IS Europe Limited

Directors' report and consolidated financial statements

Registered number 3203996

31 December 2001

Contents

Directors' report

The directors present their annual report and the audited consolidated financial statements for the year ended 31 December 2001.

Principal activities

The principal activity of the company is that of an investment company. It has exclusive rights to create Ian Schrager Hotels throughout Europe. These hotels trade through a subsidiary company, Ian Schrager London Limited. St Martin's Lane commenced trading on 7 September 1999. Sanderson was opened on the 25 April 2000. There are no other hotels currently being developed.

Results and dividends

The directors do not recommend the payment of a dividend for the year *(2000:£nil)*. The group's retained loss for the year of £1,064,000 *(2000: profit of £47,000)* has been transferred to reserves.

Directors and directors' interests

The directors who held office during the year were as follows:

J Gleek
I Schrager
J Anderson
D Hamamoto

According to the register of directors' interests, none of the directors who held office at the end of the year had any interest in the shares of group companies, nor were any rights to subscribe for shares in group companies granted to, or exercised by, any of these directors.

Employment of disabled persons

It is the group's policy to give full consideration to the suitability for employment of disabled persons. Opportunities also exist for employees of the group who become disabled to continue in their employment or be trained for other positions in the group.

Employee involvement

The group's policy is to encourage the involvement of all employees in the group's development and success. This is achieved through its established structure for communicating with employees by means of regular briefings and presentations.

Directors' report *(continued)*

Auditors

KPMG were re-appointed auditors. However, since that date their audit practice was transferred to a limited liability partnership, KPMG LLP. Accordingly, KPMG resigned as auditors on 14 June 2002 and the directors thereupon appointed KPMG LLP to fill the vacancy arising.

By order of the board

Teresa Catherine White
Secretary

20 Thayer Street
London
WIM 6DD

11 November 2002

Statement of directors' responsibilities

Company law requires the directors to prepare financial statements for each financial year which give a true and fair view of the state of affairs of the company and group and of the profit or loss for that period. In preparing those financial statements, the directors are required to:

- select suitable accounting policies and then apply them consistently;
- make judgements and estimates that are reasonable and prudent;
- state whether applicable accounting standards have been followed, subject to any material departures disclosed and explained in the financial statements;
- prepare the financial statements on the going concern basis unless it is inappropriate to presume that the group will continue in business.

The directors are responsible for keeping proper accounting records which disclose with reasonable accuracy at any time the financial position of the company and to enable them to ensure that the financial statements comply with the Companies Act 1985. They have general responsibility for taking such steps as are reasonably open to them to safeguard the assets of the group and to prevent and detect fraud and other irregularities.

kpmg

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United Kingdom

Independent auditors' report to the members of IS Europe Limited

We have audited the financial statements on pages 5 to 19

Respective responsibilities of directors and auditors

The directors are responsible for preparing the directors' report and, as described on page 3, the financial statements in accordance with applicable United Kingdom law and accounting standards. Our responsibilities, as independent auditors, are established in the United Kingdom by statute, the Auditing Practices Board and by our profession's ethical guidance.

We report to you our opinion as to whether the financial statements give a true and fair view and are properly prepared in accordance with the Companies Act 1985. We also report to you if, in our opinion, the directors' report is not consistent with the financial statements, if the company has not kept proper accounting records, if we have not received all the information and explanations we require for our audit, or if information specified by law regarding directors' remuneration and transactions with the group is not disclosed.

Basis of audit opinion

We conducted our audit in accordance with Auditing Standards issued by the Auditing Practices Board. An audit includes examination, on a test basis, of evidence relevant to the amounts and disclosures in the financial statements. It also includes an assessment of the significant estimates and judgements made by the directors in the preparation of the financial statements, and of whether the accounting policies are appropriate to the group's circumstances, consistently applied and adequately disclosed.

We planned and performed our audit so as to obtain all the information and explanations which we considered necessary in order to provide us with sufficient evidence to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or other irregularity or error. In forming our opinion we also evaluated the overall adequacy of the presentation of information in the financial statements.

Opinion

In our opinion the financial statements give a true and fair view of the state of affairs the company and group as at 31 December 2001 and of the loss of the group for the year then ended and have been properly prepared in accordance with the Companies Act 1985.

