CEE Real Estate stocks with upside potential of 15%, profitability lags behind

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- **Erste analysts forecast 4% ROE for real estate companies in 2012; 15% upside potential for CEE real estate shares possible until year end**
- **Below average profitability levels are biggest obstacle to reach P/BV levels of closer to 1.0x**
- **Upward trend in CEE driven by low vacancy, strong occupier demand and low pipeline**
- **Top picks: Buy recommendations for GTC, Immofinanz and S Immo due to best financial stability, highest retail exposure and strongest profitability**

The recent fall in highly-rated government bond yields makes investment in real estate look more attractive in terms of relative pricing between asset classes. “We are currently witnessing the highest yield gap since spring 2009. However, current ROE levels are still disappointingly low. Whereas rents have recovered from the crisis, savings in operating costs still have to be unlocked, especially as the development volumes and profits will not reach pre-crises levels anytime soon. Speaking in favour of real estate shares is the 50% discount to book value”, said Günther Artner, Co-Head CEE Equity Research. In an international peer group comparison, CEE real estate stocks show clear discounts based on book values, but are traded in line with peers on cash flow-based multiples, highlighting the below-average profitability level.

The market turbulences since August this year pushed back the valuation of real estate stocks to 2009 levels, when trough valuations were just left behind. Given these low stock price valuation levels compared to book values, it is increasingly interesting to buy back shares or other outstanding financial instruments instead of direct property investments. This is already being used by conwert and Immofinanz, others may follow.

Investment volume declined q/q by 12%

Investment volumes in Europe are following the economic development more than ever before. In 2Q11, transaction volumes in the European investment market declined by 12% q/q to EUR 25bn. Also, in a yearly comparison, the investment turnover is down by 3% from EUR 25.7bn in 2Q10. The annual prime yield compression continued in 2Q11, with the cities of Moscow, St. Petersburg, Bucharest and Kiev showing the strongest decline in CEE.

Investment volumes in the CEE property investment market reached EUR 6.9bn by mid-August 2011, which is 20% higher than the full-year figure of 2010, accounted for by roughly 120 transactions. The majority of investment turnover continued to be concentrated on the markets Poland and Russia, which account for more than 70% of total CEE investment. The Czech Republic is the third largest market in terms of property investments in the region and already reported volume growth of 50% until mid-August compared to the FY10 figure. In the office segment, investment turnover amounted to EUR 2.2bn in 1H11, mainly driven by transactions in Russia and Poland, which accounted for 75% of total volume. Even though there is still more than 50% of the turnover coming from local investors, cross-border activity is on the rise.

Retail segment with strongest rise in capital values

Among the three segments (residential, retail and office), retail properties observed the strongest growth in 2Q11 with 0.8% q/q and 3.5% y/y. The fast growing economies like Germany, Russia, Poland and the Nordics have witnessed increased turnover in the retail segment, while Southern European countries have seen only limited activity. Investors remain more cautious and are concerned about economic growth and the impact of austerity measures on consumer spending.

While capital values for industrial properties declined, the office segment reported a decrease of 0.3% q/q, but an increase of 2% y/y. Looking at the geographical level, the strongest sequential increase in capital values was recorded in the CEE region with +0.9% q/q (+3.5 y/y), followed by the Nordic region with +0.6% q/q (+4.4% y/y).

Office completion in the CEE capital cities reached a new low at a meager 460,000 sqm in 1H11 (vs. 2.1mn sqm for FY10), out of which more than half of the space was covered by Moscow. To estimate the future supply of office space, a look at the pipelines under construction provides a good indication. The capital cities in the CE region have seen a pick-up in new projects.

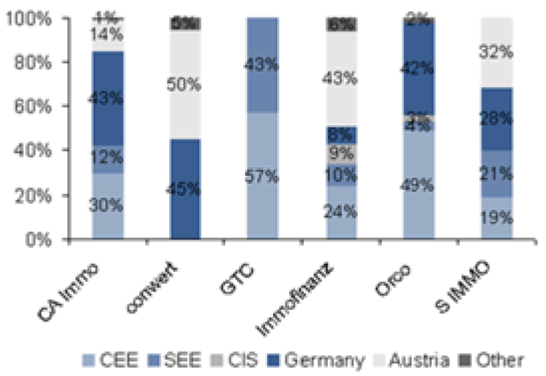
Regarding prime rents, the previous stabilization trend seems to be holding on in the European property markets. This is confirmed when looking at the EU15 Office Rent Index, which remained flat q/q in 2Q11 (+2.1% y/y), while the EU15 Industrial Rent Index showed only a minor decline of 0.5% (-0.1% y/y). The respective retail index even managed to increase by 1.7% q/q (+2.6% y/y), which was mainly due to rising rental levels in various cities in Germany, France, the UK, Finland and Sweden.

