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COLONIA REAL ESTATE AG–
Ready for recovery?

Some thoughts on recent developments

Real estate and special situations

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Colonia Real Estate AG

Ticker	KBU GR / KBUG.DE	**Last Price**	**2,16 €**	**Target Price**	**>7,00€**
Shares outstanding	22.83m				
Market capitalisation	44,05				
Free float	80,0%	**average turnover**	220.000		
Change ytd%	-32,50%	**Change 12m%**	-85,70%		
Latest news					
Next interm	31.03.2009 (2008 final)	**AGM**	July 2009	**Website**	www.cre.ag
CEO	S.Rind	**CFO**	V.Lemke	**IR**	G.Niessen

• Key points

- CRE is **more transparent than ever**, as **new CFO** changes CRE's accounting procedures
- **No re-financing issues until Q2 2010** following the disposal of CRE's hotels
- **Positive cash flow as of Q2 2009** after cost cut program enacted (costs cut by €9.5m = 35%)
- **IFRS40 impairment in Q3 2008** (loss: €43.9m), cap rate up 67bps to 7.02%, value down by 4.8%
- **NAV still well above 11.00€/share** (which is the book value estimated by end of 2008)
- Renovation of residential portfolio almost completed**, less costs in 2009**
- **Rental increases likely in 2009**, rents for renovated flats rise from €4,50 to €5,64 (+25%)
- Occupancy and rent level improvements **in line with business plan, despite crisis**
- **Improved debt structure** and sufficient liquidity, hence **no fire sales** to be expected
- **Asset management and privatisation (Riester Rente) should add to net profits in 2009**

• Recommendation

- CRE is most transparent and hence should assume less risk aversion than its peer group, which still might face IFRS40 valuation adjustments.
- CRE is cash flow positive in 2009, which should also be a trigger for reduction of risk aversion
- CRE's portfolio is cash generating and not cash burning, hence NAV are not destructed by operating costs
- CRE's share price should move towards its NAV
- Not included in estimates: Asset Management and Privatisation represent positive triggers
- Buy, as CRE currently trades at a 25% of NAV
- Share price performance triggers should be:
  - Falling TED and ITRAXX spreads (good for sector, but investors look for clarity)
  - Indications, that banks provide loans (happened with Plambeck project finance already)
  - Transactions in the sector, which provide transparency on asset prices
  - New management with new, conservative accounting principles and focus on costs

• …but, what can go wrong?

CRE looks best positioned to benefit from changes in management and effects from cost cutting. However, some things might go wrong, but we rate the possibility of this happening rather low.

- **More IFRS40 losses.**
  - Not completely unlikely, but 7% cap seems to be OK for the type of CRE's entire portfolio (Berlin: high occupancy, Hamburg: fully renovated, Salzgitter: LTV in mid 60ties %)
- **Higher financial costs.**
  - No re-financing, as no covenant breaks envisaged. If interest rates collapse, CRE's interest rate swap would cost more than expected … but this would hit all of its competitors as well. However, if rates decline, house prices might rise and valuation increases.
- **Tenant risk.**
  - Tenants become jobless and cannot afford rents. This is an US problem, but in Germany, the unemployment office is stepping in, hence tenant risk becomes sovereign risk of Germany. CRE has hardly any non-residential risk.
- **Marco risks.**
  - World falls apart….this will hit the entire capital market. However, if deflationary fears are prevailing for a very long time, highly leveraged firms might run into problems. Rent increases would not be possible. CRE's absolute rent level is low…further declines appear to be unlikely. But…negative inflation rates trigger decline in rents as these are linked to inflation (over a long time)
- **Management issues.**
  - CRE is dependent on its top management. Rind is essential for the company, but has now implemented additional talents (Thiele: real estate expertise, Lemke: CFO and restructuring expertise, Wittkopp: back at Resolution Asset Management). We rate the management risk low.
- **Shareholder risk.**
  - Swiss Real Estate as 20% shareholder has been replaced by Liechtensteiner Landesbank. Other, mainly US shareholders have sold their positions. It seems as if momentum investors have exited the sector and CRE. Hence, the shareholder structure should have improved, with long term investors becoming the predominant shareholders in CRE.

• Cost cutting in line with CRE's guidance

Colonia Real Estate said that the announced cost-cutting and efficiency program is showing its first effects. The measures focus on four areas:

- **consolidation of non-operating subsidiaries,**
- **cut back by diversification,**
- **separation or restructuring of business areas as well as external consulting expenses and**
- **staff reduction.**

So far it was agreed on annual savings of €9.5m which consists of €4.5m recurring costs and €5m variable costs.

