Real Estate
Germany

Colonia Real Estate

KBU GR Equity

Buy
(from u.r.)

Q2 results in line, positive outlook

Colonia Real Estate (CRE €37.40) presented its interim Q2 results on 15 August 2006.

CRE continued to create an integrated real estate service provider in Q2 2006. Q2 net profit came in at €4.87m, some 10% below our estimate. While basically all line items came in as expected (IFRS 40 adjustments were reported at €7.04m vs our estimates of €6.8m, fee income reached €1.44m vs our estimates of €1.594m), rental income was €1.8m lower than anticipated at €2.26m. We understand that this difference lies in the fact that the purchase date and the date at which CRE accounted for the assets differed by more than anticipated. This should, however, not alter the annualised rental income run rate.

The company provided an optimistic outlook of an investment volume of €500m until the end of the year, up from current levels of €200m. This suggests very active portfolio trading in H2 2006, coupled with attractive returns. We now rate CRE a Buy, with a target price of €43 (both previously under review).

Q2: focus on building up the portfolio

CRE bought two portfolios in April this year. A 925 unit portfolio was acquired for €18.4m, yielding above 10% (annual rental income €1.9m). The buildings are in Aachen (western Germany), Erfurt, Dresden and Cottbus (eastern Germany).

Also in April, CRE bought an asset in Cologne with 56 units (in addition to four commercial units) for €4.8m (residential vacancy rate less than 2%, commercial sites fully let with an average lease length of 4.8 years). Based on the annual rental income of €580,000, the investment has an initial yield of 12.1%. Another smaller additional investment had been made in Brake, where CRE bought another 114 units for €2.7m, yielding 11.1% (vacancy rate less than 5%).

On 30 June CRE bought a 2,478 unit portfolio in Berlin for €83.2m. While the purchase price is only due to be paid in January 2007 – i.e. no cash drain for 2006 – rental revenues are accounted for as of September 2006. The annual rental income amounts currently to €6.65m, despite a 22% vacancy rate, i.e. yielding 8%. CRE would therefore receive four months of rent, which would reduce the final purchase price by another €2.22m. CRE expects to halve the vacancy rate in the next two years, pushing the annual rental income to at least €7.6m. The transaction underlines CRE's ability to acquire what we believe to be very attractive portfolios.

Overall, CRE has acquired assets worth around €200m in H1 2006 and expects to acquire a further €300m in assets in H2 2006. This would lead to a total number of units between 10,000-15,000 within the next 12 months, up from a current holding of 8,300 units.

Outlook statement optimistic

Following the best H1 in the company's history, CRE expects to boost revenues further in H2. CEO Rind confirmed that the company is close to dispose of a partial portfolio in the coming weeks. He also re-confirmed that CRE is active in building up a new business field: retail real estate. In the press conference, Rind said that there are very intense discussions with a third party to build up a retail real estate group within CRE. These activities are not part of the €300m investment programme for H2 2006. We have not included any retail activities into our accounts so far.

CRE also issued a very optimistic outlook for its asset management unit Resolution: the business had been consolidated in the Q2 results of CRE and contributed sales of €1.43m to sales (under German GAAP accounting), with a pre-tax margin of 68%. CRE expects to achieve new third party asset transactions in the coming quarter, boosting the revenues considerably in H2 2006. So far, we have included only €100m in additional assets under management (AUM) in H2 2006, up from €700m currently. If CRE achieves the large transactions, we would need to adjust our Resolution estimates considerably for 2006 and beyond.

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CRE also remained optimistic on the development of its new fund management business. The group started operating in Q2 with the creation of the 'CareInvest I' fund (investing in nursing homes. Invested already in one asset, in close negotiations on two further assets, which aims to be launched by Q4 2006. The total fund volume is expected to reach €55m, which should – we believe – lead to fee income of around € 1.9m in 2006.

The company re-iterated its 2006 earnings guidance of €25m in net profits. We regard this as being very conservative. Based on the run rate in rental income (€26.6m) and the current yields (at around 8%) against very low interest costs (€1.2m for Q2 2006), the strong asset management pipeline and returns and the indicated portfolios deals we would expect the company to further upgrade its estimates, once the transactions on the portfolio side and the asset management side materialise. CEO Rind said in the analyst conference call that once key deals on the asset management side and on the retail asset side have been signed, he might need to upgrade the company's 2006 earnings guidance. CEO Rind stated that the current company guidance of €25m in net profits for 2006 includes IFRS 40 revaluation to the tune of €12m. In the first six months of the year, CRE added €12.8m in re-valuation. However, these increases do still not reflect the true valuation.

