FCR Immobilien

High-growth German property investor

Full coverage initiation

Real estate

FCR Immobilien (FCR) invests mainly in retail property, targeting total returns derived from recurring rental income and capital gains. The company seeks to acquire properties at attractive prices and actively manages the assets to improve income, by reducing voids and increasing rent levels and capital values with minimal or no capex. A key element of FCR's strategy is to sell properties where asset management plans are mature, with capital recycled into new opportunities. Consequently, gains on disposal are a significant element of returns, with historical average gross IRR at project level of c 25%. High leverage is part of its strategy, with net debt to total assets at 79% at end-June 2019.

Year end	FFO1* (€m)	FFO2** (€m)	P/FFO2 (x)	NAV/share*** (€)	P/NAV (x)	Dividend yield (%)
12/17	(1.4)	2.2	39.0	7.50	1.4	1.2
12/18	0.1	4.1	21.1	10.11	1.0	1.7
12/19e	0.3	9.1	9.8	11.10	0.9	2.7
12/20e	1.1	12.2	7.6	12.41	0.8	5.5

Note: *Funds from operations – defined as net profit before depreciation and amortisation (D&A) and excluding post-tax disposal gains. **Net profit before D&A. ***EPRA NAV per share. All per share figures adjusted for the issue of bonus shares conducted in 2019.

Active in a niche with limited competition

FCR is well positioned within its market niche outside of major German cities with a primary focus on retail properties, in particular shopping centres and specialty retailers. It is an experienced player in a largely semi-professional market (although with some close competitors, such as Deutsche Konsum REIT and Defama). While Germany is facing a period of economic slowdown, FCR's high exposure to tenants from defensive sectors (most notably food retailers, making up nearly 40% of FCR's net rental revenue) should provide stability. Similarly, the fierce competition from online retailers should have limited impact on FCR given its emphasis on neighbourhood stores offering products that are rarely purchased online.

Low interest rates assist FCR's exit valuations

Apart from generating enhanced rental income from acquired properties, FCR's strategy implies ongoing portfolio rotation to exit properties where its asset management initiatives have been completed. This has allowed the company to achieve strong disposal gains in recent years, assisted by favourable property prices (ie low capitalisation yields) amid the ECB's persistent monetary easing, which also provided FCR with relatively cheap debt funding. These factors will continue to determine FCR's disposal gains. This is especially important, given that its EBITDA excluding gains on property sales is below its interest expenses on a last 12-month basis as at end-June 2019 (and thus its FFO1 was negative).

Valuation: Trading at a discount on P/NAV ratio

FCR trades at a P/NAV ratio of 0.98x based on the company's EPRA NAV at end-October 2019, which represents an 11% discount to its peer group. Based on our scenario for FCR's property acquisitions and disposals, we see potential for its NAV to increase to c €12.4 per share at end-2020.

21 November 2019

Price	**€10.20**
Market cap	**€93m**

Net debt (€m) at end-June 2019	159.3
Shares in issue	9.1m
Free float	23%
Code	FC9
Primary exchange	Frankfurt
Secondary exchange	Munich

Share price performance

%	1m	3m	12m
Abs	2.6	(0.5)	7.4
Rel (local)	(1.5)	(11.9)	(9.7)
52-week high/low		€10.5	€8.3

Business description

FCR Immobilien is a German real estate investor primarily focused on small and mid-sized properties in tier two domestic locations. It looks for special situations translating into bargain purchases. Subsequent measures are aimed at improving rental income generation.

Next events

Deutsches Eigenkapitalforum	November 2019

Analyst

Milosz Papst +44 (0)20 3077 5700

financials@edisongroup.com

Edison profile page

FCR Immobilien is a research client of Edison Investment Research Limited

Investment summary

Company description: Active investor in German niche property

FCR Immobilien (FCR) is a real estate investor in German tier-2 and tier-3 cities, with a particular emphasis on retail properties, focusing on investments between €1m and €70m for individual properties. This represents an interesting market niche, which is beyond the financial capacity of retail investors, while rarely being on the radar of large institutional investors. FCR follows an opportunistic approach, acquiring properties at bargain prices from distressed owners and subsequently enhancing their rental generation potential through occupancy rate improvement and lease terms/tenant mix optimisation. The company's strategy is based on regular portfolio rotation (expected at c 20% pa in the long run), allowing it to realise hidden valuation reserves upon property disposal (its historical realised average gross IRR at c 25%). FCR has grown its property portfolio rapidly over recent years, as illustrated by its EPRA NAV increase from €26.7m in 2016 to €94.9m at end-October 2019 (based on company estimates).

Valuation: NAVPS of over €10.0 implying a discount to peers

We have decided to examine the capitalisation yield (cap yield) implied by the EPRA NAV estimate of €92.9m as at end-June 2019 provided by FCR. Consequently, we have arrived at a weighted average cap yield at 6.1%, which we believe is broadly in line with valuations in the German property markets (as illustrated by a similar yield applied by an external appraiser to the portfolio of FCR's close peer Deutsche Konsum REIT). The company's last reported NAV implies a minor upside potential of c 2% to the current share price. Having said that, FCR is currently traded at a P/NAV ratio of 0.98x, which represents a 11% discount to the peer average. This may be at least partially explained by the fact that FCR's portfolio includes a number of companies where its asset management measures have not been implemented yet. On the other hand, its current NAV does not capture the upside associated with the fact that FCR is a total return play pursuing a strategy of ongoing portfolio rotation. Based on our scenario for FCR's property acquisitions and disposals, we see potential for its NAV to rise to c €12.4 per share at end-2020.

Financials: Driven by both rental income and disposal gains

FCR was able to significantly increase the net rental revenue generated on its property portfolio from €3.1m in 2015 to €15.9m in 2018 and €9.6m in H119. The company's portfolio represents an annualised net rental revenue of c €18.0m. Meanwhile, FCR has also realised considerable disposal gains, which in FY18 amounted to €5.2m (on nine property disposals) and €10.3m in H119 (by selling three properties). Given that the company's portfolio includes a number of properties acquired before 2018 that are now characterised by high rental yields (of at least 15% pa), FCR may continue to report healthy disposal gains in the medium term assuming the favourable market conditions remain intact. Our scenario analysis suggests that under the above assumption, the company may deliver a NAV total return (TR) between 2018 and 2021 at around 13% pa. We believe that FCR is likely to sustain its relatively high leverage level and expect net debt to total assets ratios at the end of FY19 and FY20 of 78% and 81%, respectively (compared to 79% at end-June 2019).