Source: CB Richard Ellis, European Investment Quarterly, 2Q 2011

Outlook

Most real estate companies cannot take advantage of the persistently low interest rate environment, as they are hedged at higher levels. Both factors are still holding back an improvement in ROE. "Reaching the pre-crisis levels of 10% ROE and P/BV parity seems unlikely to us, as these numbers were based on a strongly positive leverage effect and included high revaluation gains as well. We expect a bit higher revaluation gains at companies with fresh assets in good locations. Based on our new reduced estimates, a regression analysis of ROE vs. P/BV shows 15% upside potential until year-end and 25% until the end of 2012 (in addition to the dividend distributions)", stated Martina Valenta, Real Estate Analyst at Erste Group. In Erste Group's regression analysis of ROE vs. P/BV, real estate companies would have to reach ROE of 11% to reach P/BV parity. The average forecast ROE is 3.7% for the Austrian real estate companies and 1.9% for CEE developers for 2012. The 25% upside until year-end 2012 would translate into an average P/BV 2013e multiple of 0.6x at this point of time.

Portfolio breakdown by region (1H11, fair value)



Germany and Austria remain attractive investments

Apart from the pure CEE play GTC, the companies in Erste Group's coverage universe all have significant exposure to the strongly performing German and Austrian markets. conwert has the biggest share of German assets with 45% (largely residential), followed closely by CA Immo with 43%.

Generally speaking, the currently strong retail segment does not score highly in the portfolios of our covered companies. GTC has the highest share with 36%, followed by S Immo (27%) and Immofinanz 25%.

Erste Group analyst's recommendation and target price overview:

Company	Curr.	Mcap (EURmn)	Price	Target NEW	Target OLD	Upside potent.	Rating NEW	Rating OLD	Performance (EUR terms) 1M	3M	6M	12M
CA IMMO	EUR	811	9.24	11.00	15.00	19%	Accumulate	Accumulate	4.4	-23.0	-29.5	-11.5
conwert	EUR	761	9.30	11.00	12.40	18%	Accumulate	Hold	-2.4	-19.8	-20.9	-11.6
GTC	PLN	537	10.84	13.60	23.10	25%	Buy	Hold	-0.2	-41.4	-48.4	-50.8
Immofinanz	EUR	2,115	2.25	3.50	4.00	56%	Buy	Buy	-5.9	-19.4	-28.8	-19.6
Orco	EUR	72	4.25	4.30	8.20	1%	Hold	Accumulate	-31.5	-44.8	-54.9	-43.4
S Immo	EUR	260	3.82	5.20	6.30	36%	Buy	Buy	2.2	-17.2	-22.7	-30.9

Prices as of (close): 28-Sep-11

Source: Factset, Erste Group

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CA Immo. Erste Group analysts cut their target price from EUR 15.0 to EUR 11.0 and confirm the **Accumulate** recommendation. With the reduced estimates, ROE for 2011 stands at 3%, which is markedly below CA Immo's full-year ROE target of 5%. However, Erste analysts have an unchanged dividend assumption of EUR 0.40 in their forecast, in line with the company's target of paying out around 2% of NAV.

conwert. Analysts upgrade conwert to **Accumulate** (from Hold) with a reduced target price of EUR 11.0 (previously EUR 12.40).

GTC trades at the historically highest 46% discount to its 1H11 book value. Analysts set the target price at PLN

13.6/share, a 42% discount to the 2013e book value. Erste Group analysts thus upgrade their recommendation from Hold to **Buy**.

Immofinanz. Analysts confirm their **Buy** recommendation, but lower their target price from EUR 4.0 to EUR 3.5. This reflects the lower estimates as well as an allowance for legal risks.

Orco. Erste Group analysts assign a **Hold** recommendation to Orco with a EUR 4.3 twelve-month target price on the stock. The target price is based on 60% discount to present value of 2013e adjusted NAV, due to the significant refinancing risk Orco faces at present.

S Immo. Analysts reduce their target price from EUR 6.3 to EUR 5.2, but confirm the **Buy** recommendation for S Immo. The cut in target price reflects the reduced estimates for 2012 and 2013 and an expected weaker economic development.

Erste Sector Real Estate [pdf; 1009.2 KB]

Präsentation: CEE Equity Research [pdf; 1.0 MB]