EDISON

Fair Value REIT

Acquisition of subsidiary

Progress on growth plans

Real estate

Fair Value REIT (FVI) has announced further progress in its growth strategy, with the acquisition of a majority stake (c 52.8%) in a closed-end real estate fund (BBV08). The €8.4m cash investment uses proceeds from the €34.7m (net) equity increase in May. The terms of the acquisition add immediate value to FVI shareholders, enhancing EPRA NAV and underlying EPRA (or FFO) earnings per share. We estimate that leveraged investment of the remaining proceeds of the equity increase could lift annualised adjusted earnings by a further 41%.

Year end	Revenue (€m)	EPRA net profit* (€m)	EPRA EPS* (€)	DPS (€)	P/NAV (x)	Yield (%)
12/13	36.4	6.4	0.69	0.25	0.86	3.3
12/14	30.1	4.4	0.47	0.25	0.90	3.3
12/15e	30.2	5.2	0.42	0.28	0.88	3.7
12/16e	32.6	6.3	0.45	0.28	0.86	3.7

Note: *Net profit and EPS are on an underlying EPRA basis (also referred to as FFO), excluding valuation movements and exceptional. P/NAV is also on an EPRA basis.

Investment enhances NAV and earnings per share

This is FVI's first major step towards achieving its growth ambitions since raising €34.7m (net of expenses) in an equity issue in May. Significant work had already been undertaken to position the company for growth, with non-core properties representing c 19% of the end-2012 total disposed of. The controlling stake in BBV08 has been acquired at a c 22% discount to NAV (enhancing NAV per share by c 16c per share), while the annualised c €1m increase in FFO (a c 12% return on the investment) enhances EPRA EPS per share. We illustrate how investing the proceeds of the remaining capital increase could lift EPRA EPS by a further 41% on an annualised basis (see Exhibit 2).

Attractive yields and fragmented market

German commercial property offers attractive yields relative to current funding costs in a robust economy. The secondary locations that FVI targets (gross yields of c 8%) have historically shown above-average rental growth and lower volatility. Over the past 10 years, large quoted residential property players have emerged, offering liquid, efficient investment opportunities giving attractive yields. The commercial property market is more fragmented, and quoted players are smaller, but it has similar potential for scale efficiencies

Valuation: Growth creating value

FVI's share price has increased by 49% over the 12 months to 3 July 2015, noticeably more than peers. However, it started from a particularly low valuation, and the P/BV (c 0.9x FY16e) and P/E (c 17.0x FY16e) are broadly in line with peers, while we estimate that further investment of the proceeds of the capital increase could lift FY16 EPS by an additional 41% on an annualised basis. That would leave our €0.28 dividend per share forecast more than 2.2x covered and may indicate room to lift the dividend, closing the small yield gap with peers.

7 July 2015

Price	**€7.62**
Market cap	**€107m**

Net debt (€m) as at 31 March 2015	140.8
Shares in issue	14.0m
Free float	72%
Code	FVI
Primary exchange	Frankfurt
Secondary exchange	Stuttgart, Berlin, Munich

Share price performance

%	1m	3m	12m
Abs	(1.1)	(6.2)	49.5
Rel (local)	1.7	3.1	37.4
52-week high/low		€8.8	€4.6

Business description

Fair Value REIT (FVI) is a real estate investment trust managing c 239,000sqm at 41 commercial properties across Germany (as at 31 March 2015). It has a diversified portfolio of office and retail assets, with a focus on regional locations.

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Edison profile page

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

Progress on growth plans

FVI has announced the acquisition of a majority (c 52.8%) stake in a closed-end real estate fund, BBV08. BBV08 will be fully consolidated into FVI, in line with the group's eight existing subsidiary investments.

BBV08 will increase consolidated real estate assets (at fair value) by €36m, or by c 13% on the Q115 total of €269m. The BBV08 portfolio comprises two regional shopping centres in Querfurt and Zittau, as well as a retirement home in Radevormwald. The total lettable area is approximately 35,800sqm (FVI at Q115: 239,175sqm) and the occupancy rate is a high 99.5% (FVI at Q115: 91.0%). The weighted average lease term is four years compared with 4.8 years for FVI as at 31 March 2015.

Taking BBV08 as a whole, the portfolio generates c €3.2m of annual total rental income (rents and service chart income) and will increase the FVI annualised total as at Q115 by c 14%. After allowing for the minority interest in BBV08, FVI anticipates a c €1.0m uplift to adjusted earnings (or FFO) attributable to FVI shareholders from the acquisition, a c 12% return on the €8.4m acquisition cost.

The purchase price for the 52.8% stake is €8.4m in cash, using proceeds from May's €34.7m (net of expenses) equity increase. This is a discount of c 21% to FVI's share of the net assets acquired, €10.7m, and enhances EPRA NAV per share by c 16c. Including accrued earnings, our EPRA NAV per share estimates increase slightly more than this, as shown in Exhibit 1. Our underlying EPRA earnings (or FFO), primarily excluding valuation movements and exceptional items, increases 10.5% for FY15 and 18.9% in FY16, including a full year of BBV08.