KPMG LLP

KPMG LLP
Chartered Accountants
Registered Auditors

19 November 2002

Consolidated profit and loss account
at 31 December 2001

	Note	**2001** **£000**	2000 £000
Turnover		**25,499**	29,558
Cost of sales		**(6,692)**	(6,947)
Gross profit		**18,807**	22,611
Administrative expenses		**(12,350)**	(12,048)
Preopening expenses		**-**	(3,575)
		(12,350)	(15,623)
Operating profit		**6,457**	6,988
Interest receivable		**429**	261
Interest payable and similar charges	*4*	**(7,950)**	(7,202)
(Loss)/profit on ordinary activities before and after taxation	*3*	**(1,064)**	47
(Loss)/profit for the financial year transferred to reserves		**(1,064)**	47

The group's historical cost results are the same as its reported results.

There were no other gains or losses during the year not reported in the above statement.

The above results relate to continuing operations.

Consolidated balance sheet
for the year ended 31 December 2001

	Note	2001		2000	
		£000	**£000**	£000	£000
Fixed assets					
Tangible fixed assets	*6*		**113,314**		115,602
Current assets					
Stocks	*7*	**383**		487	
Debtors	*9*	**2,938**		2,860	
Cash	*10*	**8,677**		11,405	
		11,998		14,752	
Creditors: amounts falling due within one year	*11*	**(7,391)**		(8,677)	
Net current assets			**4,607**		6,075
Total assets less current liabilities			**117,921**		121,677
Creditors: amounts falling due after more than one year	*12*		**(99,475)**		(102,167)
Net assets			**18,446**		19,510
Capital and reserves					
Called up share capital	*13*		**5,000**		5,000
Share premium accounts	*14*		**10,000**		10,000
Capital redemption reserve	*14*		**7,878**		7,878
Profit and loss account	*14*		**(4,432)**		(3,368)
Equity shareholders' funds	*16*		**18,446**		19,510

These financial statements were approved by the board of directors on 14 November 2002 and were signed on its behalf by:

I Schrager
Director

J Gleek
Director

Company balance sheet
at 31 December 2001

	Note	2001		2000	
		£000	£000	£000	£000
Fixed assets					
Investment in subsidiary	8		**35,000**		35,000
Current assets					
Debtors	9	**400**		-	
Cash	10	**151**		12	
		551		12	
Creditors: amount falling due within one year	11	**(13,359)**		(12,807)	
Net current liabilities			**(12,808)**		(12,795)
Total assets less current liabilities			**22,192**		22,205
Net assets			**22,192**		22,205
Capital and reserves					
Called up share capital	13		**5,000**		5,000
Share premium accounts	15		**10,000**		10,000
Capital redemption reserve	15		**7,878**		7,878
Profit and loss account	15		**(686)**		(673)
Equity shareholders' funds	16		**22,192**		22,205

These financial statements were approved by the board of directors on 14 November 2002 and were signed on its behalf by:

I Schrager
Director

J Gleek
Director

Consolidated cash flow statement

at 31 December 2001

	Note	**2001 £000**	2000 £000
Net cash inflow from operating activities	*19*	**6,748**	6,159
Returns on investment and servicing of finance	*20*	**(7,745)**	(6,605)
Capital expenditure	*20*	**(72)**	(19,747)
Financing	*20*	**(874)**	22,121
Decrease in cash and cash equivalents		**(1,943)**	1,928

Reconciliation of net cash flow to movement in net debt

(Decrease)/increase in cash in the period		**(1,943)**	1,928
Cash outflow/(inflow) from (decrease)/increase in debt		**874**	(35,783)
Non cash movements		**(182)**	(600)
Movement in net debt in the period		**(1,251)**	(34,455)
Net debt at the start of the period		**(96,983)**	(62,528)
Net debt at the end of the period	*21*	**(98,234)**	(96,983)

Notes

(forming part of the financial statements)

1 Accounting policies

The following accounting policies have been applied consistently in dealing with items which are considered material in relation to the group's financial statements.

Basis of preparation

The consolidated financial information has been prepared on a going concern basis, under the historical cost convention and in accordance with generally accepted accounting principles in the United Kingdom.

Following the waived breach described in note 12 the directors have supplied cashflow information for the periods to 31 March 2003 which shows that they will be in a position to make the loan repayments and consequently they believe that they going concern basis is appropriate.

Basis of consolidation

The consolidated financial statements include the financial statements of the company and its subsidiary undertaking made up to 31 December 2001.

Investments

Investments are stated at cost or cost less provision where there is a permanent diminution in value.

Fixed assets and depreciation

Tangible fixed assets are stated at cost less depreciation and any provision for impairment.

Assets are depreciated to their residual values on a straight line basis over their estimated residual lives as follows:

Freehold buildings	-	50 years
Building surface finishes	-	25 years
Plant and machinery	-	15 years
Fixtures, fittings and equipment	-	5-10 years

No depreciation is provided on freehold land or assets in the course of development. No residual values are ascribed to building surface finishes.

