

**Real Estate**  
Germany

# Colonia Real Estate

KBU GR Equity

**Buy**

Unchanged

## A more attractive business model

### Current price €27; Target price €43

**In Q3 we believe Colonia Real Estate moved further toward becoming an integrated real estate service provider with the €1bn asset management deal with Oaktree quickly following the acquisition of Resolution in Q2. We believe that the speed of this transaction shows the potential of Colonia's new strategy. While its assets have grown consistently over the past year this has not been adequately reflected in the share price. We expect the positive news flow to continue in the coming months and reiterate our Buy rating.**

### Q3: More transactions and continuation of residential portfolio creation

Colonia Real Estate sold its Delmenhorst portfolio for €62m in Q3, finalised the acquisition of a 2,487 apartment portfolio in Berlin – from which it is already receiving rental income despite a purchase price is payable on 1 January 2007 – and signed a €1.02bn asset management contract from the real estate investor Oaktree. In our opinion it is continuing to evolve into a leading German real estate company. Although its assets have grown consistently over the past year, we believe its share price does not reflect the positive trend. We believe that upcoming events and good Q3 results could allow the company to re-shape the market's perception of the company, helping Colonia Real Estate's shares to outperform peers over the last quarter of year and into 2007.

### Interim Q3 results due 15 November 2006

We believe that the company's Q3 earnings were largely made up of rental income and, according to our estimates, €10m from the sale of the Delmenhorst/Victoria portfolio. As a result of its recent acquisition and ahead of the release of its Q3 results, Colonia Real Estate increased its 2006 net profit guidance by 36% to €32m-€34m. Nevertheless, we regard this increase as conservative and maintain our €39m net profit expectation for 2006.

We expect Q3 sales of €21.9m and a total performance of €81m (including the full transaction price of the Delmenhorst deal (under IFRS, share deals are not accounted as sales). We expect sales to consist of €10m in gross profits from the Delmenhorst deal, €5.48m in rental income from its residential, office and hotel asset income, and €1.5m in fee income from Resolution GmbH, as well as income the company's own **asset** management arm. In addition, we expect Colonia Real Estate to have accounted for €5m in IFRS40 adjustments in Q3, mainly as a result of a reduction in vacancies in its residential portfolios.

We expect Colonia Real Estate's operating costs to have risen slightly in Q3, and we believe the cost of goods sold increased – primarily as a result of investments in assets to boost letting and so reduce vacancies. Personnel costs are also likely to have risen as the company added key people in its **asset** management arm. This business now has five employees, up from just two at the end of Q2 2006.

Other costs arose from moving its headquarters in Cologne to accommodate the increased number of business fields. Nevertheless, we believe that Q3 EBITDA margins (including IFRS40 valuation gains) have risen to 73.8% in Q3 2006 from 71.6% in Q2 2006. Excluding IFRS40 valuation adjustments, EBITDA margins would come in at 66% in Q3 2006 (23% in Q2 2006).

We expect net profits to reach €10.15m in Q3, or €0.65 a share (not fully diluted, excluding shares from a warrant expiring in 2009); we believe fully diluted earnings would reach €0.52 a share.

This would imply that nine-month EPS (fully diluted) of €1.15 a share, or about 50% of our full year 2006 target of €2.00 a share.

It should be noted that we expect rental and fee income made up 41% of total cash sales in Q3 2006, benefiting from Colonia Real Estate's pro-active management of its recently acquired Berlin portfolio, which had a vacancy rate of 22% at the time of the acquisition.

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TABLE 1: **Colonia Real Estate: Q3 results forecast (company reporting format)**