Staff reduction cost effect: €2.5m in 2009
25 employees are going to leave the CRE group which sums up to about 20 percent of the staff. This number also includes the employees which left through the management buyout of a subsidiary in the beginning of December 2008. The other employees will leave the company by the end of the year and the end of March 2009. Together with the management buyout this sums up to recurring cost savings of €2.5m. To achieve these cost savings, non-recurring restructuring costs of €0.3m have to be considered in the fourth quarter, said CRE.

Administrative functions centralized leading to cost effects of €1.25m – €1.50m
Tasks and budgets will be consolidated and centralized, especially in administrative as well as accounting functions and areas, marketing as well as the real estate sales and acquisition department. All subsidiaries will be advised by one tax consultancy.
Reorganization also takes place in the subsidiary CRE Resolution. The office in Stuttgart was closed by the end of 2008 and the business will be taken over by their office in Frankfurt. Through these centralization measures at least another €1.25m can be saved annually, writes CRE.

Comment
Total personnel and administrative costs have been blown up in the past to scope with the expected growth in business. This growth will no longer occur. Hence, CRE are cutting back their recurring costs to

scope with existing businesses. We would expect further cost cuts in 2009, if business shows no sign of recovery.

A cost cutting program at CRE was necessary in order to bring the company to positive cash flow. We understand that ongoing costs would be cut towards €3.5 – 4m on a quarterly base. CRE expects about €48m in NOI from its residential portfolio. After interest costs, we would expect CRE to show a result of around €17 – 19m. Assuming that CRE achieves an annual recurring cost level of €12m (i.e. €4m times four quarters), the company should show a result of €7m alone from its renting activities.

• Asset disposals reduced complexity and short term debt

On December 17th, 2008 Colonia Real Estate AG (CRE) successfully sold its trophy property 'Disch-Haus' in Cologne. The SPV 'VA No1 Dischhaus GmbH & Co KG', a Joint Venture between the main shareholder UBS and Redos Real Estate negotiated a sales price of over EUR 40 million, achieving an IRR of almost 20%.

In October 2006 the joint venture bought the property from the city of Cologne. Colonia Real Estate held a 2,75% stake in the investment company and CRE Resolution took over the lead of the new concept, the refurbishment and the lease-up.

Earlier in December Colonia Real Estate AG sold its hotel portfolio for €24m to two foreign investors. The price reflects the current fair market value of the properties, i.e. CRE's IFRS valuation on its balance sheet. Cost basis of the properties in 2004 were €22m. CRE realized an IRR of roughly 28 percent per annum. The deal also eliminates €19.9m in short term debt. The next refinancing on group level hence is only by early 2010, states CRE.

Comment
Disposals are an essential part of CRE's business. With the disposal of the two non-residential assets, CRE is almost entirely in residential assets. The remaining holdings in co-investments with Oaktree are likely to be disposed, once Oaktree decides to sell assets from the portfolio. CRE lost the asset management contract with Oaktree in December 2008. With the disposals, CRE has cut its asset levels and debt levels. Most importantly, CRE has no short term liabilities on its balance sheet.

• IFRS impairments already carried out in Q3 2008

Portfolio value reduced by €43.9m in Q3 2008
CRE revised its portfolio value in Q3 2008 by increasing the cap rate (exit yield) of the portfolio from around 6.35% to 7.02% in an attempt to 'clean books'. **Asset values have been reduced by 4.8%, respectively**. CRE typically uses CBRE and DTZ as appraisers for its portfolio. The company does not expect to see further IFRS40 adjustments in 2008. As a result of the measure, the company's equity capital fell from €322.5m by the end of 2007 to €273m by the end of Q3 2009. Given that CRE expects a further loss in Q4 2008 of around €11m, the group's equity might decline to €262m by the end of 2008.

Interest rate swap: total loss of €0.8m by end of Q3 2008.
The volatile environment in the capital market caused a divergence in the development of the underlying yield curves in the past few months. The result was a write-up of €8.1 million on interest-rate swaps for the first half of 2008. This is in contrast to a write-down of €8.9 million on interest-rate swaps in the third quarter of 2008 resulting in a negative cumulative impact on the net finance result of €0.8 million. The fair value of interest-rate swaps at the reporting date was €9.2 million (December 31, 2007: €10.0 million), as stated by CRE.

