EDISON **Scale research report - Update**

Noratis

Real estate

10 October 2019

Long-term commitment, short-term focus

After significant portfolio expansion in H218 (which is now contributing to rental income), H119 saw several notable and profitable disposals. With EBIT at €8.8m and PBT at €6.9m in the period, Noratis is halfway through its FY19 targets (EBIT and PBT stable vs FY18 and FY17), which it reaffirmed recently. The company continued to expand its portfolio post period-end, which supports its long-term growth prospects based on a typical two-year lead time for asset value enhancement. The dividend remains attractive, with a FY19e yield of 6.2%.

Solid H119 figures underpin full-year guidance

EBIT was €8.8m and PBT stood at €6.9m in H119, up by 76% and 82% on an adjusted basis, respectively. Growth was driven by a €2.4m rise in disposal gains as well as a €1.8m increase in rental income amid significant portfolio expansion in H218, fuelled by proceeds from the €15.3m capital increase completed in May 2018. H119 sales more than doubled to €47.7m from a low H118 base, although at the expense of gross margin, which declined to 20% from an exceptionally high 34% in H118 (although in line with management guidance). Noratis has reiterated its FY19 forecast for stable EBIT and PBT compared with FY17 and FY18, which suggests similar sales to H119.

Building mass

Noratis's intention is to remain a net buyer and increase the proportion of rental income in gross profit over time. Even though its portfolio size remained broadly unchanged at 1,791 units at end H119 vs 1,778 units at end FY18, the company has increased its acquisition activity since end June 2019, potentially adding 365 units to the portfolio (our estimate is based on company releases including deals announced but not yet completed). Growth potential remains considerable, given continued solid fundamentals in the German residential market and the significant market opportunity in Noratis's target segment of older housing stock.

Valuation: Dividend yield appeal

Noratis's position between asset holder and developer makes for a difficult comparison with listed peers, but its P/E ratio is at a c 29% discount to RCM Beteiligungs, which has a similar model (trailing 11.2x). The company offers an attractive dividend yield of more than 6% vs c 3% for large German residential asset holders.

Consensus estimates

Year end	Revenue (€m)	EBIT (€m)	EPS* (€)	DPS (€)	P/E (x)	Yield (%)
12/17	68	15.2**	3.0	1.5	6.8	7.3
12/18	56.1	15.6***	2.6	1.3	7.9	6.3
12/19e	74.4	16.7	2.5	1.3	8.3	6.2
12/20e	80.6	17.9	2.6	1.3	7.8	6.3

Source: Noratis accounts, Refinitiv consensus estimates. Note: *Based on 2.9m shares in 2017 and 3.6m shares in 2018. **Includes €1.5m IPO costs. ***Includes €0.8m capital increase costs and €0.5m reversal of a rental guarantee provision.

Price	€20.5
Market cap	€74m

Share price graph

Share details

Code	NUVA
Listing	Deutsche Börse Scale
Shares in issue	3.6m
Last reported net debt at 30 June 2019	€115.7m

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 Noratis exploits during well-structured asset sales, either through individual or block sales.

Bull

- Strong experience operating in Germany's non-core areas.
- Focused investment and asset management approach to boost yields and asset values.
- Established business concept and strong partner network across Germany.

Bear

- Smaller company in a very competitive market.
- Low interest rate environment may end.
- Dependence on attractive portfolio opportunities.

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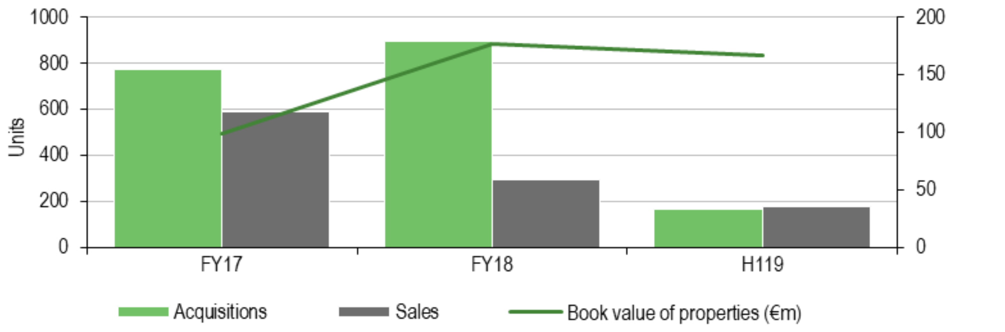
Disposal gains and rental profit lift H119 results

Operating results in H119 were driven by both a €2.4m y-o-y increase in disposal gains and a €1.8m rise in rental profit. After the shortfall in H118 results, largely linked to the timing of transactions, revenues more than doubled y-o-y to €47.7m, assisted by higher proceeds from real estate sales (€41.8m vs €17.5m in H118). The company sold 177 units in H119 (vs 133 in H118), including two block sales to institutional investors (60 units in Frankfurt and 100 units in Trier), as well as two smaller disposals. Moreover, rental income increased 79% y-o-y to €5.9m, following the solid portfolio expansion in H218 as it grew to 1,778 units from 1,404 at end June 2018. Notably, Noratis completed the acquisition of 164 units in H119 (vs 345 in H118), including Freital near Dresden (93 units, of which 40 were commercial units, mainly assisted living), Neu-Isenburg (35) and Kassel (36). As a result, portfolio size in terms of units remained broadly stable vs end 2018, when the company held 1,778 representing a rental space at 123k sqm. The book value of properties at end June 2019 stood at €166.3m vs €176.7m at end 2018.

