EDISON

Scale research report - Update

FCR Immobilien

Real estate

31 May 2019

Sustained high transaction activity

FCR continues to grow its property portfolio which, at 29 May 2019, represents lettable floor space of c 261,500 sqm compared to 175,000 at end-2017. To facilitate this growth, the company recently launched a new €30m bond issue and a share capital increase. FCR deploys its targeted higher leverage at property level, with the bank liabilities to book value of properties ratio at c 67% at end-2018. Meanwhile, it also managed to achieve a solid aggregate return of 32.3% on nine property disposals completed in FY18 (with additional profitable transactions in 2019 ytd), taking advantage of continuing strong underlying investment demand in the commercial real estate (CRE) market.

Results reflect expanding property portfolio

FCR reported net income of €1.4m in FY18, 46% ahead of FY17. This was assisted by both growing rental income (€15.9m vs €8.5m in FY17) and a net gain from property disposals of €5.2m (vs €4.6m in FY17). This allowed FCR to book EBITDA of €10.1m, ahead of management guidance released in November 2018 of €9.9m. Momentum continued into Q119, with group revenues and EBITDA at €16.6m and €6.6m, respectively. FCR's net debt to total assets reached 84% (vs 81% in FY17), including property-level bank loans (€112.1m) and holding-level bonds (€45.7m).

Rental income up, but average rental yield down

FCR's portfolio now consists of 63 properties with a current net rental income of c €17.2m pa at 29 May 2019. This compares with 41 properties with a net rental income of €9.5m (and potential €10.9m assuming full occupancy) at end-2017. However, the net rental yield declined to 9.2% pa as at May 2019 (excluding the two most recent acquisitions) vs 14.1% pa at end-2017 (and FCR's original target of at least 12% pa), which we believe is mostly due to lower yields on newly acquired properties. Retail projects outside tier one cities remain FCR's core focus and now represent more than 80% of the portfolio by net rental income.

Valuation: Trading at a moderate discount to NAV

FCR's NAV per share as at end-March 2019 was €21.30, with its shares now trading at an 8% discount. This compares with an average premium to NAV for FCR's peer group of 14% (which is, however, somewhat distorted by outliers). FCR is trading at 41% and 22% discounts to the peer group on FY19e P/E and EV/EBITDA ratios, respectively. The shares currently offer an FY18 dividend yield of c 1.9%.

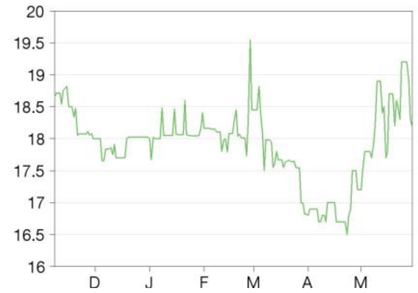
Consensus estimates

Year end	Revenue (€m)	PBT (€m)	EPS (€)	DPS (€)	P/E (x)	Yield (%)
12/17	16.4	1.3	0.23	0.00	79.1	N/A
12/18	37.2	3.0	0.34	0.35*	53.5	1.9
12/19e	43.1	9.3	1.83	1.03	9.9	5.7
12/20e	61.1	10.7	2.06	1.15	8.8	6.3

Source: Company accounts, market consensus as at 28 May 2019. Note: *Paid in 2019. Market consensus is based on available estimates of one broker (First Berlin).

Price	**€18.2**
Market cap	**€80m**

Share price graph



Share details

Code	FC9
Listing	Deutsche Börse Scale
Shares in issue	4.41m
Last reported net debt at end-2018	€154.7m

Business description

FCR Immobilien is a German real estate investor primarily focussed on small and mid-sized properties in tier two domestic locations. It looks for special situations translating into bargain purchases. Subsequent measures are aimed at improving rental income generation. FCR's portfolio currently consists of 63 properties with a lettable area of c 262k sqm, of which more than 80% represent retail properties.

Bull

- Expertise in sourcing attractively priced properties.
- Considerable portfolio expansion leads to rental income growth.
- Exposure to mostly non-cyclical tenants with limited threat from online shopping.

Bear

- High leverage level vs peers.
- Relatively high tenant concentration.
- Key personnel risk.

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Edison profile page

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FY18 results highlights

Income statement: Growing scale of operations

FCR's FY18 results reflect its dynamic property portfolio expansion and high transaction activity. The company reported FY18 revenues at €37.2m (up 127% y-o-y), of which €15.9m was rental income (FY17: €8.5m) and €21.3m represented the sale of investment properties (FY17: €7.9m). See below for a detailed discussion of these transactions. Group EBITDA increased to €10.1m from €4.9m in FY17, with EBITDA margin of 27.1% (vs 30.0% in FY17). This is ahead of management guidance for FY18 total revenues of €33.5m and EBITDA of €9.9m. As interest expense increased to €4.8m from €3.1m in FY17, the company achieved a pre-tax profit of €3.0m (up 133% from €1.3m in FY17). This is below company guidance at €4.2m. FCR booked €0.9m in other taxes, of which €0.7m represents property taxes that were previously booked under other operating expenses (€0.3m in FY17). Together with income taxes of €0.7m (compared to €0.3m in FY17), this translated into 46% y-o-y growth in net profit to €1.4m. This momentum continued into Q119, with FCR reporting revenues, EBITDA and pre-tax profit of €16.6m, €6.6m and €4.5m, respectively. This was largely a function of the €9.5m gain on the sale of three properties.

