DEMIRE

First in secondary locations

Initiation of coverage

Real estate

DEMIRE Deutsche Mittelstand Real Estate (DMRE) is an investor in German commercial property focused on secondary locations. It has grown significantly over the last two years and has a portfolio valued at €984m with annual contracted rental income of €71.7m (31 March 2017). Further efficiency gains as acquisitions are integrated are likely to increase profitability and provide a stable platform for further growth. A diverse portfolio of income streams and potential for capital growth may make this an attractive way to access the German property market at a discount.

Year end	PBT (€m)	FFO1* (€m)	FFO1/share (€)	Price/FFO1 per share (x)	EPRA NAV/ share (€)	Price/EPRA NAV (x)
12/15	33.0	28.9	1.12	3.4	4.25	0.88
12/16	40.0	8.1	0.16	23.7	4.88	0.77
12/17e	17.5	8.2	0.15	24.6	5.22	0.72
12/18e	22.0	17.3	0.32	11.7	5.53	0.68

Note: *Funds from operations before minority interests but after tax. **1 April to 31 December 2014.

Proven ability to grow

After a strategic realignment in 2013, DEMIRE has transformed its business and built a portfolio of German commercial property valued at nearly €1bn in two years. Rental income more than doubled in 2015 and 2016, with further growth expected in 2017. DEMIRE has also built a significant and efficient facility and property management operation to run its assets. At the same time, the loan-to-value (LTV) ratio and the cost of debt have been reduced, increasing profitability and NAV per share. This has been achieved in part through the acquisition of 77.7% of Fair Value REIT (FVI), which maintains its separate listing, and of Krüger Immobilien, a property management company, as well as refinancing more expensive debt.

With further to go

DEMIRE aims to provide a stable, growing income from a portfolio that has grown from €20.5m at 30 March 2014 to over €1bn at 31 December 2016. As well as rental income, DEMIRE earns fees from utility and other property management services provided to its tenants. The profitability of this segment should benefit from economies of scale as the portfolio grows. With a record of increasing funds from operations (FFO) by acquiring quality assets, both through direct investment and through corporate deals, we expect management can achieve its strategic goals.

Valuation: Scope for NAV discount to narrow

Rapid NAV and FFO growth in 2015 was reflected in the share price movement that year, but in 2016 the shares moved sideways. While it trades above the peer average price/FFO ratio, DEMIRE is at a considerable discount to EPRA NAV/share of €4.61 at 31 March 2017 (c 20% vs a peer average of a 3% premium). As the company comes out of this phase of investment in rapid growth, and acquisitions and restructuring make a full contribution, there is scope for the discount to narrow. In addition, the achievement of the long-term aim of paying a dividend could be a catalyst for the share price too, although this is not expected in FY17.

21 July 2017

Price	**€3.74**
Market cap	**€203m**
	€1.12/£
Net debt (€m) at 31 March 2017	620.1
Shares in issue	54.2m
Free float	50%
Code	DMRE
Primary exchange	Frankfurt (Xetra)
Secondary exchange	N/A

Share price performance

%	1m	3m	12m
Abs	(3.4)	(0.1)	1.5
Rel (local)	0.0	(3.6)	(18.6)
52-week high/low		€4.00	€3.34

Business description

DEMIRE Deutsche Mittelstand Real Estate is an investor in German commercial real estate with a focus on properties in secondary locations, attractive to medium-sized companies. The portfolio is well diversified geographically and by tenant and is spread across office, retail and logistics assets.