Exhibit 1: Portfolio development



Source: Noratis accounts, Edison Investment Research

Gross profit margin on asset sales decreased to 20% from 34% in H118, in line with the company's FY19 forecast, which assumes y-o-y growth in revenues coupled with normalisation of gross profit. We understand the decline is associated with particularly favourable price levels in FY18 and FY17 on the back of exceptionally strong market conditions. Hence, H119 is close to the level that management expects under normal market conditions. It is worth noting that the 36% gross margin on asset sales in FY18 compares with 29% in FY17 and 24% in FY16.

On an adjusted basis, EBIT increased to €8.8m from €5.0m in H118, with the latter figure being adjusted for a €0.8m cost of capital increase completed in May 2018 and a €0.5m non-recurring reversal of rental guarantee provision. Net interest expense was up 58% y-o-y to €1.9m in H119, driven by a rise in liabilities to banks at €127.5m from €80.4m at end June 2018 amid the portfolio expansion in H218. Consequently, adjusted pre-tax profit was €6.9m vs €3.8m in H118.

Noratis has reiterated its FY19 forecasts and expects that both EBIT and PBT will remain at a level comparable with FY18 and FY17. This means it is roughly halfway through its targets for FY19 (see Exhibit 2 below). We note that rental income contribution to gross profit has increased after the portfolio expansion (it accounted for 29% in H119 vs 22% on average between FY16 and FY18), but asset sales remain a significant driver for Noratis's bottom line. We understand that management has a positive outlook for transaction activity in the remaining part of FY19 and acknowledge that historically the timing of transactions has been an important factor for Noratis's financial results.

Exhibit 2: Financial performance						
€m, HGB	H119	H118	Change y-o-y	H117	FY18	FY17
Revenue						
Asset sales	41.8	17.5	139%	30.4	48.2	61.9
Rental	5.9	3.3	79%	2.7	7.9	6.1
Total	47.7	20.8	129%	33.1	56.1	68.0
Gross profit						
Asset sales	8.4	6.0	40%	8.5	17.3	17.7
Margin	20%	34%	(1,400bp)	28%	36%	29%
Rental	3.5	1.7	106%	1.5	4.3	3.8
Total	11.9	7.7	55%	10.0	21.7	21.5
EBIT - reported	**8.8**	**4.7**	**87%**	**8.4**	**15.6**	**16.7**
Exceptional items:						
IPO/capital increase costs	-	(0.8)	N/A	(1.5)	(0.8)	(1.5)
Reversal of a rental guarantee provision	-	0.5	N/A	-	0.5	-
EBIT - adjusted	**8.8**	**5.0**	**76%**	**9.9**	**15.9**	**18.2**
Net interest expense	(1.9)	(1.2)	58%	(1.5)	(2.8)	(3.0)
Pre-tax profit - reported	**6.9**	**3.5**	**97%**	**5.4**	**12.8**	**12.2**
Pre-tax profit - adjusted	**6.9**	**3.8**	**82%**	**8.4**	**13.1**	**15.2**
Net profit - reported	5.0	2.6	92%	3.3	9.3	8.7
EPS (€) - reported	**1.39**	**0.71**	**96%**	**1.14**	**2.57**	**2.97**

Source: Noratis accounts, Edison Investment Research

Net debt declined to €115.7m at end June 2019 from €145.4m at end 2018, triggered by a €21.6m reduction in bank liabilities to €127.5m following asset sales. Moreover, cash increased to €16.9m at end June 2019 from €7.9m at end 2018 as the company received payment for a property sold in December 2018. Loan to value at property level (expressed as bank borrowings to carrying amount of properties) decreased to 77% at end H119 from 84% at end FY18. At the holding level, the ratio of net debt to total assets improved to 61% from 68% at end FY18.

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 may be exacerbated by Noratis's preparation of accounts under HGB standards. Unlike IFRS, HGB does not use mark-to-market valuations or annual impairments. This implies 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. Under IFRS, these value increases would be recognised as profits and then typically seen in equity. Having said that, 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). We also understand that the company prefers to fund its portfolio expansion with bank borrowings, but may also consider other funding options, including the issue of an unsecured bond, as indicated by management in May 2019.

