

## Noratis

Real estate

12 May 2020

### Exits likely to be postponed

Noratis continued expanding its portfolio in 2019 and plans further asset acquisitions in 2020. However, it also expects delays in project exits and has thus issued subdued full-year guidance. Over the longer term, Noratis stresses that asset sales will remain the main revenue and earnings driver while portfolio growth will be supported by equity funding from its new major shareholder. Noratis is committed to distributing 50% of its earnings to shareholders, but due to COVID-19 part of this year's amount will be allocated to a dividend distribution reserve and a social fund. The proposed dividend of €0.80 per share (or 33% of FY19 net income) represents a yield of 4.1%.

### Solid FY19 sales and margin normalisation

Operating results in FY19 were driven by higher revenues and margin normalisation, in line with management forecasts. Disposal gains increased to €63.0m from €48.2m a year earlier, while a dynamic portfolio growth in FY18 and FY19 translated into higher rental income (€12.9m in FY19 vs €7.9m in FY18). On an adjusted basis, EBIT was €15.8m and EBT stood at €12.1m, stable and down c 8% y-o-y. Portfolio expansion in the period led to a c €26m increase in liabilities to banks and net debt reached €172.4m at end-December 2019 versus €145.4m a year earlier. Around 94% of its debt matures between 2021 and 2025.

### Enhancing earnings stability over long term

Management expects a significant decline in EBIT and EBT in 2020 compared to previous years as some asset disposals previously planned for 2020 may be delayed. Focus will be instead on portfolio growth after a new major shareholder, Merz Real Estate, agreed in March 2020 to inject €5m of equity in the near term and up to €50m by end-2024 through further capital increases. This is aimed at improving earnings stability over long term through growing rental income streams and enhancing profits by allowing Noratis to better time its asset sales.

### Valuation: Dividend reduced but still attractive

Noratis's proposed dividend of €0.80 per share for FY19 implies a 4.1% dividend yield, which compares with 3.0% for its closest peer, RCM Beteiligung. Due to the uncertainty driven by the COVID-19 pandemic, the company plans to allocate additional €0.30 per share to a distribution reserve, which could potentially be paid out to shareholders if market conditions improve. When we add this to the proposed dividend pay-out, the yield expands to 5.7%.

#### Consensus estimates

Year end	Revenue (€m)	EBIT (€m)	EPS (€)	DPS (€)	P/E (x)	Yield (%)
12/18	56.1	15.6*	2.6	1.3	7.5	6.7
12/19	75.9	15.8	2.4	0.8	8.0	4.1
12/20e	70.5	16.7	1.6	0.8	12.0	4.2
12/21e	88.4	17.9	2.3	1.1	8.5	5.9

Source: Noratis accounts, Refinitiv consensus estimates. \*Includes €0.8m capital increase costs and €0.5m reversal of a rental guarantee provision.

Price €19.3  
Market cap €70m

#### Share price graph



#### Share details

Code	NUVA
Listing	Deutsche Börse Scale
Shares in issue	3.6m
Last reported net debt at end-2019	€172.4m

#### Business description

Noratis is a specialised asset developer, acquiring residential rental income-producing assets in secondary locations with optimisation potential. Investing in the asset base and improving the tenant mix creates value, which it exploits in well-structured asset sales through individual or block sales.

#### Bull

- Equity funding from the new shareholder will support liquidity and further portfolio growth.
- Focus on portfolio expansion may bring greater stability to sales and earnings.
- Strong experience operating in Germany's non-core areas.

#### Bear

- Subdued management guidance for 2020.
- COVID-19 pandemic may affect overall demand and transaction activity in the real estate market
- Tenants are low- and mid-income earners, likely to be affected by the COVID-19 crisis.

#### Analysts

Milosz Papst	+44 (0) 20 3077 5700
Anna Dziadkowiec	+44 (0) 20 3077 5700

[financials@edisongroup.com](mailto:financials@edisongroup.com)  
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## Assets sales drive FY19 figures, rental income assists

Noratis revenues reached €75.9m in FY19, up 35% y-o-y, driven by 31% growth in asset sales to €63.0m. This followed the disposal of 339 property units over the period (vs 294 in FY18), with the most notable transactions including block sales in the Erfurt Area (121 units), Trier (100 in total) and Frankfurt-Bornheim (60). Rental revenue increased 63% y-o-y to €12.9m after the company acquired 955 units and as a result expanded the portfolio to 2,407 units at end-FY19 (vs 1,791 units at end-FY18). Over the period, Noratis continued to invest in regions where it has been present for some time (eg Celle and Rhine-Main), but also expanded its geographical footprint to other German locations (including Kassel, Leipzig and Magdeburg).