Exhibit 1: Financial highlights

€ '000s, unless otherwise stated	FY18	FY17	Change y-o-y
Revenues, of which:	**37,185**	**16,391**	**126.9%**
Rental income	15,933	8,490	87.7%
Sale of investment properties	21,252	7,901	169.0%
Increase/decrease in unfinished goods and services	2	15	N/M
Total revenue	**37,187**	**16,406**	**126.7%**
Material expenses	(21,098)	(8,367)	152.2%
Personnel expenses	(3,321)	(1,297)	156.0%
Other operating income	374	206	81.9%
Other operating expense	(3,054)	(2,019)	51.3%
EBITDA	**10,087**	**4,928**	**104.7%**
EBITDA margin	*27.1%*	*30.0%*	*(291bp)*
D&A	(2,653)	(1,193)	122.4%
EBIT	**7,434**	**3,735**	**99.0%**
EBIT margin	*20.0%*	*22.8%*	*(278bp)*
Other interest and similar income	427	644	(33.6%)
Interest and similar expense	(4,840)	(3,100)	56.1%
Write-downs of financial assets and current securities	(44)	0	N/M
Pre-tax profit	**2,978**	**1,279**	**132.8%**
Income taxes	(675)	(302)	123.7%
Other taxes	(880)	(2)	N/M
Net profit	**1,424**	**975**	**46.0%**

Source: FCR Immobilien, Edison Investment Research

Balance sheet: Taking advantage of high leverage

FCR's financing strategy involves 70–80% leverage (preferably at the upper end of the range) at individual property level, which usually takes the form of non-recourse, first-lien bank loans. The weighted average interest rate on these loans at end-2018 stood at 2.0% pa and their redemption portion stood at 9.6% pa. At end-December 2018, the ratio of bank liabilities to book value of properties stood at c 67% compared with 79% a year ago. FCR's book value of properties is not adjusted for the impact of improvement measures introduced after the purchase and thus may potentially represent an understated value.

In addition, FCR uses bonds to further gear up investments. The outstanding value of issued bonds increased to €45.7m at end-2018 in comparison to €20.7m at end-2017 following the €25m issue of bonds conducted in February 2018 at a coupon rate of 6.0% and five-year maturity. Consequently, net debt to total assets remained at a relatively high level of 84% at end-December 2018 (in line with management's intension to keep a high gearing level), up from 81% reported at end-December 2017.

Post balance sheet date, FCR launched another bond issue of up to €30m by means of a public offer which is still in progress. The bond's maturity is five years and its coupon rate stands at 5.25% pa (paid semi-annually). Until 29th May, investors subscribed to bonds worth €14m. The proceeds from the new bond issue will be used to fund further property acquisitions. FCR's earliest outstanding bond issue with a face value of €1.7m matured in April 2019 and another €4.0m issue will mature in June 2019. We note that the terms of the new bonds illustrate FCR's continued reduction in weighted average coupon rate on its bond issues, with the 2014, 2016 and 2018 issues having a rate of 8.0%, 7.1% and 6.0%, respectively. In terms of debt covenants on the new issue, it is worth noting that FCR's dividend payout ratio will be capped at 50% and the company will be also obliged to maintain a coverage ratio (expressed as EBITDA to interest expense) of at least 1.1, which compares with 2.1 at end-2018 (Edison estimate).

On the equity side, FCR completed the first stage of its capital increase through a subscription rights offering at an issue price of €17.50 per share, with gross proceeds at €3.26m. Falk Raudies (FCR's majority shareholder) subscribed to €0.5m worth of shares as part of the offering. Additional proceeds of up to €5.9m may be collected in the second stage, ending on 5 August 2019.

Portfolio expansion continues

At end-2018, FCR's portfolio consisted of 58 properties with a total usable floor space of c 248,000 sqm, which compares with 41 properties representing c 175,000 at end-2017. During 2018, FCR acquired 26 properties with a usable space of 97,000 sqm and net rental income of €7.5m pa for a total consideration of €93.3m (excluding incidental acquisition costs). At the same time, it sold nine properties covering 24,000 sqm and net rental income of €1.9m, and was able to realize a profit of €5.2m (or 32.3% in total) on these disposals. The average holding period of these investments was 22 months (according to FCR) and for individual properties ranged from six to 28 months.