Next events

Half year report	31 August 2017
Q3 report	30 November 2017

Analysts

Julian Roberts	+44 (0)20 3077 5748
Andrew Mitchell	+44 (0) 20 3681 2500

financials@edisongroup.com

Edison profile page

DEMIRE is a research client of Edison Investment Research Limited

Investment summary

Company description: German regional specialist

DEMIRE Deutsche Mittelstand Real Estate invests in commercial property, primarily in the office, retail and logistics sectors, in central locations in mid-sized cities or secondary locations in or near major metropolitan areas. As well as its core portfolio, in 2015 it acquired a controlling (77.7%) interest in Fair Value REIT (FVI), a German REIT with a similar, albeit historically more retail-leaning, investment policy. It consolidates FVI in its financial reporting and shows it as a segment, alongside the core portfolio and corporate functions. Fair Value's investment approach is complementary to DMRE's: it acquires stakes in property companies that own portfolios, enlarging its holding and rationalising the portfolio to enhance value. The consolidated portfolio had a market value of €984m (following strategic disposals in Q117) and contracted rental income of €71.7m as of March 2017, giving a rental yield of c 7.3%. Portfolio total potential rent of €80.9m implies a valuation yield of 8.1%. DEMIRE has recently completed the disposal of 84 non-core properties (mainly small post offices) for €21.6m (c €3m above fair value). This reduced rental income by c €2m but will help to further reduce management costs and marks a significant step towards the repositioning of the portfolio. As well as rental income, DEMIRE generates service charge and utility fees through facility and property management services provided to its tenants. FVI's assets were previously managed externally and the process of bringing this in-house to reduce costs and add revenue is under way.

Valuation: Scope for NAV discount to narrow

Compared to its peers, DEMIRE trades at a low price/EPRA NAV ratio, in part because it has not yet started to pay a dividend. At 52x Edison's FY17e FFO/share estimate of €0.07 it is above the peer group average of 16.5x, which may reflect market expectations of FFO expansion in the medium term. We forecast significant FFO growth (see the valuation section on page 9) as FVI is integrated and from economies of scale as the streamlined portfolio expands. The c 20% discount to last reported NAV has scope to move closer to the peer average of a 3% premium as the company restores its FFO per share growth through further efficiency and portfolio expansion.

Financials: Sound and improving

LTV of 67.5% at 31 December 2015 had been reduced to 62.5% as of March 2017 and management has a target of 50% in the medium term. The average cost of debt is being reduced from 4.2% to 3.2% following the issue of a five-year €270m corporate bond in July 2017, paying a fixed coupon of 2.85%. The proceeds will be used to repay liabilities due up to 2019, which currently bear interest of 5.2% and have a repayment rate of 1.3%. Annual cash flow is expected to benefit by €9m as a result, through a reduction of €5.6m in interest payments and the rest in repayment costs. The refinancing will also leave €216m of investment properties unencumbered and is the first step towards realising management's DEMIRE 2.0 business strategy announced at the June 2017 AGM.

The average unexpired lease term of 5.3 years provides some security of income with scope for it to lengthen as active asset management initiatives increase occupancy from the current 89.1% to the FY17 target of 90%. We expect further property management efficiencies as more of the portfolio comes onto the in-house property management system and lower vacancy to benefit DMRE's income. Management targets FFO before minority interest and after tax of €8m to €10m in FY17.

Sensitivities: Operating in a buoyant market

As with all property investors, DEMIRE is sensitive to rental values, yields and the cost of financing. These in turn are driven by the health of the German economy, bank lending rates and primary investors' demand for yield. German property is currently a popular asset class, having attracted more investment than UK property in H216, which is likely to drive down valuation yields. DEMIRE's focus on secondary locations will provide a degree of protection from competition. To some extent its market may also lag prime locations in terms of rental growth, but with German unemployment forecast to reach historic lows over the next two years and GDP growth expected to be satisfactory, secondary locations are likely to benefit too.

Specific to DEMIRE, the continued reduction of debt costs and LTV, as well as the increase of FFO could see the discount narrow. While the shares trade at a discount, equity funding will be NAV dilutive, but we expect acquisitions to be FFO/share accretive (see Exhibit 10). DEMIRE aspires to pay a dividend in due course, which could be positive for the share price.

Company description: First in secondary locations

DEMIRE Deutsche Mittelstand Real Estate is a holding company for commercial real estate investment in properties located in mid-sized cities and up-and-coming metropolitan areas across Germany. The company prefers prime properties within these locations that are immediately income generating, with strong tenants, and the potential for alternative use. As indicated by the company name, DEMIRE has a particular emphasis on properties that are likely to prove attractive to a broad spread of medium-sized corporate tenants. Since July 2016, having met the appropriate standards of transparency, the shares of DEMIRE have been trading on the Prime Standard segment of the Deutsche Börse.

DEMIRE's current business model was established in mid-2013 after significant changes in the company's ownership structure. Prior to this, the company was known as Magnat Real Estate, and had been a real estate developer in markets surrounding the Black Sea and in Eastern Europe. Execution of the new strategy has been rapid, and it has grown quickly through both the acquisition of individual property assets and corporate acquisitions suited to its investment objectives, while non-core assets and corporate interests have been sold. Recent disposals have included 84 properties (of which 83 were small post offices with individual values under €0.5m) and a 25% interest in SQUADRA, a development company. The largest transaction to date has been the acquisition of a controlling 77.7% interest in Fair Value REIT (FVI) in a voluntary take-over that was completed in December 2015. Including fully consolidated FVI, the investment property portfolio had reached 1,054k sqm of rentable space (FVI 263k sqm) with a market value of €994m as of 31 March 2017 (FVI €290m). Management's ambition is to expand the portfolio to c €2bn in the medium term and in so doing improve the cost ratio, LTV and cost of borrowing.