**Exhibit 1: Portfolio development**



Source: Noratis accounts, Edison Investment Research

Gross margin on assets sales declined to 23% in FY19 from the particularly high 36% a year earlier (vs 29% in FY17 and 24% in FY16), while gross profit margins on rental activity remained broadly unchanged over the year, according to Noratis. EBIT reached €15.8m compared with €15.6m in FY18 (or €15.9m in FY18 when adjusted for €0.8m costs of the capital increase completed in May 2018 and a €0.5m non-recurring reversal of rental guarantee provision). Pre-tax profit was €12.1m, compared with €12.8m in FY18, with the decline triggered by a €0.9m rise in net interest expense. This was a function of debt increasing by c €26m to €175.1m due to the dynamic portfolio expansion over the period. Management guidance for 2019 assumed EBIT and EBT comparable to FY18 and FY17, with higher revenues and lower gross profit.

Net debt increased to €172.4m at end-2019 from €145.4m a year earlier as cash declined only slightly and was €7.0m at end-FY19 (vs €7.9m a year earlier). At the same time, the loan to value at the property level (expressed as bank borrowings to carrying amount of properties) decreased to 73% at end-FY19 from 84% at end-FY18, while the ratio of net debt to total assets at the holding level remained broadly stable at 67%. We note that only a minor part (c 1%) of group liabilities (the bulk of which are liabilities to banks) matures before the end of 2020 and c 94% has a maturity of one to five years.

It is important to note that Noratis's properties are reflected entirely in current assets as they are acquired with the aim of being sold after successful development. Consequently, the above gearing ratios are influenced by the fact that Noratis does not apply mark-to-market valuations to its projects. This also means that all revenues from Noratis's asset sales are booked at the time of the disposal and are therefore cash earnings. On the balance sheet, this implies that hidden reserves are building up due to optimisation and rent multiple expansions.

We believe Noratis has likely already used some of its balance sheet headroom to finance several acquisitions announced after the reporting date (see below for more details). On the other hand, the

company also attracted a new shareholder in March 2020, which has committed to provide additional equity funding, including €5m in the short term (more details below).

<b>Exhibit 2: Financial performance</b>					
HGB figures in €m unless otherwise stated	FY19	FY18	Change y-o-y	FY17	FY16
<b>Revenue</b>					
Asset sales	63.0	48.2	31%	61.9	37.8
Rental	12.9	7.9	63%	6.1	6.7
Total	75.9	56.1	35%	68.0	44.6
<b>Gross profit</b>					
Asset sales	14.4	17.3	-17%	17.7	9.2
Margin	23%	36%	-1.3pp	29%	24%
Rental	7.2	4.3	67%	3.8	3.9
Total	21.6	21.7	0%	21.5	13.1
<b>EBIT - reported</b>	<b>15.8</b>	<b>15.6</b>	<b>1%</b>	<b>16.7</b>	<b>9.9</b>
Exceptional items:					
IPO/capital increase costs	0.0	(0.8)	N/A	(1.5)	0.0
Reversal of a rental guarantee provision	0.0	0.5	N/A	0.0	0.0
<b>EBIT - adjusted</b>	<b>15.8</b>	<b>15.9</b>	<b>-1%</b>	<b>18.2</b>	<b>9.9</b>
Net interest expense	(3.7)	(2.8)	32%	(3.0)	(3.9)
<b>Pre-tax profit - reported</b>	<b>12.1</b>	<b>12.8</b>	<b>-5%</b>	<b>12.2</b>	<b>6.0</b>
<b>Pre-tax profit - adjusted</b>	<b>12.1</b>	<b>13.1</b>	<b>-8%</b>	<b>15.2</b>	<b>6.0</b>
Net profit - reported	8.7	9.3	-6%	8.7	4.2
<b>EPS (€) - reported</b>	<b>2.40</b>	<b>2.57</b>	<b>-7%</b>	<b>2.97</b>	<b>N/A</b>