€ `000	Q1 2006	Q2 2006	H1 2006	Q3 2006E	Q4 2006E	2006E
Revenues	2,830	3,695	6,525	16,980	34,831	58,336
other operating income (incl. IFRS 40)	6,018	7,044	13,062	5,000	11,058	29,120
<b>Total income</b>	<b>8,848</b>	<b>10,739</b>	<b>19,587</b>	<b>21,980</b>	<b>45,889</b>	<b>87,456</b>
Cost of goods sold	-449	-923	-1,372	-2,000	-2,500	-5,872
Personnel costs	-306	-922	-1,228	-1,650	-1,900	-4,778
other operating costs	-1,213	-1,208	-2,421	-2,100	-2,100	-6,621
<b>EBITDA</b>	<b>6,880</b>	<b>7,686</b>	<b>14,566</b>	<b>16,23</b>	<b>39,389</b>	<b>70,185</b>
Depreciation/Amortisation	0	0	0	0	0	0
<b>EBIT</b>	<b>6,880</b>	<b>7,686</b>	<b>14,566</b>	<b>16,230</b>	<b>39,389</b>	<b>70,185</b>
Net Interest	-1,394	-1,216	-2,610	-1,875	-2,9145	-7,399
<b>EBT</b>	<b>5,486</b>	<b>6,470</b>	<b>11,956</b>	<b>14,355</b>	<b>36,474</b>	<b>62,785</b>
Taxes paid	-1,428	-1,586	-3,014	-4,091	-14,870	-21,975
<b>Net income</b>	<b>4,058</b>	<b>4,884</b>	<b>8,942</b>	<b>10,264</b>	<b>21,605</b>	<b>40,811</b>
Minority interests	-7	-11	-18	-250	-1,153	-1,421
<b>Net to shareholders</b>	<b>4,051</b>	<b>4,873</b>	<b>8,924</b>	<b>10,013</b>	<b>20,451</b>	<b>39,389</b>
<b>EPS (€)</b>	<b>0.26</b>	<b>0.25</b>	<b>0.51</b>	<b>0.64</b>	<b>1.37</b>	<b>2.51</b>
EPS fully diluted (€)	0.21	0.25	0.45	0.51	1.04	2.00

Source: Commerzbank Corporates & Markets

## Outlook statements for 2006 should underpin the growth story

We assumed on 15 August that closure of the Delmenhorst deal might add up to €5m in pre-tax profits to Colonia Real Estate's P&L, which would have taken the group to almost 70% of its own net profit forecast by the end of Q3 2006. We now believe that the sale had resulted in PTP income of €10m, bringing nine-month net profits to c.87% of previously announced net profit guidance for 2006 of €25m. Against this background, Colonia Real Estate increased its 2006 net profit guidance to €32m-€34m on 9 November, from €25m, i.e. by c.36%.

We regard this increase as conservative and stick to our €39m net profit target for 2006, as we believe Colonia Real Estate is still likely to sell its Hotel portfolio this year in order to re-invest the funds into the faster-growing residential portfolio. Currently, the company estimates the long-term value of its hotel assets at €27.7m (according to a company presentation of August 2006), against its purchase price of around €22m-€23m and a current book value of €26.2m. These hotel assets have long-term, triple-net leases (until 2022) of €2.0m p.a. currently. We assume that Colonia Real Estate should be able to dispose of these assets at higher prices. We estimate that it should make about €5m-€8m in gross profits from such a transaction.

On the residential portfolio side, Colonia Real Estate has successfully demonstrated its ability to reduce vacancies fast. The Delmenhorst/Victoria portfolio was sold for €62m, largely due to the fact that good asset management had reduced the vacancy rate from 14.5% at the time of the external valuation (at the beginning of the year) to just 6.5% at the time of the disposal. In other words: its asset management, which would possibly have incurred costs of €1m-€2m, generated gross profit of €10m.

We assume that its asset management arm will be similarly successful in reducing the vacancy rate at its recently acquired Berlin portfolio (2,487 units). Colonia Real Estate is already collecting rental income from the property but does not have to pay for it until 1 January 2007. We expect the vacancy rate at the time of the acquisition (22%) to be reduced significantly. This vacancy rate is equivalent to 547 units. We expect Colonia Real Estate to have cut this by 80 units (to 467) by the end of Q3 2006 and believe Colonia Real Estate's Resolution GmbH should be able to cut this figure to c.400 units by the end of Q4. We also expect housing prices in Berlin to perform well, mainly on the back of renewed interest in the city, largely from foreign asset holding companies. Against this background, we would expect a further valuation increase of c. €11m for this, and other portfolios owned by Colonia Real Estate (following c.€5m in Q3 2006 and €13m in H1 2006).

