balance sheet summary (EURm)				
Intangible fixed assets	0.4	0.3	0.3	0.2
Tangible fixed assets	691.6	670.2	648.3	625.7
Cash	88.6	88.6	88.6	88.6
Current assets	106.2	106.6	108.9	109.6
Operating liabilities	8.8	8.8	9.1	9.1
Gross debt	408.6	406.5	404.0	396.6
Net debt	320.0	317.9	315.4	308.0
Shareholders funds	535.7	510.7	487.0	464.2
Invested capital	700.8	679.7	659.7	637.8

Year to	12/2003a	12/2004e	12/2005e	12/2006e
Ratios (%)				
Revenue/IC (x)	0.1	0.1	0.1	0.1
NOPLAT margin	-9.9	4.1	9.3	13.5
ROIC	-0.7	0.3	0.8	1.2
ROE	-0.1	1.0	1.3	1.8
ROA	-0.9	0.4	1.0	1.6
ROCE	-0.9	0.4	1.0	1.6
ROIC/Cost of capital	-0.1	0.1	0.1	0.2
Cost of capital	5.9	5.9	5.9	5.9
EBITDA margin	73.9	78.7	77.4	77.8
EBIT margin	28.5	34.3	37.0	37.8
PAT margin	-4.6	2.9	8.0	13.1
Interest Cover	1.0	1.1	1.4	1.5
Net debt/equity	59.7	62.3	64.8	66.3
Net debt/EBITDA	8.8	8.0	7.2	6.7
Growth (%)				
Revenue	6.0	2.4	12.6	3.5
EBITDA	9.1	9.0	10.8	4.1
EBIT	19.1	23.4	21.6	5.8
PBT	32.2	93.1	45.6	18.6
HSBC Net profit			26.4	34.5
HSBC NOPLAT			155.8	51.3
HSBC EPS			26.4	34.5
Valuation (x)				
PE		113.4	89.8	66.7
PNAV	0.8	0.8	0.8	0.8
PCE	25.9	20.7	19.3	17.7
Yield (%)	5.3	5.3	5.5	5.5
EV/Revenue	14.9	14.5	12.8	12.2
EV/EBITDA	20.1	18.4	16.5	15.7
EV/IC	1.0	1.1	1.1	1.1
ROIC/Cost of capital	-0.1	0.1	0.1	0.2
HSBC REP		21.1	8.2	5.4

Business description

Founded in 1997 as a dividend pay-out model by Deutsche Bank, DES went public in 2001 and has been internally managed since July 2003. The company is a real estate investor that focuses on shopping centres (98% of portfolio), which are predominantly based in second-tier cities in Germany (78% of portfolio). The company structure is extremely lean, comprising five professionals, with centre management and development outsourced to European market leader ECE. DES' dividend yield net of tax is c5% at present.

Equity exposure by region



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HSBC Trinkaus & Burkhardt KGaA
Königsallee 21/23
D-40212 Düsseldorf
Germany
Telephone: +49 211 910-0
Fax: +49 211 910 33 20

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