The Delmenhorst portfolio, which CRE aims to sell in the next four weeks, has been bought for less than €50m. In H1 2006, CRE has adjusted the valuation to slightly above €50m. Most recent bids for the portfolio reached levels of more than €60m. This suggests that Q3 would at least see a profit from asset sales to the tune of €8m-€10m.

Currently, we assume CRE will reach net profits of €29.4m (excluding IFRS 40 adjustments) and around €49m including such adjustments. These earnings levels should also be seen as conservative, as we assume a higher rental income than the current run rate given by the company. This is the result of a higher number of apartments remaining in the current year within the CRE accounts, rather than CRE becoming a more active asset trader in H2 2006. In addition, we have not accounted for a major asset management deal.

Changes to previous estimates

We have re-assessed our expectations for 2006 and beyond. As the company expects a run rate for residential rental income of €26.6m from the current portfolio, we assume that the rental income this year would reach some €23m (down from previous estimates of €29m). At the same time we increased our purchasing volume to 8,000 units (for the rest of the year) from 5,000 units to reflect the company's intention to reach a holding of 10,000-15,000 units by the end of 2007.

We have so far not included any additional new businesses, which have been indicated by CEO Rind at the conference call, namely new asset management deals or retail asset deals.

TABLE 1: **Profit & loss**

Year end Dec. (€000)	2003	2004	2005	2006E	2007E	2008E
Sales	0.25	0.82	20.95	137.31	215.63	293.64
Cost of goods sold	(0.30)	(0.82)	(2.20)	(84.89)	(122.30)	(174.08)
Gross profit	(0.06)	(0.00)	18.75	52.42	93.33	119.55
Total op. expenses	(0.40)	(1.27)	(3.73)	(100.01)	(145.35)	(207.10)
EBITDA	(0.15)	(0.45)	17.22	41.36	77.21	93.80
Depreciation & amortisation	(0.01)	(0.01)	(1.80)	(0.30)	(0.40)	(0.40)
EBIT	(0.15)	(0.46)	15.42	41.06	76.81	93.40
Pre-tax profit	0.18	(0.87)	17.01	62.79	93.78	114.43
Income taxes	0.00	0.24	(6.46)	(21.97)	(28.13)	(34.33)
Income tax rate	-1.1%	27.6%	38.0%	35.0%	30.0%	30.0%
Reported net income (incl IFRS 40)	(18.62)	(0.63)	10.54	39.39	61.46	73.59
Net income (excl. IFRS 40)	(18.62)	(0.63)	6.93	21.88	46.83	61.36
No. of shares (m)	2,250	2.610	15.704	15.704	15.704	15.704
EPS (€) (incl IFRS 40)	(0.01)	(0.24)	0.67	2.51	3.91	4.69
EPS (€) (cash)	(0.01)	(0.24)	0.44	1.39	2.98	3.91

Source: Commerzbank Corporates & Markets

TABLE 2: **Balance Sheet**

Year end Dec. (€000)	2003	2004	2005	2006E	2007E	2008E
Cash & equivalents	0.41	0.02	28.12	57.61	73.17	92.07
Receivables	0.00	1.45	3.20	5.50	21.00	28.00
Inventories	3.66	26.22	89.17	182.13	245.70	184.96
Total current assets	4.50	27.67	99.27	209.03	300.00	252.96
Total assets	4.84	28.48	139.72	342.70	463.55	440.69
Total equity	(0.00)	3.22	32.71	93.10	123.82	161.62
Financial debt	4.53	23.69	89.81	190.42	251.65	177.41
Other debt items	-	1.57	17.19	59.18	88.08	101.66
Balance sheet total	4.84	28.48	139.72	342.70	463.55	440.69