Sensitivities: Growth path, cap yields and cost of debt

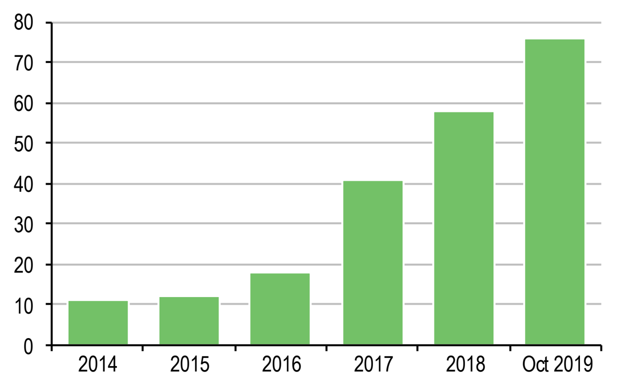
Our forecasts for FCR are dependent on a set of assumptions, such as the number, size and rental income of properties acquired and sold, capitalisation yields prevailing in the German property markets (in particular tier-2 and tier-3 retail markets) determining property prices, as well as the cost of FCR's property-level and holding-level debt. The latter is particularly important given FCR's targeted leverage at property level of 70–80%, which is then further geared up through bond issues at holding level. We also note that property markets in Germany may become affected by the broader economic slowdown unfolding at present. Some additional risk factors include its narrow sector focus, high tenant concentration and key personnel risk (ie dependency on its founder and CEO Falk Raudies, who at the same time is the only management board member).

Company description: Focus on bargain purchases

FCR Immobilien (FCR) is a real estate company headquartered in Munich and focused on retail properties, such as shopping centres, supermarkets, discount stores and specialist stores (c 83% of portfolio at present as measured by current rental revenue as at August 2019), with some presence in hotel, logistics/industrial, residential and office segments. It targets small and medium-sized properties in tier two locations in Germany that have a population of at least 5,000. FCR's preferred investment is between €1m and €70m, although the company may conduct investments up to €100m in case of particularly compelling opportunities. The current holding structure is skewed towards the lower end of this spectrum as book value per property currently stands at c €3m. The company considers this transaction range a niche market, which is beyond the reach of individual investors, but at the same time too small for institutional players. Having said that, there are a number of competitors in this segment, such as Deutsche Konsum REIT and Defama. FCR's activities cover the entire value creation chain, including bargain property acquisitions, asset management (though usually without any renovation activity) and profitable divestment (but excluding facility management activities).

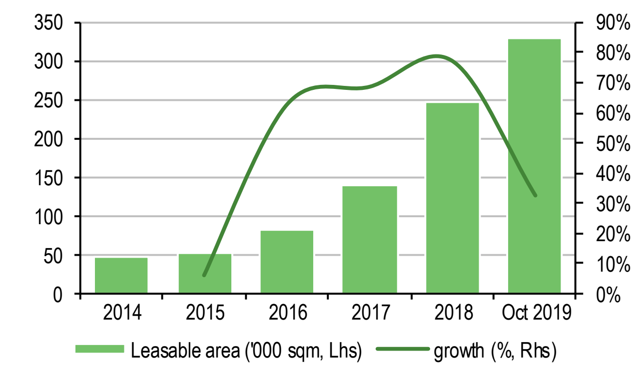
The company was able to expand its portfolio considerably over the last few years, with the number of properties increasing from 11 at end 2014 to 76 as at October 2019 (with further properties acquired since then). These represented a leasable floorspace of around 329,000sqm (compared with 48,000sqm at end 2014, see Exhibit 2).

Exhibit 1: Number of properties in FCR's portfolio



Source: FCR Immobilien

Exhibit 2: Total leasable area in FCR's portfolio



Source: FCR Immobilien

An opportunistic approach to deal origination

FCR uses its broad origination network to identify distressed entities willing to sell their properties at attractively low prices. The network includes semi-institutional and institutional buyers and sellers (such as family offices, banks, insurance companies, real estate companies, intermediaries, asset management companies), as well as affluent individual investors. Initially, the company funds the acquisition with equity in order to facilitate a quick time-to-market. As FCR operates primarily in the asset management business rather than real estate development (despite conducting selected projects in this area as well), it is essential to the acquisition process that the distressed conditions are attributable to the seller while the property does not require extensive redevelopment. In particular, it is interested in properties with a low weighted average unexpired lease term (WAULT) in order to renew the rental contracts on improved terms, but also other value-add and special situations. The company conducts an extensive due diligence of the property coupled with the preparation of a utilisation concept. Even though the company may become involved in redevelopment works if required, the main efforts within the asset management activities are related to optimisation of tenant structure, as well as lease length and other lease terms.

As FCR's ability to spot undervalued properties represents the key factor in the company's asset picking process, FCR's current and prospective portfolio split across real estate market segments is dependent on the availability of attractive opportunities rather than predefined sector exposure ranges or limits. We believe that the company's skew towards the retail sector may also be a function of the higher availability of lower-volume transactions in this segment in comparison to the office real estate market. However, as FCR's portfolio grows, the size of some of its transactions may be higher as well, as illustrated for instance by the shopping centre SchlossGalerie in Rastatt, FCR's largest acquisition so far (closed in autumn 2018) with around 21.7k sqm of leasable space.

FCR's focus on opportunistic purchases allows the company to achieve superior rental yields, with the weighted average net rental yield based on the properties' acquisition value (after subsequent depreciation) and current rental revenue at portfolio level at 9.5% as at end-June 2019. Based on recent transactions, we believe that the company is currently able to source deals at an initial yield of c 8–10% (compared to its target above 10% revised from 12% earlier). The occupancy rate at the end of June 2019 stood at 86%, implying potential to reach an 11.2% yield on a fully let basis (10.6% based on portfolio at end-October 2019). At the same time, we note that the properties acquired in H219 were already fully occupied.