Exhibit 1: Estimate revisions

	Net rental income €m)			FFO/EPRA EPS (c)			EPRA NAV €)			DPS €)		
	New	Old	Change (%)	New	Old	Change (%)	New	Old	Change (%)	New	Old	Change (%)
FY15e	18.3	17.0	7.5%	42.1	38.1	10.5%	8.7	8.5	1.8%	0.28	0.28	0.0%
FY16e	19.9	17.4	14.7%	44.8	37.7	18.9%	8.9	8.6	3.1%	0.28	0.28	0.0%

Source: Company data, Edison Investment Research

Further upside from investments expected

Management has indicated that up to 90% of the proceeds of the May equity increase are likely to be used for additional direct investments, both acquisitions from third parties as well as from existing subsidiaries. The balance is earmarked for investments in closed-ended real estate partnerships – both new participations (as in the case of BBV08) and further acquisition of minority interests in existing subsidiaries. Given the obvious difficulty of predicting exactly how FVI may invest the proceeds, and when, we only include announced transactions in our base case forecasts (as illustrated in Exhibit 4 on page 5). In our note *From value to growth* published on 11 June, we provided an illustration of the potential upside to our base case forecasts from investment of the capital increase proceeds. We estimated FFO returns on the equity invested of between 10.1% for direct investments and 10.9% for indirect investments. We showed that new investment had the potential to lift our FY15 base case estimates (at the time) by up to 74% on an annualised basis.

BBV08 is now reflected in our base case forecasts, and in Exhibit 2 we reproduce the above analysis to illustrate the potential impact of investing the balance of the capital increase proceeds. For simplicity we assume that the remaining proceeds are invested directly into properties acquired from third parties. The impact of further indirect investment in funds (as with BBV08), acquisitions of minority interest in existing subsidiaries, or direct acquisitions of properties out of subsidiaries is unlikely to make a material difference to the result.

Exhibit 2: Potential impact of additional capital increase proceeds

Balance of proceeds (€000s)	26,257
Assumed gearing	50%
Total direct investment	52,514
Assumed return	8.00%
Gross rental income	4,201
Real estate operating expenses as % rental income	20.0%
Real estate operating expenses	(840)
NOI	3,361
Marginal administrative costs	(233)
Cost of borrowing	(525)
FFO/Net income	2,603
ROE	9.9%
Existing FY16e FFO	6,280
Incremental FFO	2,603
Pro forma FFO	8,883
Increase	**41%**
FY16e EPRA EPS (€)	44.8
Pro-forma EPRA EPS (€)	63.3
Increase	**41%**

Source: Company data, Edison Investment Research.

After investing €8.4m in BBV08, the balance of proceeds from the capital increase is €26.3m. We assume this can be geared at 50% (with a cost of 2%), allowing €52.5m of investment property to be acquired, yielding an assumed 8%. Real estate operating expenses are assumed to be similar to the existing business and we have assumed a 15% marginal increase in central administration costs. We have assumed that direct investments are made at fair value but if investment is made at a discount, there would be NAV and NAV per share enhancement. We note that the illustrated assumed return on direct investment of 9.9% is slightly lower than the 10.1% previously illustrated (and below the 12% that is expected from BBV08). The reason for the slight decline in the assumed return is that we expect an increase in group administrative costs as the size of the portfolio (particularly the direct portfolio) increases – and this is now loaded onto the remaining investments, with no increase assumed in relation to BBV08.

Valuation

Exhibit 3: Peer valuation comparison

	Price	Market cap	P/E (x)		Yield (%)		P/NAV (x)	
	(€)	(€m)	2015e	2016e	2015e	2016e	2015e	2016e
Alstra Office	11.7	1,022	16.2	15.4	4.6	4.8	1.0	0.9
Deutsche Office	4.3	777	12.3	11.4	4.2	4.6	0.9	0.9
DIC Asset	8.2	546	21.4	25.2	4.3	4.4	0.7	0.8
Hamborner	8.6	572	29.1	22.5	5.0	5.0	1.4	1.4
TLG Immobilien	14.3	888	13.6	12.0	5.8	6.3	1.0	N/A
VIB Vermogen	16.2	402	12.5	11.4	3.4	3.6	1.1	1.0
Fair Value	7.6	109	18.1	17.0	3.7	3.7	0.9	0.9
Average		617	17.6	16.4	4.4	4.6	1.0	1.0

Source: Edison forecasts (FVI), Bloomberg consensus (others). Note: Prices at 3 July 2015.

Exhibit 3 shows a valuation comparison with peers. It is important to note that the table includes our revised base case forecasts for FVI, excluding the significant further potential uplift from the deployment of the balance of the equity issue proceeds. These current estimates show FVI to be on a similar P/BV and P/E ratio to peers, although its dividend yield is a little lower. However, as we show above, investment of the equity issue proceeds has the potential to significantly lift both EPS and, by implication, the earnings yield on NAV.

