Fair Value REIT

Q114 results

An encouraging start to the year

Real estate

Fair Value REIT (FVI) has reported Q1 earnings slightly ahead of management's expectation and that implied by our own full year forecast. Despite the planned reduction in portfolio size, underlying (EPRA basis) earnings actually increased slightly compared with Q113, reflecting a significant decline in interest expense. 2013 saw significant progress in FVI's efforts to enhance valuation by reducing complexity and sustainably lifting distributable income. The shares offer an attractive dividend yield (prospective 4.8%), on a par with peers but with a much lower price to NAV multiple.

Year end	Revenue (€m)	Adjusted net profit* (€m)	Adjusted EPS* (€)	DPS (€)	P/NAV (x)	Yield (%)
12/12	36.8	5.9	0.64	0.10	0.54	1.9
12/13	36.4	6.4	0.69	0.25	0.59	4.8
12/14e	30.4	5.1	0.55	0.25	0.58	4.8
12/15e	31.9	5.9	0.63	0.28	0.56	5.3

Note: *Net profit and EPS are normalised (fully diluted), excluding intangible amortisation, exceptional items and share-based payments. EPS and NAV are on an EPRA basis.

Q1 performance supports full year expectations

Underlying Q114 net profits of €1.29m (on an EPRA basis, adjusted for one-off items and unrealised valuation movements) were higher than the €1.18m earned in Q113. Gross rental income was 15% lower, reflecting planned portfolio reduction, but the decline in net rental income was limited to 10% by a 22% decline in property operating expenses. A material decline in net interest expense resulted from the lower level of debt (resulting from disposals) and lower debt costs, largely reflecting the contractual expiry and cancellation of expensive interest rate swaps. At this early stage of the year we are leaving our estimates unchanged; management guidance of €5.1m underlying net profit is similarly unchanged.

Management continues to seek growth opportunities

Over the past two years, management has been focused on shedding non-strategic assets, simplifying the group structure, and reducing complexity. Substantial progress has been made, supporting an increase in distributable income and a sustainable increase in dividends. However, commercial real estate market conditions remain favourable, and we believe FVI is near the end of its portfolio simplification and will seek opportunities to grow its direct investments, particularly in retail.

Valuation: Discount continues to look anomalous

FVI continues to trade at a c 40% discount to EPRA NAV, much larger than for peers (c 7% on average) despite a similar NAV total return over the past five years and the yield differential being closed by FVI's more than doubling of the DPS. A simplified group operating structure and improved transparency from the adoption of IFRS10 should help to highlight this difference.

9 May 2014

Price	**€5.25**
Market cap	**€49m**

Net debt (€m) as at 31 March 2014	153.6
Shares in issue	9.3m
Free float	47.5%
Code	FVI
Primary exchange	Frankfurt
Secondary exchanges	Stuttgart, Berlin, Munich

Share price performance

%	1m	3m	12m
Abs	(0.5)	9.3	24.4
Rel (local)	(0.7)	6.8	6.9
52-week high/low		€5.80	€4.01

Business description

Fair Value REIT (FVI) is a real estate investment trust managing c 370,000m² at 45 commercial properties in nine German states. It has a diversified portfolio of office and retail assets, with a focus on regional locations.

Next events

AGM	27 May 2014

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Edison profile page

Fair Value REIT is a research client of Edison Investment Research Limited

Investment summary

Attractively priced dividends

FVI is a real estate investment trust (REIT), which manages a portfolio of commercial office and retail properties in regional German locations, split equally between east and west. The group invests directly in real estate assets and indirectly through holdings in property companies, closed-end funds and partnerships. As a REIT, FVI's strategy for shareholder returns is significantly focused on dividends; having successfully restructured the group to support a more than doubling in DPS in 2013 (from €0.10, or 16% of EPRA EPS, to €0.25, or 36% of EPRA EPS) the group seeks to maintain an increased pay-out ratio of at least 45% of EPRA EPS going forwards (with a goal to increase this to 50% from 2016). The prospective dividend yield, on a forecast unchanged dividend for FY14 of €0.25 per share, is now on a par with peers, yet the discount to NAV remains substantially larger (c 40% versus c 7% for peers) despite comparable NAV total returns over the past five years.

