

Mid Cap
Real Estate
Equity – Germany

Neutral (V)

Target price (EUR)	2.00
Share price (EUR)	1.89
Potential total return (%)	5.8

Performance	1M	3M	12M
Absolute (%)	-12.9	-74.6	-88.9
Relative ^A (%)	-13.9	-63.2	-80.1

Index^A DAX-100

RIC KBUG.DE
Bloomberg KBU GR

Market cap (USDm) 54.0
Market cap (EURm) 43.1

Enterprise value (EURm) 693.1
Free float (%) 80

Note: (V) = volatile (please see disclosure appendix)

Colonia Real Estate

Difficult year draws to a close; cutting target price to EUR2 from EUR8, downgrading to Neutral (V) from Overweight (V)

- ▶ **Announced preliminary Q3 08 figures are burdened by unrealized valuation loss of EUR53m (non-cash-items)**
- ▶ **Total business model has to be scrutinized, in our view**
- ▶ **We are cutting our target price to EUR2 from EUR8 and downgrading our rating to Neutral (V) from Overweight (V)**

Colonia gets headwind from several sides; prelim Q3 08 figures burdened by valuation loss of EUR44m

Negative news about Colonia Real Estate accumulated in recent months, and incorporating preliminary Q3 08 results the company announced on 10 November, we are significantly changing our outlook on the stock. After the company already reduced its full-year guidance following H1 results to net profit of EUR20-25m from EUR73-75m, the company now reduced guidance a second time, to –EUR55-60m, mainly due to negative valuation (non-cash) movement of the portfolio stock of EUR44m. We are adjusting our net profit forecast to a total loss of EUR54m (previously +EUR11.8m) and EBIT to –EUR30.2m (HSBC EBIT of EUR13.8m, excl. valuation). Due to our estimate changes, we do not expect any dividend payout. Based on the cost-cutting program launched in the last month, we expect that the company will be in the black on an adjusted basis (excluding valuation) in H1 09.

Downgrading rating to Neutral (V) from Overweight (V) and reducing target price to EUR2 from EUR8

Based on our adjusted forecasts, we are reducing our 12-month target price to EUR2 from EUR8, which leads us to downgrade our rating to Neutral (V) from Overweight (V). Our new fair value for Colonia Real Estate shares reflects our more cautious view of the German investment market, as well as the low cash-generating business model. Although we appreciate the step by management to a leaner corporate structure by reducing administrative costs of 50% by end-2009, we question Colonia's business model. From our perspective, the business model must be scrutinized in general, as we believe that in the current economic environment, the company needs a clearly focused, cash flow-positive business model. In our view, the company has critical mass with c20,000 residential units, which should generate positive cash flow in 2009, assuming continuing cost reductions and a focus on its key competencies.

13 November 2008

Thomas Martin *

Analyst
HSBC Trinkaus & Burkhardt AG, Germany
+49 211 910 3276
thomas.martin@hsbc.de

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Changes in our estimates

Colonia Real Estate: Forecast changes

(EURm)		2007	2008e	2009e
Reported EBIT	Old	83.4	46.9	52.2
	New	83.4	-30.2	-1.5
	Chg (%)	na	-164%	-103%
PBT	Old	53.6	30.9	28.5
	New	53.6	-64.1	-22.3
	Chg (%)	na	-307%	-178%
PBT adjusted (before valuation)	Old	-7.0	15.9	20.5
	New	-7.0	-20.1	2.7
	Chg (%)	na	-226%	-87%
PAT	Old	67.2	22.9	21.1
	New	67.2	-54.0	-18.0
	Chg (%)	na	-335%	-185%
PAT adjusted	Old	6.6	11.8	15.2
	New	6.6	-10.0	6.2
	Chg (%)	na	-184%	-60%

Source: HSBC estimates

Outlook uncertain

EBIT line strongly impacted by unrealized valuation movement of EUR44m

We are cutting our full-year reported EBIT estimate to –EUR30.2m from EUR46.9, which is reflected by the following changes in our estimates for 2008.