A new strategic programme was announced at the 29 June 2017 AGM, known as DEMIRE 2.0. The main aim is to expand the portfolio from c €1bn to €2bn, with the focus remaining on secondary locations in Germany. Cost efficiencies will come from refinancing debt (already achieved through the bond issue), economies of scale as well as permanent reductions in costs. It is intended that the LTV ratio will be reduced from 62.5% as of 31 March to 50% in the medium term.

DEMIRE takes an integrated property management approach and is in the process of bringing all assets in its portfolio under in-house management (the FVI portfolio was previously managed externally). This transition will take several more months as legacy contracts run out. This approach also enables DEMIRE to maximise returns from individual assets. For example, the Logistik Park Leipzig was generating rents of €3.6m at acquisition in July 2015. The integrated in-house asset, property and facility management had increased net rent excluding utilities 14% to €4.1m by

November 2015. At the same time, the weighted average unexpired lease term (WAULT) at that property was extended 44% to 2.7 years.

The tenant base is diverse and solvent, and the company aims to have long leases to support stable and sustainable rental income. Tenants include retailers such as Lidl and other large companies such as Commerzbank as well as government departments.

Overview of the portfolio

As of 31 March 2017 DEMIRE's portfolio comprised 98 properties. These had a market value of €984m and contracted annual rent of €71.7m at an occupancy rate of 89.3% and a weighted average unexpired lease term of 5.3 years. Potential rent at full occupancy was €80.9m and the portfolio is organised into three segments:

- **Core +**: these are stable assets with low vacancy, long lease terms providing secure, long-term and predictable income. These may be sold in order to recycle capital if opportunities arise. The Gross Asset Value (GAV) of this segment is €529m, with a gross yield of 7.1% and a 6.6-year weighted average lease term (WALT).
- **Value-add**: includes properties with higher vacancy (16.7% across the segment) and shorted leases (3.8 years) but attractive yields (7.5% gross yield) and the chance to increase occupancy, income and capital value. The company takes an active approach and aims to manage these assets into the core segment.
- **Redevelopment**: this small segment has GAV of €39m and a gross yield of 7.3%, 6.9% vacancy and a WALT of 3.8 years. Most redevelopment takes the form of extensions and refurbishments, with some selective development. These are only undertaken if tenancy agreements are in place for the asset once work is complete, therefore offering low-risk upside.

Exhibit 1: Segment and sector portfolio breakdown

	GAV (€m)	GRI pa (€m)	GRI (€/sqm/month)	GRI yield (%)	Vacancy (%)	WALT (years)
Core +	529	37.7	8.7	7.1	5.4	6.6
Value-add	415	31.2	4.5	7.5	16.7	3.8
Redevelopment	39	2.9	8.2	7.3	6.9	3.8
Total	**984**	**71.7**	**6.2**	**7.3**	**10.7**	**5.3**
Office	667	48.8	7.4	7.3	6.6	5.1
Retail	238	16.9	8.8	7.1	10.4	6.5
Logistics	54	3.8	1.4	7.0	45.2	1.9
Other	26	2.2	4.6	8.7	3.0	6.3
Total	**984**	**71.7**	**6.2**	**7.3**	**10.7**	**5.3**

Source: Company data

The portfolio has diversified considerably since the start of 2015 when it was dominated by office properties. This has happened mainly as a result of the acquisition of FVI, which has a more retail-focused portfolio, but also through investments held in the core portfolio including the Logistik Park Leipzig and Kurfürsten Galerie, a major retail centre in Kassel (94.9% interest acquired in July 2015). FY16 has seen more focus on profit improvement, by integrating FVI and through management of the already substantial existing portfolio. These efforts have seen new lease agreements on properties in Bad Kreuznach, Eisenhüttenstadt, Goslar and Stralsund, as well as the disposal of three non-core assets in North Rhine-Westphalia from the FVI portfolio.