Q1 in brief

FVI reported IFRS consolidated net income of €1.17m for Q114 (Q113: €1.35m). Underlying profits (calculated on an EPRA basis) increased from €1.18m to €1.29m or €0.14 per share compared with €0.13 per share in Q113. The result for both years is on the new accounting basis adopted at the end of FY13, which, adopting IFRS10, now fully consolidates the former associate investments that were previously equity accounted. Management comments that the Q114 result is somewhat better than its expectations (driven by higher than anticipated net rental income) but that at this early stage in the year it has left its full year guidance of €5.1m underlying consolidated profit (EPRA basis) unchanged. Our own estimate (also €5.1m) remains unchanged for the same reason. As the year progresses we would expect earnings to benefit from an increase in occupancy, but for the benefit to be limited by the full impact of recent property disposals.

Exhibit 1: Summary P&L

€000's	Q1FY14	Q1FY13	Difference	
Gross rental income	6,185	7,240	(1,055)	-15%
Income from operating and incidental costs	1,324	1,596	(272)	-17%
Realestate related operating expenses	(2,728)	(3,513)	785	-22%
Net rental result.	4,781	5,323	(542)	-10%
General administrative expenses	(679)	(811)	132	-16%
Net other operating income & expenses	40	160	(120)	-75%
Net result from sale of investment properties	(102)	0	(102)	
Net valuation result	0	(62)	62	-100%
Operating result	4,040	4,610	(570)	-12%
Result from equity accounted investments	0	648	(648)	-100%
Net interest income/(expense)	(1,432)	(2,312)	880	-38%
Minority interests	(1,434)	(1,595)	161	-10%
Net attributable income (IFRS)	1,174	1,351	(177)	-13%
Net attributable income (EPRA)	1,293	1,179	114	10%

Source: Company data, Edison Investment Research

As at 31 March 2014, occupancy was unusually low at 89.6%. This compares with a year-end level of 93.3% and a five-year average of 95.3%. New leases have subsequently become effective, which will see the rate begin to increase again. The weighted average unexpired lease term of five years at the end of Q1 was unchanged from the FY13 year end.

Gross rental income declined by 15% in Q114 versus Q113, reflecting the planned reduction in portfolio size. Property related operating expenses fell further, by 22%, such that the decline in net rental income was limited to 10%. Net rental income was a little ahead of management's and our expectations. Administrative and other expenses showed the expected decline, and other income and expenses showed a small positive variance with forecasts, but this was offset by realised valuation movements reflecting the transaction costs of recent property disposals.

Following the adoption of IFRS10, the only associated company contributing to the 2013 P&L was BBV09, but FVI's limited partner interest was terminated as of 31 December 2013. Hence, the Q1 FY14 P&L has no associate contribution and the balance sheet receivables include the €11.6m that FVI should receive in respect of BBV09 over the coming three years.

Lower net interest expense (€1.43m versus €1.60m in Q113) reflects both lower debt (resulting from disposals) and a lower effective interest rate. Gross debt was €170.2m at the end of Q114 compared with €191.2m at year end FY13. Included within the IFRS net interest expense are a positive movement in the fair value of derivative financial instruments and the expense of cancelling part (€5m of the €10m remaining at year end 2013) of the remaining interest rate swap covering the parent company debt; both were c €0.9m and broadly off-setting. After allowing for commitment fee charges, the underlying net interest expense was in in line with the weighted average cost of c 2.8% brought forward from the end of 2013 (4.3% at the end of 2012).

A combination of earnings and asset disposals saw the REIT equity ratio increase to 50.4% from 46.9% in December 2013, well above the 45% minimum.

EPRA NAV per share increased slightly during Q1 to €8.89 from €8.86 at the end of 2013.

Portfolio transactions

At 31 March 2014 the directly and indirectly held portfolio consisted of 47 properties (down from 49 at year end FY13 and 65 at the end of 2012). The market value (as assessed at 31 December 2013) was €293.3m (FY13 year-end €311m and €463m at the end of 2012). In February 2014, FVI announced the sale of a small directly owned bank building at Henstedt-Ulzburg for c €1.1m (similar to carried value), along with the disposal of a hotel with office and commercial space in Hannover. The Hannover disposal generated €17m, the value carried in the year-end accounts, but lower than its previous market value by c 13%. At the end of Q1, three properties (in Erlangen, Sparrieshoop, and Weyhe-Leeste) were held as available for sale, with an aggregate value of €4.5m (1% of assets). The sale of the properties in Sparrieshoop and Weyhe-Leeste completed in April and that in Erlangen will do so once the land registry documentation can be completed. Sparrieshoop (a small office and residential building) was sold for €0.18m and Weyhe-Leeste (a doctors' practice with supermarket) for €2.86m; both sale prices were similar to carrying value.