- ▶ Our previous forecasts incorporated a trading profit of EUR10.8m, which was in line with the guided trading profit of EUR10-13m that the company made following its H1 08 report. Meantime, investment turnover in the German real estate market has been significantly reduced, and management has commented cautiously on that issue. Therefore, our new estimate excludes any trading profit.
- ▶ The company's reporting structure incorporates valuation movements of the investment portfolio already on the EBIT line. Therefore, given management's expectation of a valuation loss of EUR44m, which represents a c4.7% value adjustment of the total investment portfolio, we are cutting our EBIT estimate to –EUR30.2m (-164%). Changes in capital values are based on higher discount rates (equivalent yields), which also reflect the higher cost of debt and not lower estimated rental value.

PBT is impacted by revaluation losses on hedge instruments of EUR9m

Profit before tax is impacted by valuation losses of EUR44m from lower market values of interest hedge instruments that the company uses to hedge 90% of their debt position. After revaluation gains of EUR16.6m in Q2 08 and a revaluation loss of EUR8.5 in Q1 2008, the company now announced a further loss of EUR9m, which burdened the financial results.

Dividend estimate cut as result of expected negative EPS of –EUR2.40

Based on our new PAT forecast of –EUR54m, we are cutting our previous dividend estimate of EUR0.25/share to zero.

Besides non-cash items, top and bottom lines are hurt by lower-than-expected operating performance

Although the financials are mostly impacted by non-cash items (EUR53m valuation movement in total), the operating performance was also below the company's and our expectations. We are incorporating a more cautious outlook on the real estate market, not in terms of rental value, but rather on investment turnover, which mainly affects the asset management business.

Segment forecast

Colonia Real Estate: Forecast changes

		2008e	2009e	2010e
Investment	Old	41	48	52
	New	33	37	38.5
	Chg (%)	-12%	-21%	-27%
A&F	Old	4.5	6.2	6.8
	New	1.8	2.0	4.2
	Chg (%)	-57%	-42%	-38%

Source: HSBC estimates

Investment portfolio

Despite a significant increase in gross rental income in Q3 2008 to EUR16.6m (EUR14.1m in Q2 08), we are reducing our net rental income forecast to EUR32.8m (-12%) due to higher-than-expected property operating costs. As most modernization measures in the Hamburg and Aachen portfolio are completed, we expect a significant increase in 2009 NOI (+12 y-o-y) but in general on a level lower than primarily expected.

Asset & Funds Management (incl. privatisation)

The A&F segment once again couldn't generate a significant contribution to earnings. Based on the preliminary figures of net EUR0.9m (-422% y-o-y), we are reducing our outlook for 2008-2010. As we do not expect a fast rebound by the investment market, lower-than-expected transaction fees lead to our segment forecasts of EUR1.8m for 2008 and EUR2.0m for 2009.

Colonia starts cost-cutting program: Admin costs reduced by 53.5% q-o-q

Due to market concerns about the company's cost structure, we believe that management seems to perceive this problem. The management plan indicates a 50% reduction in total admin costs by end-2009, based on the 2007 number of EUR31m. The first results of the program are visible in the Q3 08 figures. According to management, admin costs have been reduced by 53.5% to EUR4.3m, compared to EUR9.1m in the previous quarter. We are incorporating that cost development by reducing our total admin estimate to EUR23.9m for 2008 and EUR17.5m for 2009. The cost savings imply a restructuring of the subsidiaries and reductions of external consulting expenses. In light of the significant reduction in AuM (canceled Oaktree mandate of EUR1.5bn) beginning in 2009, we believe that the restructuring measures will not worsen asset management quality. As result, the company intends to generate positive cash flow without trading profits and service fees. We appreciate that step by management, as we believe that a leaner corporate structure in light of the cautious market outlook is essential.