Taking our potential post-investment annualised EPS for FY16 (investments in FY15 will not fully contribute until FY16, and so reported earnings will lag annualised earnings) of 63.3c (base case 44.8c), the P/E ratio would fall from 17.0x to 12.0x, which is at the lower end of the peer group, and the forecast dividend of €0.28 is 2.3x covered, compared with the c 2.0x that management has been targeting. Dividend-paying capacity is determined by the local statutory HBG accounts (rather than the reported IFRS); as the share of direct investment increases, we believe it is possible that management will review and possibly increase the targeted pay-out ratio.

Adjusting the 31 March 2015 value of the investment portfolio for BBV08 takes the total to c €305m. Including the potential further investment illustrated in Exhibit 2, this would increase to c €358m, still a long way below management's medium-term target of c €1bn. If management can satisfy its growth ambitions on similar terms to those illustrated above, there is potential for additional accretive growth to that illustrated.

Exhibit 4: Financial summary

Year ending December	€m	2013	2014	2015e	2016e
		IFRS	IFRS	IFRS	IFRS
PROFIT & LOSS					
Revenue		36.4	30.1	30.2	32.6
Net property expenses		(13.3)	(12.5)	(11.9)	(12.7)
Net rental income		23.1	17.6	18.3	19.9
Administrative expenses		(3.3)	(2.9)	(3.2)	(3.1)
EBITDA		19.8	14.7	15.1	16.8
Net other operating income and expense		(0.0)	(0.6)	4.9	0.0
Revaluation of inv. Property		(14.0)	(7.5)	0.6	0.0
Net resuly from sale of inv. Property		(0.7)	(0.7)	(0.0)	0.0
Net other income & expenses		(0.0)	(0.6)	4.9	0.0
EBIT		5.0	5.9	20.5	16.8
Associates		1.5	0.0	0.0	0.0
Net Interest		(12.7)	(5.0)	(4.7)	(4.7)
Profit Before Tax (IFRS)		(6.2)	0.8	15.9	12.1
Minority interests		0.9	(0.9)	(5.2)	(5.8)
Net income (IFRS)		(5.2)	(0.0)	10.6	6.3
EPRA adjustments:					
Net other operating income and expense		0.0	0.6	(4.8)	0.0
Revaluation of inv. Property		14.0	7.5	(0.6)	0.0
Net result from sale of inv. Property		0.7	0.7	0.0	0.0
Associates		0.1	0.0	0.0	0.0
Net Interest		3.9	0.0	0.1	0.0
Minority interests		(7.1)	(4.4)	(0.0)	0.0
Profit Before Tax (norm)		6.4	4.4	5.2	6.3
Average Number of Shares Outstanding (m)		9.3	9.3	12.5	14.0
EPS - normalised (c)		68.68	47.20	42.07	44.77
Dividend per share (€)		0.25	0.25	0.28	0.28
BALANCE SHEET					
Non-current assets		292.5	277.9	315.2	315.2
Investment property		292.3	267.7	305.4	305.4
Equity accounted investments		0.0	0.0	0.0	0.0
Other non-current assets		0.2	10.2	9.8	9.8
Current Assets		53.4	34.0	60.5	62.5
Trade receivables		2.5	3.0	2.8	2.8
Cash		17.4	14.6	54.6	56.5
Assets held as available for sale		19.6	13.2	0.0	0.0
Other		13.9	3.2	3.1	3.1
Current Liabilities		(70.9)	(61.0)	(46.6)	(46.5)
Trade payables		(2.2)	(2.3)	(1.8)	(1.8)
Short term borrowing		(64.6)	(54.2)	(41.1)	(41.0)
Other		(4.1)	(4.6)	(3.7)	(3.7)
Long Term Liabilities		(128.7)	(112.5)	(145.4)	(145.0)
Long-term debt		(126.6)	(110.9)	(144.6)	(144.3)
Derivative financial liabilities		(2.1)	(1.0)	(0.1)	(0.1)
Provisions and other		(4.1)	(4.6)	(3.7)	(3.7)
Net Assets		146.3	138.3	183.7	186.1
Minorities		(65.6)	(60.0)	(61.8)	(61.8)
Shareholders' equity		80.7	78.3	121.9	124.3
EPRA adjustments:					
Market value of derivative financial instruments (net of minorities)		1.9	0.9	0.1	0.1
EPRA adjusted NAV		82.6	79.2	122.0	124.3
Period end number of shares (m)		9.3	9.3	14.0	14.0
IFRS NAV per share (€)		8.65	8.39	8.69	8.86
EPRA NAV per share (€)		8.86	8.49	8.69	8.86
CASH FLOW					
Operating Cash Flow		14.7	10.8	15.7	11.0
Net Interest		(11.9)	(4.7)	(4.9)	(4.7)
Tax		0.1	0.0	0.0	0.0
Acquisitions/disposals		29.1	22.4	(2.5)	0.0
Financing		0.0	0.0	34.7	0.0
Dividends		(0.9)	(2.3)	(2.3)	(3.9)
Other		(2.3)	(2.8)	(21.2)	0.0
Net Cash Flow		28.7	23.3	19.4	2.4
Opening net debt/(cash)		202.6	173.8	150.5	131.1
Closing net debt/(cash)		173.8	150.5	131.1	128.7

Source: Company accounts, Edison Investment Research

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