In 2014 FVI has continued to take advantage of a positive property market environment to dispose of non-core properties and simplify its overall structure. Disposals also had the effect of increasing the share of retail property, an area that management favours. We believe there are more non-core assets to be disposed of, but note management is also keen to be able to once again begin to grow the portfolio, with a focus on directly owned properties, the retail sector and increasing exposure to faster-growing regions of the German economy.

Exhibit 2: Financial summary

Year ending December	€m	2012	2013	2014e	2015e
€m		IFRS	IFRS	IFRS	IFRS
PROFIT & LOSS		**Re-stated**			
Revenue		36.8	36.4	30.4	31.9
Net property expenses		(11.5)	(13.3)	(12.4)	(12.5)
Net rental income		25.3	23.1	18.0	19.4
EBITDA		21.6	19.8	15.4	16.7
Intangible Amortisation		0.0	0.0	0.0	0.0
Revaluation of inv. Property		(9.7)	(14.0)	0.0	0.0
Gain on disposal of inv. Property		0.1	(0.7)	0.0	0.0
EBIT		11.9	5.0	15.4	16.7
Associates		(0.6)	1.5	0.0	0.0
Net Interest		(10.9)	(12.7)	(5.7)	(4.4)
Profit Before Tax (norm)		10.1	8.6	9.7	12.3
Profit Before Tax (IFRS)		0.4	(6.2)	9.7	12.3
Tax		0.0	0.0	0.0	0.0
Minority interests		(0.6)	0.9	(5.5)	(6.5)
EPRA Net income		5.9	6.4	5.1	5.9
Net income (IFRS)		(0.2)	(5.2)	4.2	5.9
Average Number of Shares Outstanding (m)		9.3	9.3	9.3	9.3
EPS - EPRA basis, normalised fully diluted (€)		0.6	0.7	0.5	0.6
EPS - (IFRS) (€)		(0.0)	(0.6)	0.4	0.6
Dividend per share (€)		0.1	0.3	0.3	0.3
BALANCE SHEET					
Fixed Assets		366.7	292.5	288.4	288.4
Investment property		355.9	292.3	288.2	288.2
Equity accounted investments		10.6	0.0	0.0	0.0
Other non-current assets		0.2	0.2	0.2	0.2
Current Assets		18.4	53.4	36.9	34.3
Trade receivables		1.8	33.5	15.0	15.0
Cash		14.2	17.4	19.4	16.8
Other		2.4	2.5	2.5	2.5
Current Liabilities		(61.1)	(70.9)	(36.4)	(36.4)
Trade payables		(1.7)	(2.2)	(2.1)	(2.1)
Short term borrowing		(55.9)	(64.6)	(30.2)	(30.1)
Other		(3.5)	(4.1)	(4.1)	(4.1)
Long Term Liabilities		(170.0)	(128.7)	(139.2)	(131.2)
Long-term debt		(160.8)	(126.6)	(137.2)	(129.1)
Provisions and other		(9.2)	(2.1)	(2.1)	(2.1)
Net Assets		154.0	146.3	149.6	155.1
Minorities		(73.6)	(65.6)	(67.1)	(69.6)
Shareholders' equity		80.4	80.7	82.5	85.5
IFRS NAV per share (€)		8.62	8.65	8.84	9.17
EPRA NAV per share (€)		9.58	8.86	9.05	9.38
CASH FLOW					
Operating Cash Flow		18.0	13.4	11.5	12.9
Net Interest		(10.2)	(12.0)	(5.8)	(4.5)
Tax		0.0	0.0	0.0	0.0
Capex		0.0	(0.0)	0.0	0.0
Acquisitions/disposals		3.3	29.1	22.6	0.0
Financing		(0.1)	(0.8)	(0.1)	(0.5)
Dividends		(0.7)	(0.9)	(2.3)	(2.3)
Net Cash Flow		10.3	28.7	25.9	5.5
Opening net debt/(cash)		212.9	202.6	173.8	147.9
Other		0.0	0.0	(0.0)	(0.0)
Closing net debt/(cash)		202.6	173.8	147.9	142.4

Source: Company data, Edison Investment Research