Both these effects alone – i.e. the gross profit from a potential sale of hotel assets (€3m-€6m) and further upward revisions in its residential portfolio (€11m) – would be a major boost for Q4 2006 earnings. We also expect a boost in sales from fees in asset management from the Hercules deal (we estimate €1.5m); and fees from the launch of the 'nursing home' closed end fund (we estimate €1.2 – 1.5m).

If we assume: 1) the hotel assets are sold for €27.7m; 2) additional rental income of €5.5m (unchanged from Q3); 3) portfolio management fees of €1.5m; and 4) fund management fees of €1.9m, sales would be 36.6m, i.e. €2m more than

we currently forecast. Our IFRS40 assumption of €29m is about 60% higher than was accounted for after nine months in 2006. We feel that this is likely to be met on the back of the very successful reduction in vacancies and the faster than previously expected increase in portfolio transaction prices.

For these reasons, we maintain our 2006 earnings estimates of €39m, which is 18% above the company guidance. Given the potential we see for Colonia Real Estate, we would not be surprised to see the company further increase its guidance.

## Outlook statements for 2007 expected

We understand that Colonia Real Estate intends to provide a 2007 sales and earnings guidance with the Q3 results. We would regard this as a very positive sign, as it underlines our view that Colonia Real Estate has become a more predictable and solid company. We expect it to perform well in 2007, with net profit of €61.5m, on total revenues of €215m (€137m in 2006E). We expect Colonia Real Estate to comment on the change to its business model at this time.

We currently expect the following to affect 2007 net earnings:

- 1) Rental and fee income become a strong base for the group's profitability. We understand that Colonia Real Estate's annualised rental income will probably reach €30m by the end of 2006. We also expect the group's asset management arm to contribute significantly to 2007 earnings. The Oaktree portfolio has significant vacancies, so we would expect Colonia Real Estate's Resolution GmbH to successfully reduce them in 2007, helped by both its multi-local approach and better-than-expected 2007 GDP growth, which should – we believe – stimulate office demand.
- 2) Resolution GmbH is, we believe well positioned to benefit from the government's decision to exclude residential property from REITs. Essentially, this decision means that municipalities can either sell their residential assets to off-shore private equity groups (which might not have been the key intention of the lawmakers), or increase returns from those assets through better asset management – and here Resolution GmbH, with its excellent track record on the Grasmus and the Berlin portfolios, should be a key beneficiary.
- 3) Co-investments, such as the Resolution-Oaktree deal, are likely to be a way to boost assets under management faster than previously expected. Currently, Resolution GmbH has €2bn in assets under management (AUM), which it had previously expected to reach only in 2009. We expected AUM of €1.6bn by the end of 2007, so we see some scope for perhaps upgrading our numbers at a later stage. We would not be too surprised to see Colonia Real Estate lifting its AUM target to €4bn-€5bn by 2009.
- 4) Attractively priced asset disposals should continue, despite Colonia Real Estate's ambition to increase its residential portfolio. The company has proven its ability to acquire portfolios at extremely attractive prices, largely because these portfolios were 'under-managed'. It now has a proven track record of reducing vacancy rates quickly and sustainably, following its experience with the Delmenhorst/Victoria and Berlin portfolios. We thus expect Colonia Real Estate to dispose of well developed portfolios at attractive selling prices and then to acquire new and larger portfolios at prices that will allow it to boost rental returns. Given the higher asset base at the end of 2006 against 2005, we would expect Colonia Real Estate to increase its total revenues to €151m in 2007 from an estimated €103m in 2006.

## Positive news flow expected toward the end of the year

Real estate is currently 'en vogue' in Germany, and there will be a number of opportunities to find out more about the German real estate market in the near future. For those interested in Colonia Real Estate, the following dates could be important:

15 November	Release of the Q3 results and 2007 outlook statement
16 November	G-REIT Congress
25/26 November	EK-Forum, Frankfurt
27 November	Mid-cap conference, London
30 November	Hamburg real estate convention
7 December	Frankfurt real estate convention

## Valuation

While Colonia Real Estate's assets have grown consistently over the past year, we believe its share price does not reflect the positive trend. In our opinion, one reason for this is the increased number of real estate companies in the German equity market (latest IPO: Gagfah), which allows investors to be more selective. However, we believe that Colonia Real Estate's

transition from being a company with erratic trading income into an integrated, fast-growing real estate group is not yet fully appreciated.