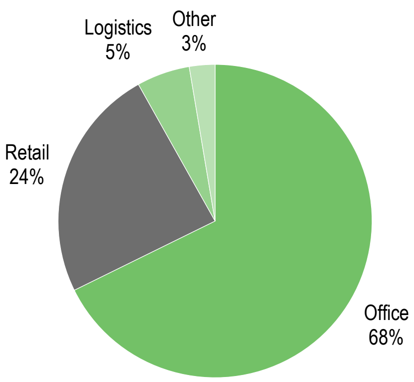
Exhibit 2: Portfolio overview

City	Type	Segment	GAV (€m)	Share (%)	Area (000 sqm)	EPRA Vacancy (%)	GAV/sqm (€)	GRI pa (€m)	GRI yield (%)	WALT (years)
Bonn	Office	Core +	78.0	7.9	38.4	0	2,033	5.4	6.9	8.0
Rostock	Retail	Core +	64.9	6.6	19.3	5.3	3,361	4.2	6.5	5.0
Ulm	Office	Core +	63.2	6.4	47.5	10.9	1,330	4.3	6.7	7.4
Kassel	Retail	Core +	56.5	5.7	21.5	11.7	2,628	3.6	6.4	9.0
Leipzig	Logistics	Value-add	53.7	5.5	217.6	45.2	247	3.8	7.0	1.9
Freiburg	Office	Redevelopment	37.1	3.8	22.7	0	1,636	2.6	7.1	4.0
Regensburg	Office	Value-add	31.0	3.2	29.2	0	1,060	2.5	8.0	4.0
Düsseldorf	Office	Value-add	30.1	3.1	24.3	27.7	1,238	1.9	6.5	5.1
Eschborn	Office	Core +	29.6	3.0	18.8	0	1,577	2.0	6.8	7.9
Eisenhüttenstadt	Retail	Value-add	26.9	2.7	30.5	34.1	881	1.8	6.6	5.4
Top 10 total			**470.9**	**47.9**	**469.8**	**16.4**	**1,002**	**32.1**	**6.8**	**6.0**
Leipzig	Office	Value-add	25.2	2.6	23.2	16.6	1,086	1.6	1.6	4.1
Wittenberg	Retail	Core +	21.6	2.2	14.7	4.2	1,468	1.7	1.7	5.9
Zittau	Retail	Value-add	18.6	1.9	17.5	6.2	1,066	1.3	1.3	12.1
Unterschleißheim	Office	Value-add	17.1	1.7	15.7	37.8	1,092	1.0	1.0	3.3
Flensburg	Office	Value-add	16.4	1.7	23.8	0	690	1.6	1.6	4.1
Quickborn	Office	Core +	15.6	1.6	10.6	0	1,476	1.1	1.1	4.9
Neumünster	Office	Value-add	15.2	1.5	11.8	0	1,287	1.0	1.0	8.4
Kempten	Office	Value-add	15.0	1.5	16.8	11.9	893	1.0	1.0	2.8
Stahnsdorf	Office	Value-add	14.5	1.5	17.1	0	846	1.8	1.8	4.0
Köln	Office	Core +	14.4	1.5	9.1	0	1,581	1.0	1.0	4.3
Top 20 total			**644.6**	**65.5**	**630.1**	**12.6**	**1,023**	**45.3**	**7.0**	**5.8**
Other			338.9	34.5	337.5	7.4	1,004	26.5	7.8	4.4
Total			**983.5**	**100.0**	**967.6**	**10.7**	**1,016**	**71.7**	**7.3**	**5.3**

Source: Company data

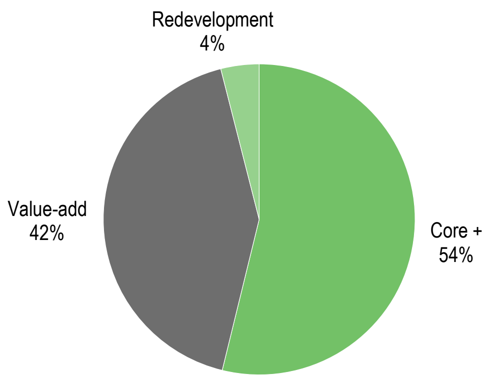
Office properties remain the largest component of the portfolio despite the growing diversification, at 68% of gross asset value and gross rents (Exhibit 3). We show the segmental value breakdown in Exhibit 4, which closely resembles the gross rental income breakdown too.