Properties in the course of development are included at the lower of cost and net realisable value. The cost includes directly attributable costs together with interest on specific external debts.

Notes *(continued)*

1 Accounting policies *(continued)*

Foreign currency transactions

Translations into sterling are made at the average of rates ruling throughout the period for profit and loss items and at the rate ruling at 31 December for assets and liabilities. Exchange differences arising in the ordinary course of trading are included in the profit and loss account.

Deferred taxation

Deferred taxation is provided under the liability method in respect of the taxation effect of all timing differences to the extent that it is probable the liabilities will crystallise in the future.

Finance costs

Finance costs are included within the carrying value of the loan and are amortised over the term of the loan.

Stocks

Stocks are stated at the lower of cost and net realisable value. In determining the cost of raw materials and consumables the weighted average purchase price is used.

Turnover

Turnover represents the amounts (excluding value added tax) derived from the provision of goods and services to customers.

2 Staff numbers and costs

	2001	2000
The average number of employees in the year was:		
Hotel operating staff	**152**	206
Management/administration	**20**	29
Sales and marketing	**9**	7
Repair and maintenance	**13**	11
Total	**194**	253

	2001 £000	2000 £000
The aggregate payroll costs for these persons were as follows:		
Employee costs	**4,361**	5,277
Social security costs	**409**	443
Pension costs	**51**	17
	4,821	5,737

Notes *(continued)*

2 Staff numbers and costs *(continued)*

None of the directors received any remuneration during the year or previous year.

Funded defined contribution scheme for employees (group scheme)

Pension costs of £51,000 *(2000: £17,000)* were charged to the profit and loss account of which £1,000 *(2000:£3,000)* was outstanding at the balance sheet date.

The pension scheme is held with Standard Life and is administered by Inter Alliance.

3 (Loss) /profit on ordinary activities before taxation

	2001	2000
	£000	£000
(Loss)/profit on ordinary activities before taxation is stated after charging:		
Auditors' remuneration:		
- Group	**85**	85
- Company	**5**	5
- Non audit - Group	**-**	30
Depreciation and other amounts written off tangible fixed assets:		
- Owned	**2,490**	1,626
- Leased	**-**	432
Loss on disposal of tangible fixed assets	**655**	274

4 Interest payable and similar charges

	2001	2000
	£000	£000
Amounts payable on bank loans and overdrafts	**7,858**	6,209
Finance charges	**92**	1,738
Finance charges payable in respect of finance leases	**-**	188
Less interest capitalised	**-**	(933)
	7,950	7,202

Notes *(continued)*

5 Taxation

No corporation tax has been provided due to losses incurred in the year.

6 Fixed assets - Group

	Freehold land and buildings £000	Plant and machinery £000	Fixtures, fittings and equipment £000	Total £000
Cost				
At start of the year	99,870	7,887	10,401	118,158
Additions	173	64	620	857
Disposals	(591)	-	(118)	(709)
At end of year	**99,452**	**7,951**	**10,903**	**118,306**
Depreciation				
At start of the year	810	512	1,234	2,556
Charge for the year	816	528	1,146	2,490
Disposals	-	-	(54)	(54)
At end of year	**1,626**	**1,040**	**2,326**	**4,992**
Net book value				
At 31 December 2001	**97,826**	**6,911**	**8,577**	**113,314**
At 31 December 2000	99,060	7,375	9,167	115,602

Included in the total net book value of freehold buildings is £4,356,000 *(2000: £4,418,000)* of capitalised interest (net of accumulated depreciation).

All tangible fixed assets of the group are held by the subsidiary undertaking, Ian Schrager London Limited.

Notes *(continued)*

7 Stocks

	Group 2001 £000	Group 2000 £000
Raw materials and consumables	**383**	487

8 Investment in subsidiary company

	£000
At 1 January 2001 and 31 December 2001	35,000

The company owns 100% of the ordinary shares of Ian Schrager London Limited, a company incorporated in England and Wales, whose principal activity is the operating of two Ian Schrager hotels in London.

9 Debtors: amounts due within one year

	Group 2001 £000	Company 2001 £000	Group 2000 £000	Company 2000 £000
Trade debtors	**1,242**	**-**	2,179	-
Receivable from related parties	**1,364**	**400**	620	-
Other debtors	**33**	**-**	-	-
Prepayments and accrued income	**299**	**-**	61	-
	2,938	**400**	2,860	-

10 Cash

	Group 2001 £000	Company 2001 £000	Group 2000 £000	Company 2000 £000
Cash	**4,241**	**151**	6,184	12
Restricted cash	**4,436**	**-**	5,221	-
	8,677	**151**	11,405	12

Under the terms of the loan agreement, the company was required to set aside cash as a general reserve and an amount to cover outstanding construction liabilities and future fixed asset replacements. At 31 December 2001 these amounts totalled £4,000,026 and £435,602 respectively.