We believe that upcoming events (see above) and good Q3 2006 results could allow the company to re-shape its perception in capital markets. This in turn could result in Colonia Real Estate's shares outperforming peers towards the end of the year and beyond, in our opinion. We maintain our Buy recommendation.

 TABLE 2: **Peer group: EV/EBITDA**

	Last price (€)	EV 2006	EV 2007	EV 2008	EV/EBITDA 2006E	EV/EBITDA 2007E	EV/EBITDA 2008E
FranconoRheinMain	3.39	142.32	250.80	300.17	25.3	12.0	10.9
Deutsche Wohnen	47.38	1338.32	1413.72	1733.76	20.8	21.6	16.2
Conwert Immobilien	16.38	1983.83	2326.60	2461.25	21.0	13.7	13.3
Vivacon AG	19.01	525.55	564.06	649.56	7.6	7.0	5.1
Colonia Real Estate AG	27.51	588.00	633.00	540.00	12.2	8.8	5.8
Patrizia Immobilien AG	18.85	1018.52	1119.96	1204.57	15.2	11.7	9.6
HII	10.88	38.56	44.96	42.56	21.4	12.2	8.5
<b>Average</b>	–	–	–	–	<b>17.6</b>	<b>12.4</b>	<b>9.9</b>

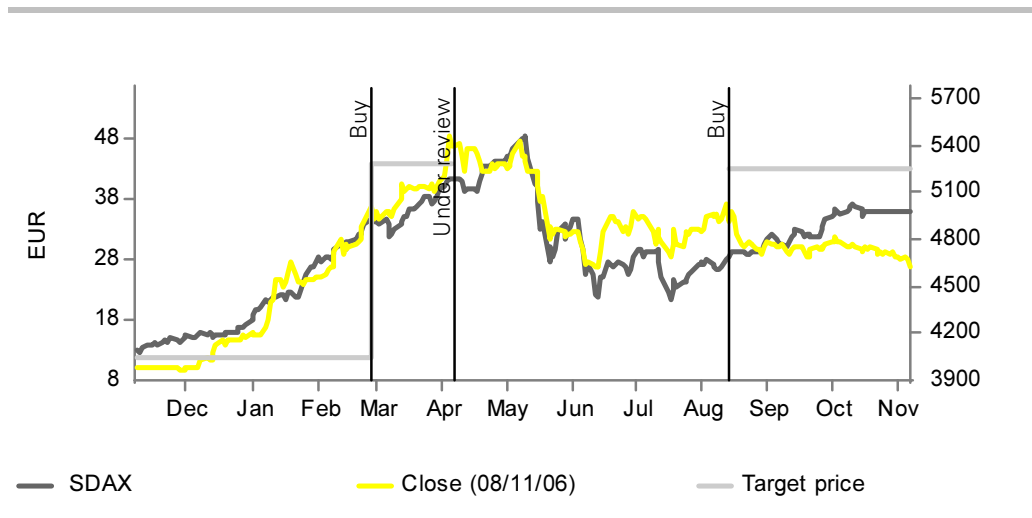
Source: Commerzbank Corporates & Markets, JCF, Bloomberg

 TABLE 3: **Peer group: P/E**

P/E	P/E 2006E	P/E 2007	P/E 2008
Deutsche Euroshop AG	17.73	20.49	17.73
Deutsche Wohnen AG	43.31	41.41	27.58
Conwert Immobilien	15.92	9.71	7.38
Vivacon AG	9.92	8.86	9.53
Colonia Real Estate Ag	13.79	8.84	7.37
Patrizia Immobilien AG	23.41	13.76	11.82
HII	26.67	9.82	7.13
<b>Average</b>	<b>17.91</b>	<b>11.91</b>	<b>10.16</b>

Source: Commerzbank Corporates & Markets, JCF, Bloomberg

CHART 1: **Colonia Real Estate price chart**



Source: Commerzbank Corporates & Markets

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TABLE 4: **Stock rating allocation**

	<b>Buy</b>	<b>Hold</b>	<b>Sell</b>
No. of companies under coverage with this rating	48	30	5
% of companies under coverage with this rating	58%	36%	6%

Source: Commerzbank Corporates & Markets

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