Exhibit 3: Portfolio breakdown by GAV/sector



Source: DEMIRE data as at 31 December 2016

Exhibit 4: Portfolio breakdown by GAV/segment



Source: DEMIRE data as at 31 December 2016

DEMIRE's tenant profile is shown in Exhibit 5. Although Deutsche Telekom (DT) represents 30% of rental income, the tenant list is otherwise diverse and DT has a good covenant: its 18 leases have a WALT of 5.8 years and two strategic locations make up 43% of DT's rent. It manages its rental contracts on a long-term basis and where it wants to vacate space it makes significant efforts to sublet to new tenants. This gives DEMIRE notice of any impending vacancy as well as the opportunity to build a relationship with the subtenant, ensuring a smooth transition of tenancy at the end of the lease and diversifying the tenant base. DT has a credit rating of Baa1/BBB+ and no other tenant accounts for more than 3% of rental income.

Exhibit 5: Tenant profile

Tenant	Company sector	% of GRI
Deutsche Telekom	Telecoms	30
Bundesanstalt für Immobilienaufgaben	Government	3
Sparkasse Südholstein	Public bank	2
RIMC	Hotels	2
Penta Hotels	Hotels	2
Deutsche BKK	Insurance	2
Bundesagentur für Arbeit	Government	2
Momox	Online retail	2
comdirect	Banking	2
ZAPF	Construction	2
Other		52

Source: Company data

The German real estate market

Market commentators tend to focus on six or seven major cities: Berlin, Cologne, Düsseldorf, Frankfurt, Hamburg, Munich and sometimes Stuttgart. While markets in these centres do provide some indication of the general health of the national property market, DEMIRE's focus is on secondary locations. These are characterised by higher yields, partly as a result of lower investor competition for assets, but benefit from similar levels of occupancy to and less speculative development than prime locations. We would draw attention to a recently published study of the German property market commissioned by DEMIRE and produced by bulwiengesa, which provides a detailed analysis of the property market in secondary cities. In this section, we will look at the office, retail and logistics markets on which DEMIRE focuses at a higher level; two broad trends affect all three:

- **A growing German economy:** Germany has the biggest economy in Europe and the fourth biggest globally, after the US, China and Japan. The most recent twice-yearly economic outlook published by the German Institute for Economic Research (DIW) for the German Economics Ministry upgraded the GDP growth estimate for 2016 to 1.9% and forecasts 1.4% and 1.6% expansion in 2017 and 2018. Unemployment is expected to reach a post-reunification low in the next two years, supporting consumption and wages. Although the euro-area recovery is uneven, in general it benefits German exporters. The impact of the UK leaving the EU is unclear, but it may provide opportunities for German companies in the financial sector and make German exporters more competitive if the UK leaves the single market. These factors support demand for all kinds of commercial real estate.
- **Demography:** Although it believes an eventual decline in the national population is inevitable, the German Statistics Office (Destatis) forecasts growth over the next five to seven years, as immigration compensates for a decline in the ratio of births to deaths. Urbanisation continues, with city population growth higher than the national average, and people are still moving from the former East German states to the west and to Berlin. With the exception of the Saarland, all the states of the former West Germany showed population growth in 2013, while all the former East German states showed population declines and internal migration to larger cities. These trends are likely to increase demand for office and retail property in cities across Germany.

Offices

JLL reported that in Q117 office vacancies in Germany's leading office markets remained around their lowest levels since 2002. Despite a high level of completions, demand continues to outstrip supply, increasing rents in both prime and non-prime buildings, Significant rent growth is reported by various commentators in secondary locations: for example, according to Cushman & Wakefield, the outskirts of Berlin, Dresden and Stuttgart were all in the top 10 areas in Europe for office rent growth in H216. It is reasonable to expect this trend to continue as the German economy, and the service sector in particular, expands.