Profitable disposals an inherent part of FCR's strategy

The company's business model generally assumes an investment horizon of three to seven years, but FCR conducts asset disposals only when it is able to generate an attractive IRR. The proceeds are subsequently recycled into new investment opportunities with asset management potential. Basically, as this means exchanging a well-performing property against an asset that is performing below its potential, there is a certain transaction risk embedded in this approach. The above indicative holding period implies an annual portfolio rotation of c 20%. However, given the high number of acquisitions completed in 2017 (28 properties) and 2018 (26 properties), we believe that FCR's portfolio rotation in the near term is likely to stand at around 10–15% pa, which would translate into about five to 15 disposals per year. Since 2014, FCR has acquired 98 properties and sold 22 projects. Consequently, it should be considered a total return play (dependent on the timing and return generated on property disposals) rather than a pure income play.

Exploring opportunities outside of German retail as well

The company's strategy involves increasing market penetration in the German retail real estate segment, but also selective rental-oriented expansion of the business model into the hotel, residential, office and logistics segments. Apart from Germany, FCR is also aiming to explore other markets, such as Austria, Italy and Spain. In fact, the company already owns certain assets outside Germany (representing around c 5% of its net rental revenue), such as the Il Pelagone Hotel and Golf Resort in Italy. In its October 2019 investor presentation, FCR highlighted that it is currently in the process of acquiring 18 properties, constituting an investment volume at around €50m. We understand that FCR's property sourcing abilities are based on the contact network of Falk Raudies (the company founder and CEO), backed by a team of asset managers.

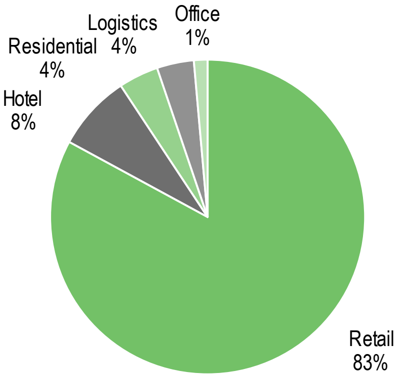
Portfolio overview: >80% exposure to German retail

As at end-August 2019, the company's portfolio consisted of 71 properties with a 324k sqm total leasable area and a book value of c €191m, according to company data. FCR invests mainly in properties available on the secondary market, and the age structure of its portfolio is dominated by assets build in the 1990s or earlier (c 64% of portfolio as measured by leasable floorspace at end-August 2019). Despite this, FCR prefers to keep capital expenditure low, and concentrate on improving the occupancy rate and tenant structure in the acquired properties. Of the 71 properties held by FCR at end-August 2019, around 50 were fully let (representing 56% of the total lettable area). At a c 86% occupancy rate, the portfolio generated annualised net rent income of €17.1m, with potential to reach €19.9m at full occupancy according to the company. This has increased to €18.0m and €20.7m at end-October 2019, respectively.

The company's high emphasis on retail properties is illustrated by their c 83% share in FCR's portfolio (as measured by current net rental revenue), with hotel contributing 7.8%, residential 4.1% and logistics 3.8% (see Exhibit 3). We note that this split excludes FCR's development properties.

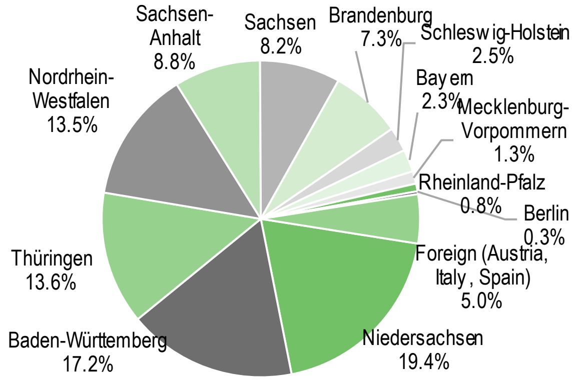
FCR's portfolio includes assets spread across the majority of German regions (ie 12 out of 16). However, in terms of net rental revenue (as at end-August 2019), nearly 64% of the portfolio is generated in four regions, including Niedersachsen (19.4%), Baden-Württemberg (17.2% from the shopping centre in Rastatt), Thüringen (13.6%) and Nordrhein-Westfalen (13.5%, see Exhibit 4).

Exhibit 3: FCR's portfolio structure by segment



Source: FCR Immobilien. Note: Split as measured by net rental revenue at end-August 2019. Excludes the recently acquired 409 sqm property in Hagen and the 1,000 sqm property in Aschersleben.

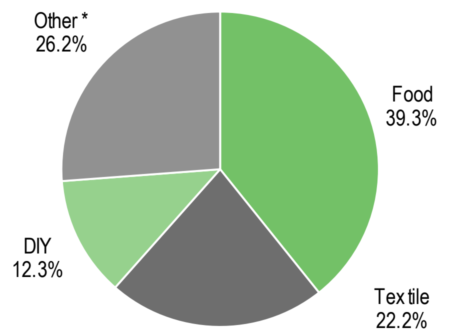
Exhibit 4: FCR's portfolio structure by region



Source: FCR Immobilien. Note: Split as measured by net rental revenue at end-August 2019. Excludes the recently acquired 409 sqm property in Hagen and the 1,000 sqm property in Aschersleben.

Nearly 40% of the retail segment represents net rental revenue from food retailers (such as EDEKA, Lidl or HIT). However, a certain proportion of the multi-retailer sale (categorised as 'other' in Exhibit 5) is also attributable to food products. The second largest tenant group is the textile retail business (c 22%), with a significant part of the rental revenue coming from discount retailers (eg KiKa, Takko). This suggests that the majority of FCR's rental revenue is attributable to non-cyclical tenants, which, at the same time, are not being meaningfully affected by the ongoing shift to online shopping. Moreover, most properties in FCR's portfolio are positioned as neighbourhood stores, which should experience limited impact from online shopping. It is worth noting that FCR has a relatively concentrated tenant base, though key tenants represent large stable retail store chains such as EDEKA, Netto, Jawoll or OBI, with which FCR has longstanding relationships across multiple properties. The company highlights that the top three tenants currently represent around 25–30% of rental revenue.

Exhibit 5: Rental structure of FCR's retail portfolio by subsector as at end-August 2019



Source: FCR Immobilien. Note: *Other includes, among others, medical practices and fitness centres.