Notes *(continued)*

11 Creditors: amounts falling due within one year

	Group 2001 £000	Company 2001 £000	Group 2000 £000	Company 2000 £000
Bank loans	**3,000**	**-**	1,000	-
Trade creditors	**1,051**	**3**	1,897	3
Amounts due to group undertakings and related parties	**371**	**13,351**	783	12,804
Other creditors including taxation and social security	**719**	**5**	1,650	-
Accruals and deferred income	**2,250**	**-**	3,347	-
	7,391	**13,359**	8,677	12,807

12 Creditors: amounts falling due after more than one year

	Group 2001 £000	Group 2000 £000
Bank loans and overdrafts	**99,475**	102,167

Bank loans are repayable as follows:

	2001 £000	2000 £000
Within one year	**3,000**	1,000
Between two and five years	**18,500**	10,500
In five years or more	**80,975**	91,667
	102,475	103,167

Bank loans falling due in five years or more are as follows:	2001 £000	2000 £000
Sterling bank loans repayable in quarterly instalments, secured on the group's hotels.	**80,975**	91,667
An interest rate swap fixes the interest payable at rates varying between 7.54% and 7.62% *(2000: 7.54% and 7.62%)*		
	80,975	91,667

The group has a £105 million loan facility. This is due to be repaid over the next seven years with the timing of repayments contingent on achieved ratios of EBITDA to net interest.

During the year the Group had a technical breach of its loan covenants. Following discussions the banks have agreed to waive the breach and suspend the covenant conditions until March 2003.

Notes *(continued)*

13 Called up share capital

	2001 £000	2000 £000
Authorised		
1,000 ordinary shares of £1 each	**1**	1
2,499,999 A ordinary shares of £1 each	**2,500**	2,500
2,499,997 B ordinary shares of £1 each	**2,500**	2,500
2 preferred non-voting ordinary shares of £1 each	**-**	-
	5,001	5,001
Allotted, called up and fully paid		
2 ordinary shares of £1 each	**-**	-
2,499,999 A ordinary shares of £1 each	**2,500**	2,500
2,499,997 B ordinary shares of £1 each	**2,500**	2,500
1 preferred non-voting ordinary shares of £1 each	**-**	-
	5,000	5,000

Both the A and B ordinary shares carry equal voting rights and rank pari passu with each other. The preferred ordinary shares carry non-voting rights and rank pari-passu with the A and B ordinary shares.

14 Reserves – group

	Share premium £000	**Profit and loss account £000**	**Capital redemption reserve £000**
At 1 January 2001	10,000	(3,368)	7,878
Loss for the financial year	-	(1,064)	-
At 31 December 2001	**10,000**	**(4,432)**	**7,878**

Notes *(continued)*

15 Reserves - company

	Share premium	Profit and loss account	Capital redemption reserve
	£000	£000	£000
At 1 January 2001	10,000	(673)	7,878
Loss for the financial year	-	(13)	-
At 31 December 2001	**10,000**	**(686)**	**7,878**

16 Reconciliation of movement in equity shareholders' funds

	Group 2001 £000	Company 2001 £000	Group 2000 £000	Company 2000 £000
Retained (loss)/profit for the financial year	(1,064)	(13)	47	(627)
Repayment of capital	-	-	(12,122)	(12,122)
Net decrease in shareholders' funds	(1,064)	(13)	(12,075)	(12,749)
Opening shareholders' funds	19,510	22,205	31,585	34,954
Closing shareholders' funds	18,446	22,192	19,510	22,205

During 2000 the courts authorised the repayment of £20,000,000 of paid up share premium split equally between the group's shareholders, Ian Schrager Hotels LLC and Burford Hotels Limited. £12,122,000 was paid in 2000, the remainder is held in the capital redemption reserve.

17 Immediate and ultimate controlling parties

IS Europe Limited is owned 50% by Burford Hotels Limited, whose ultimate holding company is Lehman Brothers Holdings Inc., a company incorporated in the state of Delaware in the USA.

The consolidated accounts of the ultimate holding company are available to the public from 399, Park Avenue, New York, USA and from One Broadgate, London.

The other 50% is owned by IS Europe Holdings LLC, a wholly owned subsidiary of Ian Schrager Hotels LLC, a company incorporated in the USA, whose principal place of business is 475 10th Avenue New York, NY 10018 USA.