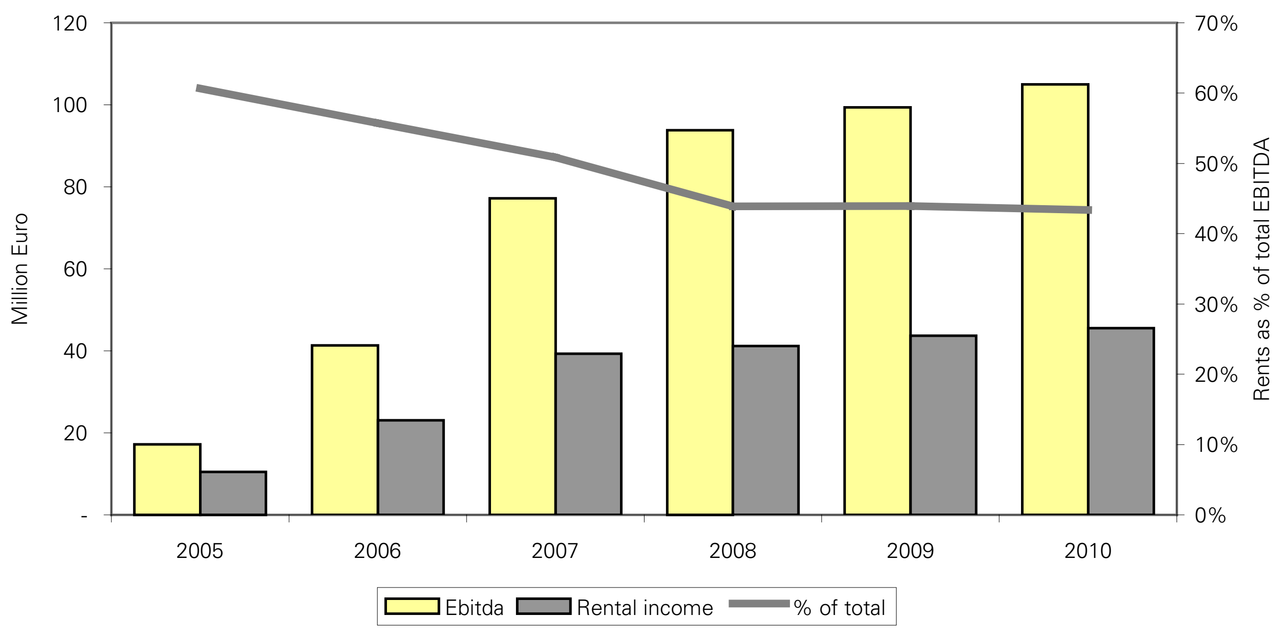
Source: Commerzbank Corporates & Markets

Valuation

Given the changes in the accounts, we assume that rental income as % of EBITDA would reach about 44% throughout the next years, as the portfolio would be built up initially in 2006 and 2007, but face privatisation in the following years.

Overall, the changes in EPS estimates are very mild, reflecting slightly less trading activities in 2006 and rental income in 2006, but a stronger earnings trend in 2007, due to higher assets in the residential business segment.

CHART 1: **Rental income**



Source: Commerzbank Corporates & Markets

TABLE 3: **EPS changes**

€		2005	2006E	2007E	2008E	2009E	2010E
Cash EPS	old	0.44	1.47	2.94	3.85	3.98	4.24
	new	0.44	1.39	2.98	3.91	4.04	4.30
Reported EPS	old	0.67	2.67	3.87	4.63	4.81	4.94
	new	0.67	2.51	3.91	4.69	4.86	4.99

Source: Commerzbank Corporates & Markets

Peer group valuation

We have used our estimate for reported earnings for CRE. Using cash earnings, CRE would trade at a 2007E P/E of 14.4. This valuation would still be comfortably below market average levels.

TABLE 4: **Peer group**

Company	P/E 05	P/E 06E	P/E 07E
Deutsche Wohnen AG (DWAG)	64.4	46.7	39.3
Tag Tegernsee (TAG)	-16.1	-597.5	367.2
Patrizia	20.8	12.4	12.4
Franconofurt	287.5	19.2	11.5
Ivg Immobilien AG	32.1	24.9	23.3
MLP AG	37.7	24.2	19.6
AWD Holding AG	35.3	20.2	15.8
Mpc (Munchmeyer Petersen Ca	13.5	13.3	12.2
Silic	44.3	41.1	31.4
Immofinanz Immobilien Allag	38.6	31.5	27.0
Vivacon AG	14.2	10.3	9.2
Colonia Real Estate	76.4	13.5	8.7
Average (exlc. DWAG and TAG)	*66.7*	*23.4*	*19.0*
Colonia Real Estate at TP of €43		17.1	11.0

Source: Commerzbank Corporates & Markets, JCF, Bloomberg

PEG valuation

Another way of looking at CRE’s earnings and valuation prospects might offers the PEG ratio valuation. Assuming a PEG ratio of 1.0 in each of the following years, CRE’s shares should reach levels around €41/€42 – we believe.