Comfortable debt maturities

Equity markets' major concerns in terms of German real estate companies include lower expected capital values, and in particular the financing situation. Colonia's debt structure looks comfortable to us in the current market environment. By incorporating the sold Marriott hotels on 12 November, the company has no short-term refinancing risk. The average duration of 6.7 years is financed with an average cost of debt of 4.8%. In terms of covenants, only two portfolios (Maximilian and Berlin) have LTV covenants of 80%. According to management, the actual LTVs amount to 65% and 69%, respectively. Furthermore, 90% of total debt is hedged via corresponding instruments.

Valuation

We value Colonia Real Estate using a DCF model based on adjusted cash flow from operations for discounting purposes (beta 1.175 provided by Bloomberg, WACC of 7.9%, and free cash flow growth 3.25%). Our DCF valuation generates a new fair value of EUR2, which we are setting as our new target price, down from EUR8. The decrease mainly reflects cuts in our segment forecasts, our more cautious outlook on capital values, and the low cash-generating business model.

On an NAV basis, Colonia trades at an 87% discount to our adjusted NAV of 14.5EUR (basic NAV of EUR12.3).

Under our research model, for stocks with a volatility indicator, the Neutral band is 10 percentage points above and below our hurdle rate for German stocks of 8.5%, or -1.5% to +18.5% around the current share price. Our new target price of EUR2 indicates a potential total return of 5.8%, which is within the Neutral band; therefore, we are downgrading our rating to Neutral (V) from Overweight (V).

Colonia Real Estate: Scenario analysis

Beta	Perpetuity growth rate		
	3.0%	3.25%	3.5%
0.95	4.3	5.6	7.1
1.00	3.5	4.7	6.1
1.10	2.0	3.1	4.3
1.18	1.0	2.0	3.1
1.20	0.7	1.6	2.7
1.25	0.1	1.0	2.0

Source: HSBC estimates

Risks

To the downside

- ▶ Stronger-than-expected decline in capital values, leading to higher yields
- ▶ Weaker-than-expected letting performance, which leads to higher vacancy rates and lower top line
- ▶ Slower-than-expected implementation of the cost-cutting program

To the upside

- ▶ A faster-than-expected rebound by the German real estate investment market
- ▶ Stronger-than-expected letting performance

Financials & valuation

Financial statements

Year to	12/2007a	12/2008e	12/2009e	12/2010e
Profit & loss summary (EURm)				
Revenue	47.6	62.0	63.0	63.5
EBITDA	22.8	13.8	23.5	25.8
Depreciation & amortisation	0.0	0.0	0.0	0.0
HSBC EBIT	22.8	13.8	23.5	25.8
Net interest	-29.8	-33.9	-20.8	-23.8
PBT	53.6	-64.1	-22.3	2.0
HSBC PBT	-7.0	-20.1	2.7	2.0
Taxation	13.6	10.1	3.5	-0.3
Net profit	67.2	-54.0	-18.8	1.7
HSBC net profit	6.6	-10.0	6.2	1.7
Cash flow summary (EURm)				
Cash flow from operations	22.8	13.8	23.5	25.8
Capex	0.0	-2.0	-2.0	-2.0
FCF enterprise	36.4	22.0	25.0	23.5
Dividends	-5.0	0.0	0.0	0.0
Change in net debt	434.7	110.5	-7.0	-4.0
FCF equity	6.6	-12.0	4.2	-0.3
Balance sheet summary (EURm)				
Tangible fixed assets	918.9	777.3	754.3	756.3
Current assets	115.0	222.0	218.0	221.0
Cash & others	26.2	22.0	18.0	21.0
Total assets	1060.2	1021.3	990.3	998.3
Gross debt	565.8	672.0	661.0	660.0
Net debt	539.5	650.0	643.0	639.0
Shareholders funds	320.8	277.3	264.3	266.3
Invested capital	918.9	777.3	754.3	756.3