Market overview: Retail spending holding up well

In our opinion, when examining external factors influencing the German retail property markets, it is worth looking at general macroeconomic conditions in Germany, European Central Bank (ECB) monetary policy as well as the trend towards online shopping.

Private consumption robust despite industrial slowdown

Following a period of relatively solid growth in recent years, the macroeconomic environment has deteriorated, with GDP growth at 0.4% y-o-y in Q219 (down from 0.9% y-o-y in Q119), according to Eurostat. This reflects a visible slowdown in the export-driven industrial sector (which has most likely entered a recession). Germany's leading economic research institutes (joint forecast prepared by DIW, Ifo Institute, IfW, IWH and RWI) now expect German GDP to grow by only 0.5% in 2019 and 1.1% in 2020. Having said that, private consumption remains solid, assisted by a low unemployment rate, which should decline to 5.0% in 2019 (down from the 5.2% recorded in 2018). We believe that this should be supportive for retail-oriented FCR, whose business is relatively defensive given its high exposure to food retail as well as discount stores (see above).

Online shopping is having limited impact on FCR

The retail property sector is shaped by the ongoing trend towards online shopping, which is affecting both letting volumes and its structure. E-commerce sales in Germany are growing at a low-double-digit pace and according to the German E-Commerce and Distance Selling Trade Association (Bevh), more than an eighth of total retail industry turnover has been generated online. This illustrates the continued pressure on traditional retailers, especially clothing retailers that are moving their interest away from central locations towards outlet stores located either on the city outskirts or in secondary locations. While part of the vacant space that was previously occupied by clothing retailers is filled by the restaurant/food sector, the restrained demand puts downward pressure on rental levels. According to JLL, this has been particularly pronounced in smaller cities with a population below 100,000 (a 9% rental decline over the last five years) and between 100,000 and 250,000 (a five-year decrease of around 8%). Having said that, we acknowledge that FCR's focus on neighbourhood stores offering products that are unlikely to be purchased online means that the company should remain largely shielded from this market trend.

Stronger investment volumes in Q319 assisted by large deals

After a more muted H119, transactional activity in the broader German real estate investment market rebounded in Q319, with 9M19 volumes reaching €57.3bn (up 1% y-o-y), according to JLL.

Having said that, Savills' data indicates that 12-month rolling transaction volumes as at end-November 2019 across B and C/D cities fell by 5% and 10% y-o-y, respectively. This represents a risk for FCR, as it may potentially reduce the number of property disposals and result in lower disposal gains in the short term. On the other hand, the continued accommodative monetary policy of major central banks is encouraging further investment in real assets (including in particular real estate) as attractive fixed-income investment alternatives remain scarce. As a result, retail prime yields in Germany's top seven cities remained largely stable at around 3.9% for specialist retailers and 4.3% for shopping centres, according to Savills' Q319 Market in Minutes German investment market overview. JLL expects yields to remain stable in H219 across the commercial property markets in the 10 largest cities.

In terms of credit availability, it is interesting to note that according to JLL, bank lending at higher Loan-to-Values (LTVs), ie in excess of 65% for senior investment loans or more than 70% for senior development loans is currently more difficult to obtain. Also, lending margins have risen for the majority of real estate segments compared to last year.

Management

FCR has a two-tier board structure, where the management board sits beneath the (non-executive) supervisory board. The sole member of the management board and FCR's CEO is the company founder Falk Raudies. He has more than 20 years of professional experience, with an extensive background in real estate valuation and transactions. In the past, he also served as a managing director and board member of Alldis Computer and Rhinos Energy Drink & Food. Since 2009, Falk Raudies has been the owner (95% stake) of RAT Asset & Trading, the majority shareholder of FCR.

The supervisory board is composed of three members:

- **Professor Dr Franz-Joseph Busse**, who has served as portfolio manager and supervisory board member in several German investment funds. He has also been a lecturer at the University of Applied Sciences in Munich since 1982.
- **Professor Dr Kurt Faltlhauser**, who is a member of the Bavarian government, initially as Secretary of State and Head of the State Chancellery, and later as Minister of Finance. He is a long-time member of the Bavarian Landtag and a Bundestag member (as Parliamentary State Secretary at the Federal Ministry of Finance).
- **Frank Fleschenberg** joined the supervisory board in 2014. His previous experience comes from managing football teams in Germany, as well as his own real estate and financial services company. Since 2006 he has been a management board member of Deutsche Gesellschaft für Grundbesitz in Leipzig.

Sensitivities

Based on our examination of FCR's business profile, as well as the current real estate market environment, we have identified a number of sensitivities:

- High leverage level: as discussed in the financials section, FCR targets an LTV ratio of 70–80% at individual property level, which is further leveraged through bond issuances at group level. Consequently, FCR's net debt to capital level (84% at end-2018 and 79% at end-June 2019) is relatively high in comparison to the market average (which we believe is closer to 50% for major listed peers). This leaves a relatively small safety margin in the event of adverse changes in property values (driven by yield expansion, decline in occupancy rates or lower rental levels), potentially leading to a breach of debt covenants. However, the current reported gearing level does not take into account regular property revaluations, which may have a positive or negative impact depending on the economic cycle. It also does not reflect the positive impact of FCR's asset management initiatives (in particular, the increased occupancy rate) on the valuation of individual properties. As a result, the book value of FCR's investment properties after successful implementation of improvement measures would be understated (which would imply elevated LTV levels for successful properties). If the current fair values of FCR's properties (based on the company's reported EPRA NAV) were pencilled in, the ratio would stand at c 62% at end-June 2019.