Exhibit 6: Office rents and yields, top five cities

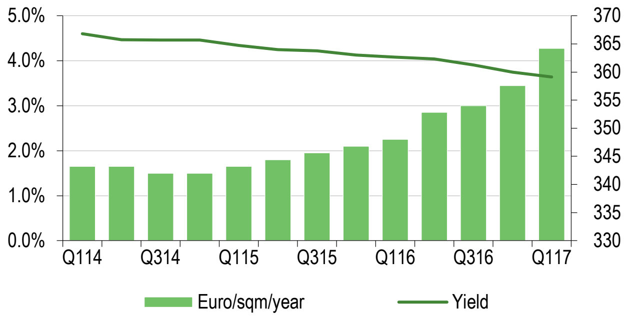
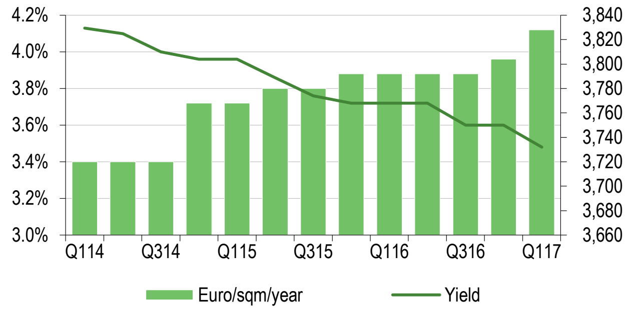


Exhibit 7: Retail rents and yields, top five cities



Source: Cushman & Wakefield. Note: The cities are Berlin, Düsseldorf, Frankfurt, Hamburg and Munich.

Retail

The retail letting market is less buoyant than the logistics and office markets, but still robust. Average retail rents in the 185 cities surveyed by JLL appear to have peaked in Q416, although take-up remains firm and yields are flat or falling, indicating that demand for assets remains high. Several commentators note that planning restrictions constrain the development of new town centre retail sites, limiting new supply. More generally, the strength of the economy, and wage growth in particular, is likely to keep demand for good locations in secondary cities high over the next two years.

Logistics

Germany is a leading logistics centre in Europe as well as having a sizeable domestic market. The five biggest warehousing markets, around Berlin, Düsseldorf, Frankfurt, Hamburg and Munich, are performing well, at the five-year average take-up so far in 2016, and above the 10-year level. However, the first nine months of 2016 saw the highest ever take-up of warehousing space outside those five markets in the first nine months of any year. This demand is increasing rents. The growth of online retail is positive for logistics property demand, and the recovery of the eurozone economy, although uneven, is beneficial for Germany as Europe's biggest exporter of manufactured goods.

In short, all three subsectors are performing well and seem likely to continue to do so in the medium term. As a specialist in secondary locations DEMIRE may see less volatility in rents and values than prime markets exhibit, but will benefit from the same trends that affect them.

Tax impact

It is worth noting that tax (real property transfer tax or RETT) is payable on the purchase of real estate throughout Germany, with different states setting different rates, from 3.5% in Bavaria and Saxony to 6.5% in several others. RETT is typically paid by the buyer; sellers may be liable for capital gains tax. When buying a company or partnership that owns real estate, tax is payable if 95% of the shares in that entity are acquired or accumulated. For that reason it is not uncommon for investors to acquire a 94.9% interest in an asset (as with Kurfürsten Galerie for example). Notary fees must also be paid on all transactions and non-REITs, such as DEMIRE but not FVI, are liable to pay 15% corporation tax on rental profits, subject to various allowances and exceptions, plus a 5.5% solidarity charge.

Major investors in German property

Germany property saw foreign inflows of €13.4bn in Q316 (more than the UK for the first time since 2012), over €20bn in Q416 and €12.6bn in Q117, still well above the long-term average of c €10bn. Germany has 66 listed property companies, of which only four are REITs, vs 32 out of 61 in France and 39 out of 106 in the UK. Compared with other European markets, Germany has a high number of residential property companies, including Germany's two biggest listed property investors, Vonovia and Deutsche Wohnen, and relatively few listed commercial real estate companies compared to the UK or France. DEMIRE is one of the top 10 non-residential listed real estate investors in Germany by market cap. A list of peers is shown in Exhibit 9. We note that VIB Vermögen has made an offer for WCM that is supported by the management and board of WCM.

Management

DEMIRE is managed by a two-member executive board, overseen by a three-strong supervisory board. The composition of both boards continues to reflect the strategic shift of the business in 2013, and it has continued to evolve subsequently. The executive board consists of Markus Drews (CEO) and Ralf Kind (CFO). The supervisory board's chairman is Professor Dr Hermann Anton Wagner, who joined the board in April 2013 and became chairman in October of the same year. Frank Hölzle, CEO of the management company of Wecken, the largest shareholder, was elected as vice chairman on 22 February 2017. His appointment followed the acquisition by Wecken of a further 8.32% of the shares in DEMIRE from DeGeLog, taking its stake to 26.53%. The third member of the supervisory board is Thomas Wetzel, a partner at Swiss law firm Wenger Plattner specialising in real estate.