Comment:
On the interest rate swap side, further losses are to be expected in Q4 2008. The reason is that interest rates fell further. Unfortunately, credit spreads rose at the same time. As a result, the hedge lost in value, while it had become even more costly for CRE to re-finance itself.
CRE's IFRS40 valuation losses of €44m (gross, excluding the dissolution of deferred taxes, i.e. €34,5m net) should represent the current expected maximum write off from its portfolio value (€920m by the end of 2007). The impairment hence represents 4.8% of the asset value and 13.7% of the group's equity = book value.
At €262m, CRE's book value should be about €11.50/share by the end of 2008.

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• Positive cash flow by Q2 2009 through cost measures

The cost cutting program at CRE brings the company to positive cash flow. We understand that ongoing costs would be cut towards €3 – 4m on a quarterly base. CRE expects about €49m in NOI from its residential portfolio in 2009. After interest costs of around €32m (excluding potential losses from interest rate swap), we would expect CRE to show a result of around €14 – 16m. Assuming that CRE achieves an annual recurring cost level of €12 - 14 - (i.e. €3m times four quarters), the company should show a result of €4 - 5m alone from its renting activities.

It might be possible that CRE shows even higher cash results in 2009, if the company were able to cut rent related coasts further. We understand that CRE streamlines its facility management contracts to achieve better conditions and restricts unnecessary work. CRE now estimates its gross rental yield at 7.02%, based on an asset value of €876.5m, i.e. implying €61.53m gross rental income after revaluation and renovation. This compares to €920m, and a gross rental income of €58.42m (yield 6.35%) by the end of 2007.

Comment
CRE is likely to show net income of around €3.5 – 5.0m alone from its rental income in 2009, depending at which time the company become cash flow positive (we believe by Q2 2009). Based on the current market value, the stock trades at a P/E of just 9 times. This figure does not include any income from asset management or privatisation. Both should ADD to net income, given that CRE has cut off unprofitable activities by the end of 2008.

• Current consensus estimates (as of 15.01.2009)

Table: KBU consensus estimates

€ '1000	2007	2008e	2009e	2010e
Sales	124.100	59.580	84.450	136.100
EBITDA	108.750	4.100	34.217	40.317
EBIT	94.020	- 9.460	25.620	36.050
Operting Profit	53.100	40.076	61.723	98.000
Net Income GAAP	70.333	- 58.550	- 17.100	1.000
EPS adj. (€)	2.192	- 1.582	- 0,288	0,113
EPS GAAP (€)	3.308	- 2.494	- 0,690	- 0,003
CFPS (€)	10,23	- 1,17	0,19	0,53
ROA (%)	18,00%	-4,80%	0,25%	0,85%
Net Debt	592.333	624.667	597.667	611.333
NAV	315.000	182.000	227.000	232.000
NAVPS (€)	14,03	7,98	8,17	8,35

Source: bloomberg consensus estimates

Comment
2009 consensus results suggest that KBU will still experience a negative IFRS40 impairment, given that cash flows are positive (consensus estimate €5.5m). We believe that consensus estimates are likely to be revised upwards in the run of 2009, particularly when re-financing is improving. This should lead to more transactions, which are likely to be carried out at yields close to or lower than 7.00%.

• Company description and current assessments

The acquisitions carried out in 2007 expanded the Group's holdings in high-return residential portfolios to about 19,800 units. As part of CRE's active portfolio management, management is considering shedding some residential and commercial properties, and has already sold Disch Haus and its hotel assets.
The dramatic deterioration of the financial markets and in its wake, the real estate transaction markets as well led, however, to an almost complete paralysis of the markets.

The announced partial sales of the residential real estate portfolio will not likely be fully completed in 2008. Based on the results for the third quarter of 2008 and due to the continued difficult market environment for transactions, the CRE had adjusted its annual guidance accordingly and expects a consolidated loss of €55 to 60 million by year end 2008, excluding possible interest rate hedging losses, as these are going to be booked against equity on the balance sheet (income neutral).

No substantial losses from the reappraisal of the real estate portfolio at year end 2008 are expected. It is thus fully expected that no dividend will be paid for 2008.
With the reappraisal of the real estate portfolios as of the third quarter of 2008, the Management Board feels that all significant negative market impacts of the financial crisis have been depicted in the balance sheet.
The positive rental income trend and the adjusted measurement of the real estate portfolio in conjunction with the planned cost savings should make it possible to obtain sustained surpluses from business operations starting in 2009, i.e. CRE will become cash flow positive by Q1/Q2 2009, according to CRE.

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