- Narrow sector focus: although the company's investment strategy entails potential exposure to five different segments of the real estate market, the retail sector represents more than 80% of the lettable area within FCR's portfolio. Moreover, the company invests almost exclusively in Germany (c 95% of portfolio at end-August 2019). This makes it particularly susceptible to any major negative developments in the German retail real estate sector. This includes the potential adverse impact of the ongoing trend towards online shopping, in particular for non-food sectors.
- High tenant concentration (the top three represent c 25–30%) may potentially translate into stronger bargaining power on the part of key tenants, although it may also turn out to be a solid foundation for building stronger relationships with these clients. It definitely makes FCR more sensitive to any major change in these clients' strategies with respect to their store network.
- Key personnel risk: FCR's operations are largely dependent on the expertise and investment decisions of Falk Raudies, the sole member of the management board and FCR's majority shareholder (68.3% stake after the recent share issue in September) through his investment vehicle RAT Asset & Trading (in which he holds a 95% stake).
- Exposure to less liquid markets: FCR focuses on smaller properties in secondary markets characterised by lower liquidity, which might translate into depressed prices in the event FCR is forced to sell selected projects quickly (eg due to financial liquidity issues or a breach of covenant). On the other hand, this may generate opportunities to buy properties at attractive price levels when the seller is under pressure (which is in fact part of the company's investment approach).
- Rapidly increasing scope of operations: the strong growth that the company is currently experiencing may pose challenges from an organisational perspective and may require team expansion and the introduction of new management measures. On the other hand, a successful expansion would improve economies of scale and potentially also improve FCR's EBITDA margins.
- Written form requirement: FCR normally enters into long-term, but not indefinite rental contracts. The fixed-term contracts are regulated by Article 550 of the German Civil Code, according to which a contract is considered indefinite if it was not prepared in a written form for more than a year. There is a risk that the requirements will not be met for some or all contracts between FCR and its tenants, which would make them indefinite and thus terminable at any time.

Valuation

In order to understand the value behind FCR's shares, we consider the capitalisation yield implied by FCR's current EPRA net asset value (NAV, see Exhibit 6). The analysis requires access to balance sheet data at the date of the NAV figure, with the last available numbers for FCR at end-June 2019. The capitalisation yield is expressed as net operating income generated by the properties divided by their gross market value. FCR's EPRA NAV at end-June 2019 stood at €92.9m. Based on the share count post the recent share issue in September, this translates into a NAV per share of c €10.16 (compared to the current share price at €10.20). We note that this figure does not account for the 16 property acquisitions completed post reporting date (which in aggregate represent a leasable floorspace at around 40k sqm). It is important to note that this NAV estimate is not based on regular valuations performed by external real estate experts (which is often the case with real estate investment companies). Instead, FCR relies predominantly on received purchase offers, as well as bank valuations on debt refinancing and internal fair market value assessments to calculate the EPRA NAV.

We note that under the German accounting standards, FCR's property portfolio is recorded at book value on the company's balance sheet within property, plant and equipment (PP&E) and subsequently depreciated. This means that the balance sheet value does not capture the market value of these properties, which would be the case under IFRS, where these properties would be recognised as investment property and would be subject to regular revaluations (based on valuations of an external appraiser) rather than depreciated over time. Having said that, we understand that the company plans to report its FY19 numbers under IFRS and is currently facilitating external property valuations.

In order to arrive at the gross market value of FCR's total assets, we have added debt, accounts payable and other liabilities to the EPRA NAV. We then subtracted cash and equivalents, notes/accounts receivable and other assets as at end-June 2019 to arrive at a clean property value. We also deducted the value of development projects (which at present do not generate any rental income). In this context, we have prepared our own assessment of the student apartments project in Bamberg (FCR's key development project). We understand that the project completion has been postponed until end-2020 (compared to early 2020 assumed previously). We cautiously reflect the remaining three development projects (Frankenberg, Duisburg and Monument) in our valuation at book value. Consequently, we arrive at a conservative aggregate value of FCR's development projects of €10.5m and a gross value of income-generating properties of c €247.0m.

For the purpose of calculating the implied capitalisation yield, we have relied on FCR's potential net rental revenue (ie excluding costs, which are charged back to tenants) for the respective properties of €19.0m (as provided by the company). The annualised net rental revenue reported by FCR as at end-June 2019 is closer to €15.9m pa, while an additional c €3m may be achieved upon full occupancy. We believe that c 80% of the rental revenue potential is attributable to seven properties, including the SchlossGalerie in Rastatt. We assume that property expenses that cannot be charged back to tenants represent around 20% of the total net rental revenue.

Consequently, we arrive at a net operating income (NOI) across FCR's portfolio of €15.1m, which implies a capitalisation yield of 6.1%. We believe this is broadly in line with current market yields, given that the weighted average capitalisation yield across Deutsche Konsum REIT's portfolio was 6.32% at end-September 2018 (last available data) and subsequently property markets in Germany have seen some minor yield compression. Similarly, we estimate that FCR's implied net rental yield (ie potential net rental revenue to gross property value) stands at 7.7% at end-June 2019 compared with 7.8% for Deutsche Konsum REIT (at end-September 2019). As a result, we believe that FCR's net asset value after accounting for the market value of its properties may indeed be slightly above €10.0 per share as at end-June 2019. We would like to reiterate that this has been calculated based on the potential net rental revenue (at full occupancy) for FCR's portfolio. When applying the current net rental revenue, FCR's implied capitalisation yield stands at 5.2% and its net rental yield amounts to c 6.4% pa.

Exhibit 6: FCR's NAV valuation

	€000s unless otherwise stated
EPRA NAV (company estimate) at end-June 2019	**92,900**
Total debt	171,040
Notes/accounts payable	1,848
Other liabilities	12,198
Market value of assets	**277,986**
Total cash and equivalents (including restricted cash)	11,744
Notes/accounts receivable	882
Other assets	7,918
Value of development projects	10,496
Implied gross property value	**246,947**
Potential net operating income (NOI) at end-June 2019	15,139
Implied capitalisation yield	**6.1%**

Source: FCR Immobilien, Edison Investment Research

It is also instructive to review the market multiples at which FCR and its peers are currently trading. Here, we consider Deutsche Konsum REIT and Deutsche Fachmarkt (Defama) as the company's closest comparators given their primary focus on retail properties (>90% of portfolio) in small and medium-sized cities in Northern Germany with strong anchor tenants. Moreover, both have high exposure to tenants from the food sector (c 45–47% compared to FCR at c 40%). Having said that, we note that both Deutsche Konsum REIT and Defama pursue a buy-and-hold strategy rather than constant portfolio rotation. Moreover, the targeted transaction size is somewhat lower at €1–5m for Defama and €1–25m for Deutsche Konsum REIT. We present selected key characteristics of these companies in Exhibit 7. We note that Deutsche Konsum REIT's lower LTV and net debt to total assets figures are partially attributable to the fact that it reflects its property portfolio at market value (as per IFRS), whereas both FCR Immobilien and Defama report under German accounting standards (HGB) and thus reflect properties at acquisition cost and subsequently depreciate these.