While seeking to maintain a lean corporate structure, DEMIRE has taken steps to manage its rapid growth over the past year in particular. Operational management, immediately below board level, in areas such as asset, property, facility management and acquisition, has been reinforced with the recruitment of experienced industry professionals and the acquisition, in February 2016, of F Krüger Immobilien GmbH in Bremen. Investment has also been made in central functions such as accounting and controlling. The company has 78 employees, of whom 20 are at the head office in Langen, near Frankfurt.

Financials

Historical performance

DEMIRE reports under IFRS but also publishes EPRA NAV and EPRA earnings figures (the latter being equivalent to operating cash flow, funds from operations or FFO). EPRA NAV excludes deferred taxes. The FFO number is DEMIRE's key performance indicator and is derived as per Exhibit 8 below.

The FY16 results showed the impact of acquisitions completed in 2015 and early 2016. Rental revenue (excluding ancillary charges) increased to €76.4m from €33.3m in FY15, achieving management's target of €75m for the year. Net rental income ("profit/loss from rental") was €58.6m compared with €23.7m in FY15. Tax-mitigation measures and cost savings that management had hoped to implement in the year were not achieved and the FFO figure of €2.7m was short of the €13m target as a result. Adding back profits from disposals (€4.9m) and adjusting for €0.1m of those profits that were attributable to minority shareholders gives net attributable profit of €7.5m. The Q117 results show some progress, with LTV down 30bp to 62.5%. As mentioned above, average finance costs were reduced as well, helping bring the net finance expense down from €9.5m in Q116 to €5.5m in Q117. Despite these improvements and a year-on-year increase in net rents of 4.1% to €18.5m, lower other income (€1.8m vs €6.7m) and a higher tax charge (€2.8m vs €1.0m) contributed to much lower net profits of €0.1m (vs €1.7m). These in turn fed through to lower FFO. The company gave new FFO guidance at its AGM on 29 June and expects to generate €8-10m of FFO before minority interests but after tax, in line with our forecasts (€9.9m, and €4.1m after minority interests and tax).

Exhibit 8: FFO in Q117

€000s	Q117	Q116
Net profit/loss for the period	**126**	**1,663**
Income tax	712	89
Deferred tax	2,069	910
Net profit/loss to NCIs	1,926	2,493
PBT	**4,833**	**5,155**
Profit/loss from the sale of real estate companies	0	(3)
Profit/loss from the sale of real estate	194	0
Profit or loss from fair value adjustments in investment properties	(6)	0
Profit or loss from investments accounted for as equity	(155)	(7,009)
Profit or loss from revaluation of financial instruments	(3,363)	924
Other adjustments	1,196	4,393
FFO 1 before tax	**2,699**	**3,460**
Income tax	(712)	(89)
FFO 1 after tax	**1,987**	**3,371**
Attributable to company shareholders	**237**	**2,089**
Attributable to non-controlling interests	1,750	1,282
Profit/ loss from the sale of real estate and real estate companies after tax	(163)	3
FFO 2 after tax	**1,824**	**3,374**
Attributable to company shareholders	84	2,092
Attributable to non-controlling interests	1,740	1,282
Weighted average no of shares (thousands)	54,256	49,304
Diluted shares (thousands)	67,882	62,951
Basic FFO 1/share (c)	3.7	6.8
Diluted FFO 1 after tax (c)	**2.9**	**5.4**
Basic FFO 2/share (c)	3.4	6.8
Diluted FFO 2/share (c)	**2.7**	**5.4**

Source: DEMIRE data

Leasing progress in the year to date brought benefits in Q117 but will have a larger impact in the rest of the year. Underlying general, administrative and other expenses are targeted to decline in FY17 as previously outsourced costs are internalised into the existing internal property management infrastructure. Management expects that in the rest of the year DEMIRE will continue to benefit from lower costs of debt and administrative costs and that net profits and FFO will pick up. We forecast FFO/share of €0.08 for the year.

DEMIRE's adoption of its new strategy and rapid growth over the past two years had left it with a relatively high weighted average cost of debt. Re-financing began during 2015 and continued in FY16; net finance expense should benefit from repayments of the 15% coupon HFS bond (with €10m of the €17m proceeds from the August capital issue being directed to repay the final outstanding amount). The annualised saving is c €4.8m, of which c €2.2m was realised by the end of FY16 and the balance will be seen in H117. The average interest rate on the group's financial debt dropped to 4.1% as a result of the repayment (as of January 2017), reaching the target range of 4-4.5%.