Post balance sheet date, the company finalised the transfer of ownership of three properties for which acquisition was agreed in FY18, including a 1,000 sqm retail property in Aken (January 2019), a hotel in Westerburg (February 2019) and a residential property with eight units in Köpenick/Berlin. Moreover, the company carried out the acquisition of five more properties: a retail property in Söhlde with a floor space of 1,700 sqm, a retail property in Würselen, a 13,000 sqm specialist retailer store in Brandenburg, a 1,700 sqm retail property in Weidenberg and a 1,800 sqm neighbourhood store in Niederlausitz. The transaction volume of the above-mentioned five acquisitions is in excess of €20m. FCR has also benefited from the current favourable investment market for real estate in Germany with the disposal of three properties: Stadtpassage in Salzgitter (8,600 sqm), a shopping centre in Hennef (3,950 sqm) and a specialist retail store in Würzburg (1,900 sqm). FCR generated a strong profit of €9.5m (or 85.3%) on these transactions, based on an average holding period of 35 months. This activity is already in line with FCR's near-term targets of two to four property disposals per year.

As a result, FCR's portfolio at 29 May 2019 consists of 63 properties with total lettable floorspace of c 261,500 sqm generating a net rental income of €17.2m pa. The current net rental yield on the portfolio stands at 9.2% as at May 2019 (excluding the two acquisitions announced on 29 May), while the yield based on potential rental income estimated by FCR equals 11.0%. This compares with the company's earlier target of at least 12% and end-2017 levels of 14.1% and 16.1%, respectively. We believe this is because yields on newly acquired properties in 2018 and so far this year have been less attractive than for transactions before 2018 and in many cases represented an initial net rental yield closer to 7–9% pa. The weighted average unexpired lease term currently stands at c 5.3 years (broadly unchanged vs the end-September 2018 figure). Retail properties made up 83.7% of FCR's portfolio at end-March 2019, followed by hotels (8.8%), residential (4.7%) and offices (1.5%). FCR retained a high exposure to the food sector (39.3% of current net rental income at end-March 2019), textiles (22.2%) and DIY (12.3%).

CRE market remains robust

CRE transactions in Germany reached €60.3bn in 2018 (up 6% y-o-y), according to Jones Lang LaSalle (JLL). If we include the broader living segment (ie multi-family housing, student accommodation, retirement/nursing homes etc.), the transaction value stood at c €79bn in 2018. Retail property transactions represented €10.5bn (or 13% of the total CRE volumes), which is a 9% decline from €11.5bn in FY17. Of this, more than 40% was attributable to retail warehouses and retail parks. Last year was characterised by a high level of investor caution towards shopping centres due to the threat from online shopping. As a consequence, transaction volumes in this segment declined by 30% y-o-y to €1.38bn. However, from FCR's perspective it is worth noting that JLL saw greater demand for properties with a high local convenience retail profile and high proportion of food, personal care products or cleaning agents (which are largely immune to the growing trend towards online shopping). Moreover, the outlook seems positive for specialist retail stores, in particular those with anchor tenants from the food sector, which may experience a further capitalisation yield compression in 2019 (according to JLL). Q119 data seem to reinforce this view, with specialist retail store yields in Germany down 10bp to 5.10%. On the back of the above, FCR management expects clearly positive net income and a significant increase in both rental and disposal income in FY19. The company's acquisition pipeline remains robust at around €69m. Moreover, FCR has outstanding offers to acquire three of its portfolio properties.

Valuation

FCR's NAV at end-2018 reached €89.3m and increased further to €93.9m at end-March 2019, translating into a NAV per share of €21.30. This implies that FCR's shares are currently trading at an 8% discount to NAV. We acknowledge that FCR's NAV estimate is not based on regular valuations performed by external real estate experts (which is often the case with real estate investment companies). Instead, FCR relies predominantly on received purchase offers, as well as bank valuations on debt refinancing and internal fair market value assessments. FCR estimates the gross market value of its property portfolio at €257m compared to the current book value of €172m (implying a potential value uplift on disposal of c €85m).

It is instructive to review the market multiples at which FCR and comparable companies are currently trading. FCR is trading at an FY18 P/NAV ratio at 0.92x, which represents a 19% discount to the peer group. Based on FY19e P/E and EV/EBITDA ratios, FCR is trading at 41% and 22% discounts to the peer average, respectively. Management recently recommended a dividend per share of €0.35 based on FY18 net income, which represents a yield of c 1.9%.

Exhibit 2: Peer comparison

	Market cap	P/NAV	P/E (x)		EV/EBITDA (x)	
	(€m)	(last reported)	2019e	2020e	2019e	2020e
Demire	538	0.89	11.2	12.7	18.6	17.2
Deutsche Konsum REIT	437	1.78	8.8	7.7	11.6	9.9
Defama AG	64	1.45	25.6	11.8	17.6	11.2
Hamborner REIT	733	0.84	40.6	25.5	19.9	19.1
VIB Vermogen	701	1.22	11.3	10.8	16.2	15.7
Deutsche EuroShop	1,683	0.63	12.2	12.3	15.8	15.8
Peer group average	**-**	**1.14**	**18.3**	**13.5**	**16.6**	**14.8**
FCR Immobilien	86	0.92	10.7	9.5	12.9	11.3
Premium/(discount)	**-**	**(19%)**	**(41%)**	**(29%)**	**(22%)**	**(24%)**

Source: Company accounts, Edison Investment Research, market consensus as at 28 May 2019. Note: Consensus is based on the available estimates of a single broker (First Berlin).

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