Exhibit 7: Comparison of FCR versus its closest peers

Data as at end-June 2019 unless otherwise stated	FCR Immobilien	Deutsche Konsum REIT	Defama
Number of properties	64	113	31
Leasable floorspace (in '000 sqm)	306	638	131
Occupancy rate	86%	91%	96%
WAULT (in years)	5.3	5.4	4.1
Annualized rental revenue (€m)	15.9	42.5	10.0
Leasable floorspace CAGR (end-2016 to end-June 2019)	69%	54%	32%
Exposure to tenants from the food sector	40%	46%	45%
Reporting standard	HGB	IFRS	HGB
LTV at property level* (excl. holding-level debt)	65%	31%	84%**
Net debt to total assets	79%	49%	78%

Source: Company accounts, Edison Investment Research. Note: *Based on property value as presented on the balance sheet and debt excluding holding-level indebtedness. **LTV based on market value of properties as given by Defama stands at 61%.

Moreover, our peer group includes other German real estate investment companies: Deutsche EuroShop, Hamborner REIT, Demire and VIB Vermögen. Deutsche EuroShop also focuses on the German retail market, but is a larger player, acquiring properties with at least 15k sqm of leasable space in locations with a catchment area of at least 300,000 inhabitants. The remaining peers have a more diversified real estate portfolio than FCR, including office and logistics properties.

Based on the company's EPRA NAV (divided by the share count post recent secondary public offering), FCR is trading at a P/NAV ratio of 0.98x, which represents a 11% discount to the peer group. Based on the FY19e EV/EBITDA ratio, FCR is trading at a 21% discount to the peer average. This may be partially explained by the fact that FCR's portfolio includes a number of companies where its asset management measures have not been implemented yet. Since FCR recognises its real estate portfolio under property, plant and equipment (which is being depreciated on an ongoing basis), while some of its peers book it under investment property (under IFRS) and revalue it regularly, a comparison based on P/E ratios has limited informational value. FCR's AGM recently approved a dividend payout of €0.35 per share (calculated excluding the bonus shares), which currently represents a dividend yield of 1.7%.

Exhibit 8: Peer comparison

	Market cap (€m)	P/NAV (last reported)	EV/EBITDA (x)		P/E (x)	
			2019e	2020e	2019e	2020e
Demire	550	1.00	21.3	16.2	9.3	8.9
Deutsche Konsum REIT	503	1.53	11.0	11.0	7.5	7.7
Defama	68	1.23	19.0	11.5	29.2	12.7
Hamborner REIT	752	0.89	20.4	19.5	43.2	38.6
VIB Vermogen	783	1.36	17.7	17.0	14.6	13.4
Deutsche EuroShop	1,579	0.62	15.5	15.6	10.4	12.3
Peer group average	-	**1.11**	**17.5**	**15.1**	**19.0**	**15.6**
FCR Immobilien	91	0.98	13.8	10.9	24.3	16.3
Premium/(discount)	-	**(11%)**	**(21%)**	**(28%)**	**28%**	**5%**

Source: FCR Immobilien, Edison Investment Research, Refinitiv consensus as at 21 November 2019

Total return play with limited FFO1 yield

We note that FCR is a total return rather than a pure income play, as the company's strategy is based on ongoing portfolio rotation aimed at opportunistic purchases followed by measures to enhance rental income and subsequent disposals to realise the added value. Consequently, we forecast that the net operating income (NOI) generated by its properties will represent only c 50% of its gross profit and that in the near term, FCR's shares will offer a minor FFO1 yield (defined as net profit before D&A and excluding disposal gains divided by current share price). We expect the FY19e yield to be close to 0% and subsequently improve to 1% in FY20e and 3% in FY21e. We understand however that this is due to the fact that the best performing properties are normally sold with the proceeds being recycled into lower-yielding properties. We also acknowledge that part of the corporate overheads may be closely linked to FCR's activities aimed at profitable property disposals.

Hence, we have also calculated the potential NAV total return (TR) after accounting for the portfolio rotation and disposal gains that we have included in our forecasts. For the purpose of preparing these, we have made assumptions as presented in Exhibit 9 below. We have assumed that FCR will continue its portfolio expansion (acquiring 20+ properties per annum) while also realising the hidden reserves through disposals of properties following successful asset management measures. Here, we have pencilled in a portfolio rotation at c 10–15% pa. Moreover, we have factored in a broadly stable occupancy rate across the portfolio, as disposals of fully let properties and acquisition of projects with occupancy potential should be offset by rental successes for retained investments.

We estimate that the company still has more than 20 properties acquired before 2018 that are most likely characterised by high current net rental yields (based on book value recognised on the balance sheet) of 15% pa or more. We expect these to be an important contributor to disposal gains over the next two to three years. Meanwhile, we assume gross rental revenue will grow at around 22% pa on the back of portfolio expansion and a minor increase in rent per square metre across the portfolio of 1.0% pa.

Having said that, we would like to stress that the scenario we have outlined here is subject to a number of parameters that are difficult to predict. These include the number, size, as well as rental and vacancy rates of properties acquired and sold per annum, the rental revenue generation improvement achieved by FCR, as well as the yields at which the company will be able to acquire properties and subsequently sell them. These in turn are dependent on the conditions prevailing in the German property markets, which are uncertain given the unfolding economic slowdown.

Exhibit 9: FCR Immobilien KPI forecasts

	2018	2019e	2020e	2021e
Number of properties (end of period)	58	80	96	113
Properties acquired	*26*	*26*	*24*	*27*
Properties sold	*9*	*4*	*8*	*10*
Net rental revenue pa (€m)	14.8	19.1	22.8	26.5
Occupancy rate	85%	89%	89%	89%
Net rental yield pa	9.7%	9.4%	9.3%	9.4%

Source: Edison Investment Research

Based on the above assumptions, FCR provides a potential NAV TR at around 13% pa over the next three years (see Exhibit 10 below).

Exhibit 10: FCR NAV total return potential

	2018	2019e	2020e	2021e
EPRA NAV (€m)	85.3	101.5	113.6	124.2
NAV/share (€)	10.11*	11.10	12.42	13.58
DPS paid in the period (€)	0.12*	0.17	0.27	0.56
NAV TR		*11%*	*14%*	*14%*

Source: FCR Immobilien ,Edison Investment Research. Note: *Adjusted for the issue of bonus shares in 2019.