Source: Noratis accounts, Edison Investment Research

While Noratis remains committed to distributing c 50% of its profits to shareholders, it aims to retain flexibility in the face of the current market uncertainty amid the COVID-19 pandemic. It has proposed to pay out €0.80 per share in the form of a dividend, allocate an additional €0.30 per share to a dividend distribution reserve (available over short to medium term) and a further €0.10 per share to a social fund, aimed at supporting its tenants affected by the coronavirus crisis. These components sum to €1.20 per share (or c 50% of FY19 net earnings).

## Long-term shareholder to support portfolio growth

At end-March 2020, Noratis announced that Merz Real Estate (Merz), an affiliate of a German pharma company Merz Group, will become its largest shareholder. As a first step, Merz has agreed to acquire c 29% shares in Noratis from two key shareholders for €21.0 per share (vs the closing price of €15.75 per share a day prior to announcement). This includes Noratis's CEO, Igor Christian Bugarski, whose stake in the company will decline to c 8% (from c 19% at end-2019). Moreover, in the near term, Noratis will issue c 252k new shares (or c 7% of outstanding shares) to Merz at a price of €19.8 per share, translating into gross proceeds of c €5m. We estimate this will increase Merz's stake in the company to c 36%. Finally, Merz has agreed to invest up to €50m through capital increases in Noratis by the end of 2024. The transaction has recently been approved by the regulator.

Noratis will use the funds to expand its portfolio, which it hopes will stabilise earnings over the longer term and enhance profits by allowing the company to better time its asset sales. Still, it stresses that asset disposals will remain the main source of revenues and earnings (they represented 83% of its sales in FY19 vs 86% in FY18 and 91% in FY17). The company continues to invest in residential properties with value enhancement potential in secondary locations across Germany and plans to set up regional subsidiaries, which will buy smaller real estate portfolios and individual properties for up to €5m per transaction. Its first subsidiary, Noratis West, has already acquired 25 residential units. Earlier in 2020, Noratis acquired a real estate portfolio in Emden in February 2020 (79 residential units) and in Leipzig and Halle in April 2020 (50 residential units).

## Management guidance reflects delays in project exits

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For 2020, Noratis guides to a significant decline in EBIT and EBT compared to previous years as the company can postpone some asset sales originally planned for 2020 (to 2021 or later) after it attracted the funding from Merz. Noratis says that significantly higher rental income after the planned portfolio expansion will not compensate for the declines in asset sales in 2020. It also adds that completion of the transaction with Merz is an important factor for achieving its forecasts.

Noratis anticipates that the COVID-19 pandemic will have a temporary impact on its results and believes that medium- and long-term fundamentals of the business remain good. According to market reports, overall demand for residential space in the coming months is likely to be affected by households focusing on securing their jobs and basic needs rather than buying apartments. At the same time, new completions could decline sharply this year due to bottlenecks caused by lockdown rules, but rents in existing homes are unlikely to increase and might even decline over short-term in regions hit by the pandemic. That said, the medium-term outlook for the residential market in Germany remains solid given the persisting low interest rate environment.

While in the COVID-19 crisis, the affordable living sector may be less exposed to demand shocks than high-end apartments, we acknowledge that the company's tenants are low- and middle-income earners, who may be affected by the economic effects of the pandemic. We believe this is illustrated by the company's decision to direct part of its FY19 earnings in a social fund with the aim to support its tenants. Notably, the vacancy rate across Noratis's portfolio was relatively low at 5.6% while annualised in-place net rent was €11.6m at end-2019.

## Valuation

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Noratis's position between asset holder and developer makes for a difficult comparison with listed companies, but we believe RCM Beteiligungs is the closest peer as it has a similar model. Noratis currently trades at a 2019 P/E of 8.0x and P/NAV of 1.3x, implying a 15% and 34% discount to RCM (there are no consensus estimates for RCM). Noratis has proposed to pay out a dividend at €0.8 per share, representing a 4.1% yield. If we add the €0.30 per share allocated to the dividend distribution reserve (potentially available to Noratis shareholders over short to medium term), the company's dividend yield increases to 5.7% and compares with 3.0% for RCM.

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