Portfolio expansion continues

Noratis has consistently grown its portfolio in recent months. In addition to acquisitions closed in H119 (see above), it purchased a fully let property with 111 apartments in Steinfurt (North Rhine-Westphalia), along with 21 residential and four commercial units in Frankfurt in June 2019. Noratis expects these to close in Q319.

After the reporting date, Noratis executed two notable transactions. It acquired 65 apartments in Celle in July 2019 (expected to close in Q419), which expanded its portfolio in this Lower Saxony city to 303 units. The deal followed the purchase of 150 flats and 100 parking spaces in Neu-Isenburg from Alpha Real Estate Group. We note that the properties in Celle and Neu-Isenburg meet Noratis's usual acquisition requirements, ie older buildings (mainly from the 1960s) with value potential on modernisation and reduction of the 5% vacancy rate. It also added eight residential units to its Frankfurt portfolio, which has increased to more than 600 apartments. Noratis announced the optimisation of group structures in August 2019, including integrating the purchasing and sales departments, personnel changes and team expansion, which it believes will improve the efficiency of its value chain and support further growth.

Long-term fundamentals in the residential market in Germany are strong, as it is still experiencing supply shortages and a declining number of building permits due to land deficit. Having said that, Savills estimates that transaction volumes on the residential market in Germany have declined by 6.3% y-o-y in the last 12 months ending September 2019 to c €16.3bn. According to Savills, this was due to regulatory uncertainties partially offset by price increases (in large cities in particular), a few large transactions and public sector activity, which accounted for 20% of transaction volumes in the period. Regulatory actions include the rental cap introduced in Berlin to limit the pace of growth in rents, as well as ongoing discussions in Berlin's senate to freeze rents for five years and enable tenants to apply for rent decreases if net rent exceeds 30% of household income. It is important to note that Noratis has no exposure to Berlin and its portfolio is largely focused on secondary locations (albeit in the peripheral regions of metropolitan cities, eg Frankfurt), which makes it more resilient in the face of the above regulatory actions. In addition, Noratis's management believes that the market segment it targets (secondary cities) demonstrates lower volatility and higher returns than prime locations. We acknowledge that the market opportunity for Noratis is significant as its primary acquisition targets are older buildings, which account for c 60% of housing stock in Germany (properties built in the period 1919–86), according to the Federal Statistical Office.

Valuation

Noratis's position between asset holder and developer makes for a difficult comparison with listed companies, but we believe RCM Beteiligungs (RCM) is the closest peer as it has a similar model. Noratis currently trades at a 2018 P/E of 8.0x and P/NAV of 1.5x, implying a 29% discount and a 29% premium to RCM, respectively. Noratis paid a dividend per share of €1.3 from 2018 earnings (in line with its dividend policy to distribute c 50% of the net income), which represents a yield of 6.3% vs 3.0% for RCM.

Although Noratis's business model is clearly different to German residential asset holders (which at the same time are larger players mainly focused on prime locations), we nevertheless think it is helpful to present a multiples comparison with these companies. This is justified by the increasing share of rental income in Noratis's revenues (which is one of management's strategic goals). However, we note that Noratis recognises its real estate portfolio under current assets, while its peers book it under investment property (under IFRS) and revalue it regularly. Based on last reported NAV per share, Noratis is trading at a P/NAV ratio of 1.5x, which represents a 49% premium to the peer group. Based on FY19e EV/EBITDA and P/E ratios, it trades at 54% and 45% discounts to peers, respectively. It also offers a dividend yield which is above the peer average (c 6.2% vs c 3.0%).

Exhibit 3: Peer comparison

	Market cap (€m)	P/NAV (x) (last reported)	P/E (x) 2019e	P/E (x) 2020e	EV/EBITDA (x) 2019e	EV/EBITDA (x) 2020e	Dividend yield (%) 2019e	Dividend yield (%) 2020e
Adler Real Estate	790	0.47	5.4	7.1	24.0	26.2	0.0%	0.0%
TAG Immobilien	3,146	1.45	7.6	10.3	24.9	24.0	3.8%	4.0%
LEG Immobilien	6,591	1.32	20.2	19.2	26.0	24.6	3.6%	3.8%
Deutsche Wohnen	12,234	1.01	23.4	22.7	28.9	29.1	2.8%	2.9%
Grand City Properties	3,428	0.73	18.6	16.9	20.8	19.6	4.1%	4.3%
Peer group average	**-**	**0.99**	**15.1**	**15.2**	**24.9**	**24.7**	**2.9%**	**3.0%**
Noratis	73.84	1.48	8.3	7.8	11.4	10.6	6.2%	6.3%
Premium/(discount)	**-**	**49%**	**(45%)**	**(49%)**	**(54%)**	**(57%)**	**-**	**-**

Source: Edison Investment Research, Refinitiv consensus as at 4 October 2019

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