Notes *(continued)*

18 Related party transactions

Ian Schrager Hotels LLC

Ian Schrager Hotels LLC recharge staff costs, overheads and any direct costs they incur in support provided to the company. Total costs incurred in the period were £326,000 *(2000: £1,364,000).*

ISUK Management

ISUK Management is 100% owned by Ian Schrager Hotels LLC.

ISUK Management charge IS Europe Limited a management fee and staff costs relating to hotel management, which totalled £2,552,000 *(2000: £2,989,000).*

SC London

SC London is indirectly owned 50% by Ian Schrager Hotels LLC and 50% by Chodorow Ventures LLC.

SC London pays rent and recharged expenditure to IS Europe Limited, which totalled £3,246,000 *(£3,017,000).*

GK UK London Limited

GK UK London Limited is 50% indirectly owned by Ian Schrager Hotels LLC and 50% indirectly owned by Sam Gold.

GK UK London Limited pays rent and recharged expenditure to IS Europe Limited, which totalled £92,000 *(2000:£127,000).*

GK UK London Limited ceased operating the shop in St Martins Lane in September 2001. The remaining outstanding balances from GK UK London Limited were not recoverable due to insufficient assets and were written off. Amounts written off totalled £346,000.

Ian Schrager

Ian Schrager, a director of the group, was reimbursed expenses totalling £7,000 in the year *(2000:£11,000).*

Related party balances and transactions	**2001**	2000
	£000	£000
Debtors: amounts falling due within one year		
- SC London Limited	**900**	457
- GK UK London Limited	**-**	163
- Ian Schrager Hotels LLC	**464**	-
	1,364	620

	2001	2000
	£000	£000
Creditors: amounts falling due within one year		
Ian Schrager Hotels LLC	**-**	367
ISUK Management	**371**	416
	371	783

Notes *(continued)*

18 Related party transactions *(continued)*

The directors confirm that there were no related party transactions other than those disclosed in these financial statements.

19 Reconciliation of operating profit to net cash flow from operating activities

	2001 £000	2000 £000
Operating profit	**6,457**	6,988
Loss on disposal of fixed assets	**655**	274
Depreciation	**2,490**	2,058
Decrease in stock	**104**	112
Increase in debtors	**(78)**	(729)
Decrease in creditors	**(2,880)**	(2,544)
Net cash flow from operating activities	**6,748**	6,159

20 Analysis of cash flows

	2001 £000	2000 £000
Return on investment and servicing of finance		
Interest receivable	**429**	261
Interest on bank loan	**(8,136)**	(5,662)
Interest on finance leases	**-**	(66)
Finance costs	**(38)**	(1,138)
	(7,745)	(6,605)
Capital expenditure		
Purchase of tangible fixed assets	**(857)**	(14,526)
Increase in restricted cash	**785**	(5,221)
	(72)	(19,747)
Financing		
Repayment of bank loan	**(874)**	(66,466)
Draw down of new loan	**-**	104,124
Repayment of capital	**-**	(12,122)
Capital element of finance lease repayment	**-**	(1,875)
Amounts repaid to joint investor	**-**	(1,540)
	(874)	22,121

Notes *(continued)*

21 Analysis of changes in net debt

	At 1 January 2001 £000	Cash flows £000	Other non-cash movements	**At 31 December 2001 £000**
Cash at bank and in hand	6,184	(1,943)	-	**4,241**
Debt due within one year	(1,000)	-	(2,000)	**(3,000)**
Debt due after more than one year	(103,124)	874	2,000	**(100,250)**
Finance leases	-	-	-	**-**
Deferred finance costs	957	-	(182)	**775**
Net debt	(96,983)	(1,069)	(182)	**(98,234)**

22 Contingent liabilities

The compensation of the hotel designer consists of a base fee that has been paid to the designer and a fee of 1% of hotel gross revenues, as defined, for the period from the opening of each hotel to August 2009 for St. Martins Lane and to March 2010 for Sanderson. The group paid a portion of the revenue-based design fee during 2001. The two sole shareholders of the group acknowledge that the nature of the group's obligation to the designer, if any, is disputed by the parties. Each shareholder has agreed to pay 50% of prospective payments due to the designer.

23 Post balance sheet events

During the year, the company was the subject of a routine Inland Revenue investigation, following which a number of matters have been raised, which the company, together with its advisors, is in the process of discussing.

No provision has been made for any liabilities that might arise as it is impractical to quantify any potential liability given the early stage of the investigation and discussions with the Inland Revenue.