PEG (incl.IFRS)	2003	2004	2005	2006E	2007E	2008E	2009E	2010E
EPS growth	11	28	2.84	5.68	1.56	1.20	1.04	1.03
EPS (incl. IFRS)	-0.01	-0.24	0.44	2.51	3.91	4.69	4.86	4.99
Fair Price at PEG=1	-0.95	-67.11	1.25	142.51	61.06	56.11	50.48	51.24
Year factor	9.00%		1.000	0.917	0.842	0.772	0.708	0.650
Discounted price			1.25	130.74	51.40	43.33	35.76	33.30
Average price			66.00	91.07	47.36	39.54	34.53	
Current P/E at average prices				36.31	12.10	8.44	7.10	
Average discounted price						58.91		

Source: Commerzbank Corporates & Markets, JCF, Bloomberg

DCF valuation

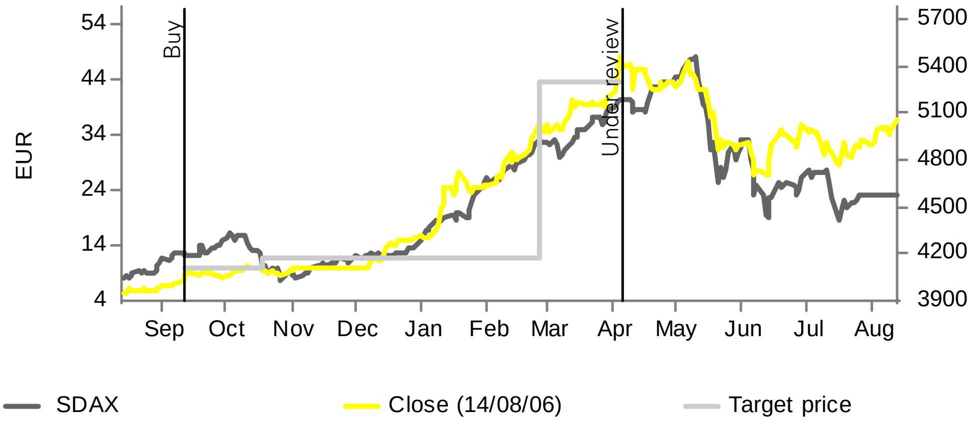
We use a 9% discount rate in our DCF model. We arrive at a fair value of €3.96.

TABLE 6: **DCF**

€m		2001	2002	2003	2004	2005	2006E	2007E	2008E	2009E	2010E	2011E	2012E
												Terminal Growth rate	
Sales growth			*5.28%*	*-4.25%*	*231.45%*	*2448.60%*	*555.44%*	*57.03%*	*36.18%*	*5.07%*	*2.04%*	***2.00%***	*2.00%*
Sales		0.2	0.3	0.2	0.8	20.9	137.3	215.6	293.6	308.5	314.8	321.1	327.5
Adjusted EBITA		0.0	(0.3)	(0.2)	(0.5)	15.6	41.3	77.0	93.6	99.2	104.8	106.9	109.0
- Taxes on EBIT (used 35% tax rate)		-	(0.0)	(0.0)	0.1	(5.9)	(14.4)	(23.1)	(28.1)	(29.8)	(31.4)	(32.06)	(32.70)
- Changes in deferred tax		-	-	-	1.18	7.82	(1.36)	(0.59)	(0.03)	0.85	-	-	-
= NOPAT		**0.0**	**(0.3)**	**(0.2)**	**0.8**	**17.5**	**25.5**	**53.3**	**65.5**	**70.3**	**73.3**	**74.8**	**76.3**
+ Depreciation		-	-	0.0	0.0	1.6	0.1	0.2	0.2	0.2	0.2	0.20	0.21
- Incr (Decr) in Working Capital					2.3	7.3	11.9	2.1	(0.3)	(1.7)	(1.76)	(1.79)	(1.83)
- CapEx					-	-	-	-	-	-	-	-	-
- Other changes in cash					(0.4)	28.1	29.5	15.6	18.9	16.0	14.1	14.4	15.0
- Investments					-22.0	-30.0	-52.1	-61.8	-104.3	-107.7	-103.2	-30	-20
= Free Cash Flow					**(22.1)**	**13.9**	**35.8**	**40.4**	**40.2**	**24.1**	**49.6**	**57.6**	**69.7**
Cost of Capital	**9.00%**												
Year factor						1.000	0.917	0.842	0.772	0.708	0.650	0.596	0.547
Discounted value of Cash Flow						13.94	32.84	33.97	31.05	17.07	32.24	34.35	38.10
Cumulated value of Cash Flows	233.56												
Terminal value	544.32												
Operating value	777.88												
Debt LT	89.10												
Equity value	688.78												
Number of shares	15.7040												
Fair Value (€)	**43.86**												

Source: Commerzbank Corporates & Markets

CHART 2: **Colonia Real Estate price chart**



Source: Commerzbank Corporates & Markets

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TABLE 7: **Stock rating allocation**

	Buy	Hold	Sell
No. of companies under coverage with this rating	49	21	3
% of companies under coverage with this rating	69%	27%	4%

Source: Commerzbank Corporates & Markets

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