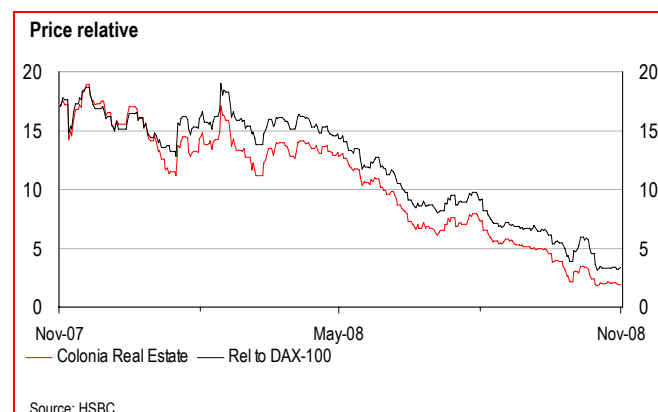
Ratio, growth and per share analysis

Year to	12/2007a	12/2008e	12/2009e	12/2010e
Y-o-y % change				
Revenue	132.2	30.2	1.7	0.8
EBITDA	156.2	-39.4	70.1	9.8
EBIT	156.2	-39.4	70.1	9.8
PBT	26.1	-219.6		
HSBC EPS		-251.0		-73.0
Ratios (%)				
Revenue/IC (x)	0.1	0.1	0.1	0.1
ROIC	4.5	1.4	2.6	2.9
ROE	3.1	-3.3	2.3	0.6
ROA	3.6	-2.8	-0.9	0.1
EBITDA margin	47.9	22.3	37.3	40.6
Operating profit margin	47.9	22.3	37.3	40.6
EBITDA/net interest (x)	0.8	0.4	1.1	1.1
Net debt/equity	168.2	234.4	243.3	240.0
Net debt/EBITDA (x)	23.7	47.0	27.4	24.8
CF from operations/net debt	4.2	2.1	3.7	4.0
Per share data (EUR)				
EPS reported (fully diluted)	2.99	-2.40	-0.84	0.07
HSBC EPS (fully diluted)	0.29	-0.44	0.28	0.07
DPS	0.25	0.00	0.00	0.00
NAV	16.12	12.34	11.76	11.85
NAV (adjusted)	16.68	14.52	13.95	14.03

Valuation data

Year to	12/2007a	12/2008e	12/2009e	12/2010e
Premium/ (discount) to NAV	0.1	0.2	0.2	0.2
Premium/ (discount) to NAV (adj)	0.1	0.1	0.1	0.1
FCF yield (%)	15.3	-27.7	9.8	-0.7
Dividend yield (%)	13.2	0.0	0.0	0.0

Note: * = Based on HSBC EPS (fully diluted)



Note: price at close of 12 Nov 2008

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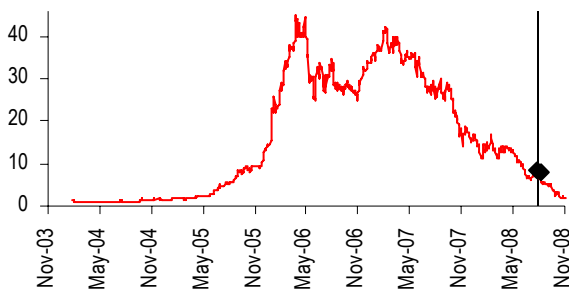
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Share price and rating changes for long-term investment opportunities

Colonia Real Estate (KBUG.DE) Share Price performance EUR Vs HSBC

rating history



Source: HSBC

Recommendation & price target history

From	To	Date
N/A	Overweight (V)	06 August 2008
Target Price	Value	Date
Price 1	8.50	06 August 2008
Price 2	8.00	18 August 2008

Source: HSBC

HSBC & Analyst disclosures

Disclosure checklist

Company	Ticker	Recent price	Price Date	Disclosure
COLONIA REAL ESTATE	KBUG.DE	1.89	12-Nov-2008	6, 11

Source: HSBC

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Issuer of report

HSBC Trinkaus & Burkhardt AG

Königsallee 21/23

D-40212 Düsseldorf

Germany

Telephone: +49 211 910-0

Fax: +49 211 910 33 20

Website: www.research.hsbc.com

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