Financials

Income statement: Fuelled by rental income and disposals

FCR derives its revenues from two main sources: rental income, which is recurring in nature; and income from the disposal of properties, which varies depending on the number of transactions executed during the period. FCR's rental revenue has grown considerably from €3.1m in 2015 to €15.9m in 2018 and €9.6m in H119 alone. This is a function of the rapid expansion in the company's leasable floorspace from 51k sqm (12 properties) in 2015 to 329k sqm (76 properties) at end-October 2019 (see Exhibit 11). According to company data, the portfolio as at end-October 2019 represents an annual net rental revenue of €17.1m (with a potential to increase further to €20.7m at full occupancy) compared to €14.8m (€17.7m) at end-2018 and €9.5m (€10.9m) at end-2017.

It is important to highlight that growth in FCR's real estate portfolio has been achieved despite the execution of selected property disposals following successful letting activities. In 2017 and 2018, FCR purchased 28 and 26 properties, while selling five and nine properties, respectively. The disposals translated into a portfolio rotation (based on the number of properties at the beginning of the period) of 28% and 22%, respectively. This compares with FCR's long-term expectation at 20% pa as mentioned earlier. In 2019 to date, the company has continued with its active transactional activity, purchasing around 30 properties for €72m while selling three real estate projects. We estimate that the disposals completed by FCR in 2017, 2018 and this year to date represent a healthy average gross IRR at around 25% pa.

The net rental yield (which is calculated as annualised net rental revenue divided by the book value of property) across FCR's portfolio declined to 9.7% at end-2018 and 9.2% at end-October 2019 from around 14% seen in 2015–17. We believe that this is a function of the lower yields (ie higher prices) of properties purchased in 2018 and 2019 to date (which we estimate were closer to 8–10%), as well as the profitable disposal of properties purchased in earlier periods. Considering the potential rental revenue increase from improved occupancy and lease contract extensions on improved terms (as per FCR's estimates), the net rental yield for the portfolio at end-October 2019 stands at 10.6%.

We note that FCR is currently dependent on gains from property disposals to cover its interest expenses. Its EBITDA interest coverage ratio (after excluding the €5.2m disposal gains) stood at c 1.1x in FY18, with the ratio declining to c 0.5x in H119. While interest payments seem well covered at the property level, the coverage is visibly lower after accounting for corporate overheads. The low ratio is to some extent related to the fact that FCR's proceeds from this year's bond issue were not fully deployed (cash and equivalents as at end-June 2019 were at €11.7m) and due to the considerable number of properties acquired in 2018 and H119 where FCR's asset management initiatives have not fully materialised yet. After accounting for disposal gains, these ratios stood at 2.1x and 4.0x, respectively. We note that FCR's outstanding bonds have an EBITDA interest coverage covenant at 1.1x, which may require continued profitable asset disposals in the near term (which of course are part of FCR's business strategy).

Having said that, we estimate that FCR's coverage ratio excluding disposal gains should gradually improve to around 1.0–1.2x over the next few years and stand at around 3.0x when disposal gains are included. This is because we assume a slightly slower portfolio expansion (relative to its existing portfolio), which reduces the proportion of properties at an early stage of asset management measures. Moreover, we expect some economies of scale with corporate overheads growing at a slower pace than FCR's income. This is particularly important given that interest coverage at property level (ie excluding corporate overheads) is solid even at the quite high LTV levels. FCR aims to acquire properties at attractive price levels, implying net rental revenue yields of around 8–10% according to our estimates. This compares with the average interest rate on FCR's bank loans at c 2.2% pa and a weighted average cost of debt at group level of 3.3%.

Exhibit 11: FCR Immobilien KPI summary

	2015	2016	2017	2018	H119	October 2019
Number of properties	12	18	41	58	64	76
Lettable space ('000 sqm)	51	83	140	248	306	329
Net rental revenue pa (€m)	3.2	4.5	9.5	14.8	15.9	17.1
Occupancy rate	82%	88%	88%	85%	86%	N/A
Potential net rental revenue pa (€m)	3.9	5.5	10.9	17.7	18.8	20.7
Net rental yield pa*	14.2%	14.2%	14.1%	9.7%	9.5%	9.2%
Potential net rental yield pa**	17.3%	17.3%	16.1%	11.5%	11.2%	10.6%
WAULT (in years)***	N/A	4.5	3.9	5.5	5.3	4.7

Source: FCR Immobilien, Edison Investment Research. Note: *Based on current book value. **Assuming a 100% occupancy rate. ***Weighted average unexpired lease term.

Balance sheet: Benefiting from high leverage

FCR's financing strategy assumes a 70–80% leverage level (with a preference to the upper end of this range) at individual property level. The debt component normally represents bank loans secured by first ranking fixed charges against the investment property (predominantly floating rate – average interest rate of 2.2% as at August 2019), while the equity component is provided by the parent company, which is either sourced from FCR's equity or bond issuance. All currently outstanding bonds (with a face value at €57.7m as at August 2019) constitute second lien mortgage debt and have a weighted average coupon rate at around 6%. They provide the company with additional flexibility during deal execution and effectively gear up FCR's investments further. A detailed summary of FCR's outstanding bonds is presented in Exhibit 12. We note that the company was able to reduce the coupon rate over time, with its first bonds issued in 2014 bearing an 8.0% rate compared to the bonds currently being offered at a rate of 5.25%.

Exhibit 12: FCR's outstanding bonds summary

	Face value outstanding (€m)	Coupon rate*	Coupon payments	Maturity	Comments
Bonds 2016–2021	15.0	7.10%	Annual	Oct-21	Second lien debt
Bonds 2018–2023	25.0	6.00%	Semi-annual	Feb-23	Second lien debt
Bonds 2019–2024	17.7*	5.25%	Semi-annual	Apr-24	Second lien debt
Total	**57.7**	**6%**	**-**	**-**	**-**

Source: FCR Immobilien, Edison Investment Research, Note: *The 2019–2024 bonds issue is still in progress, with more than €20m subscribed for as at 31 October 2019 (total placement volume equals €30m).

In March 2019, the company completed the first stage of its capital raise, collecting c €3.3m of gross proceeds with a c 4% dilution at an issue price of €8.75. The second stage of the offering was successfully finalised in September 2019, allowing FCR to raise an additional €3.2m with a roughly similar level of dilution (the issue price stood at €9.50 per share). The secondary public offering was aimed at securing additional equity that could be geared up to fuel further portfolio expansion.

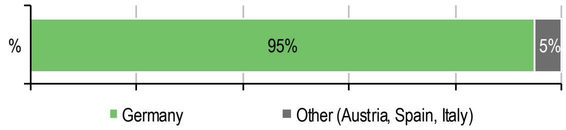
FCR's ratio of bank liabilities to book value of properties stood at around 65% as at end-June 2019. After accounting for bonds issued at the holding level, FCR's net debt to total assets stood at 79% at end-June 2019. This is a slight decline from 84% at end-2018, which is a function of the first stage of the recent new share issue as described above. It must be noted though that these leverage calculations are based on the book value of FCR's investment properties (as included on the balance sheet) rather than their market values. Based on our estimate of the gross fair value of FCR's properties at end-June 2019, the net debt to total assets stood at c 62%.

With respect to FCR's dividend distribution, the payments were relatively irregular historically and depended on the extent of the company's capital needs. FCR paid out 21% of net income in 2015, while it refrained from paying a dividend in 2016 and then distributed 19% of 2017 earnings. This year, it has paid a dividend per share at €0.35 (before the issue of bonus shares), compared to an FY18 EPS at €0.34. The company's covenants embedded in the currently placed bond include a payout cap at 50% (applicable to either P&L group result or balance sheet profit).

Exhibit 13: Financial summary

Year ending 31 December (€000s)	2016	2017	2018	2019e	2020e	2021e
Income Statement						
Rental revenue	5,729	8,490	15,933	19,638	24,802	28,829
Sale of investment properties	6,400	7,901	21,252	24,493	36,417	45,088
Change in inventory and other revenues	(257)	15	2	(0)	0	0
Total revenues	**11,873**	**16,405**	**37,186**	**44,131**	**61,219**	**73,917**
Material expenses	(6,682)	(8,367)	(21,098)	(19,065)	(30,161)	(38,340)
Personnel expenses	(739)	(1,297)	(3,321)	(4,282)	(4,924)	(5,417)
Other operating income/(expense), net	(1,344)	(1,814)	(2,681)	(2,855)	(3,461)	(3,878)
EBITDA	**3,109**	**4,928**	**10,087**	**17,928**	**22,673**	**26,282**
Depreciation and amortization	(775)	(1,193)	(2,653)	(5,434)	(6,505)	(7,737)
EBIT	**2,334**	**3,735**	**7,434**	**12,494**	**16,168**	**18,545**
Financial result	(1,484)	(2,456)	(4,456)	(6,154)	(7,586)	(8,405)
Pre-tax profit	849	1,278	2,977	6,339	8,582	10,139
Net profit	562	975	1,423	3,703	5,717	6,899
EPS*	N/A	0.06	0.17	0.42	0.63	0.75
FFO1 per share*	N/A	(0.17)	(0.01)	0.03	0.12	0.28
FFO2 per share *	N/A	0.26	0.48	1.04	1.34	1.60
DPS*	N/A	0.12	0.17	0.27	0.56	0.41
Balance Sheet						
Intangible assets	27	20	154	142	142	142
Fixed assets	31,794	69,109	168,927	208,531	248,265	287,093
Financial assets	1,731	2,709	4,079	1,480	1,480	1,480
Total non-current assets	33,552	71,838	173,160	210,153	249,887	288,715
Inventory	238	248	340	349	360	370
Receivables and other assets	5,743	2,879	6,167	4,812	4,839	4,867
Securities	0	0	858	858	858	858
Cash and cash equivalents	6,312	4,946	3,112	19,930	17,062	23,754
Total current assets	12,292	8,073	10,477	25,950	23,119	29,850
Prepaid expenses	225	236	684	407	407	407
Total assets	46,069	80,147	184,320	236,510	273,413	318,972
Equity	5,931	6,906	9,038	17,758	21,068	22,821
Bonds	9,311	20,676	45,676	70,000	70,000	70,000
Liabilities to banks	27,710	49,537	112,128	134,650	168,187	211,933
Provisions	1,512	1,459	2,012	2,567	2,567	2,567
Other liabilities	1,605	1,569	15,465	11,535	11,592	11,651
Ratios						
LTV (based on book value of properties)	87%	72%	67%	65%	68%	74%
Net debt to total assets	67%	81%	84%	78%	81%	81%
EBITDA interest coverage ratio	2.0	1.6	2.1	2.9	3.0	3.1
ROE	9.6%	15.2%	17.9%	27.6%	29.4%	31.4%
ROIC (pre-tax)	6.4%	6.2%	6.1%	6.4%	6.7%	6.6%
EBITDA margin	26.2%	30.0%	27.1%	40.6%	37.0%	35.6%
Valuation metrics						
Share price	N/A	N/A	8.9	10.2	10.2	10.2
P/FFO (x)	N/A	N/A	18.4	9.6	7.5	6.2
Dividend Yield (%)	N/A	N/A	1.9	2.7	5.6	4.1

Source: FCR Immobilien, Edison Investment Research. Note: *Adjusted for the bonus share issue in 2019.

Contact details	Revenue by geography
Paul-Heyse-Straße 28 München - 80336 Germany Phone: +4989 413 249 600 www.fcr-immobilien.de	

Management team

CEO: Falk Raudies

Falk Raudies has more than 20 years of professional experience with an extensive background in real estate valuation and transactions. In the past, he also served as a managing director and board member of Alldis Computer and Rhinos Energy Drink & Food. Since 2009, Mr Raudies has been the owner (95% stake) of RAT Asset & Trading, the majority shareholder of FCR Immobilien.

Principal shareholders	(%)
RAT Asset & Trading (majority-owned by FCR's CEO)	68.3%
FAMe Invest & Management GmbH	8.8%
Other	22.9%

Companies named in this report

Deutsche Konsum REIT, Defama, Demire, VIB Vermögen, Deutsche EuroShop, Hamborner REIT, Jones Lang LaSalle, Savills