The issue of a five-year €270m corporate bond rated BB+ and Ba2 by S&P and Moody's respectively will reduce that to 3.2%: the bond has a 2.875% annual coupon and will enable DEMIRE to pay down debts due over the next two years which bear interest of 5.2% and have repayments of 1.3% per annum. This will add c €9m to annual cash flow and €5.6m to FFO1 (after tax but before minority interests). The issue also marks the first step towards realising DEMIRE's new strategy.

Near-term forecasts

Although we similarly assume no portfolio additions, we have adjusted for the H216 sale of three additional non-core assets from within the FVI portfolio and the Q117 disposal of 84 further assets and the 25% interest in SQUADRA, with the assumption that occupancy stabilises at 90% throughout 2017. Other than the occupancy level, our forecasts are based on service charge income stabilising at 30% of net rent and non-allocable expenses at 15% of net rent; these averaged 21% and 18% in FY16, respectively, and we expect improvements to come. We have assumed no revaluation or non-recurring items in FY17.

Valuation

In Exhibit 9 we show summary performance and valuation data for a range of German listed peers that are active in the commercial real estate market. In terms of price/EPRA NAV, DEMIRE, at 81%, trades at about 22pp below the peer group, which trades at a 3% premium to EPRA NAV on average, but as it focuses on further portfolio growth and LTV moderation it does not pay dividends. As we discuss above, FFO should increase rapidly as FVI's assets come under internal management, as occupancy rises and as cost savings are made. We forecast that the FFO yield on the share price will rise from the current level to 6.7% in FY17. On our forecast FY17 FFO of €0.07 per share, DEMIRE trades at c 50x. While we note that the FY16 FFO multiple would be even higher (c 70x), given the lower FFO, we believe that DEMIRE has potential to increase FFO per share through efficiency gains, further portfolio expansion (illustrated below) and higher occupancy rates.

Exhibit 9: Peer comparison

Name	Price (€)	Market cap (€m)	Price/EPRA NAV (x)	P/FFO/share (x)	FY17 prospective dividend yield (%)	LTV (%)	Total return performance		
							3m (%)	6m (%)	12m (%)
DEMIRE	**3.74**	**203**	**0.81**	**71.6**	**N/A**	**62.8%**	**0.7%**	**-3.5%**	**0.9%**
Alstria	12.25	1,878	1.07	16.1	4.3%	39.6%	8.6%	12.5%	1.1%
Deutsche EuroShop	34.91	2,039	0.81	14.5	4.1%	35.2%	-5.7%	-4.1%	-12.4%
TLG Immobilien	18.50	1,372	0.99	16.2	4.6%	37.5%	4.1%	13.2%	-0.7%
Hamborner REIT	9.03	720	0.93	20.1	4.9%	35.1%	1.0%	5.5%	-8.3%
VIB Vermogen	20.86	575	1.20	16.0	2.9%	52.9%	-0.4%	10.5%	12.9%
WCM	3.21	431	1.17	18.3	3.5%	56.6%	5.6%	18.9%	0.7%
Average (ex DEMIRE)	**16.46**	**1,169**	**1.03**	**16.9**	**4.0%**	**42.8%**	**2.2%**	**9.4%**	**-1.1%**

Source: Edison Investment Research, Bloomberg. Note: Averages exclude DEMIRE and Fair Value REIT. EPRA NAV figures are the last reported by each company, total return and price data to 20 July 2017.

Exhibit 10 below illustrates the potential impact of further investment on our estimates. Assuming that the current portfolio gross rental income yield of 7.3% can be replicated, and using a 3.2% cost of debt on 50% gearing, €10m of new equity raised at €3.77 per share could increase FFO by c 0.9 cents per share. In other words, a 2% increase in the portfolio by value would add 4% to our FY18 forecast FFO of 23 cents per share.

Exhibit 10: Illustrative impact of ongoing direct investment, part equity-funded

Additional equity proceeds (€000s)	10,000	Existing IFRS NAV (€000s)	272,299
Assumed gearing	50%	New IFRS NAV (€000s)	282,299
Total direct investment (€000s)	20,000	Existing shares (m)	54.2
Assumed gross yield	7.3 %	Old NAV/share (€)	5.02
Gross property income (€000s)	1,460	New NAV/share (€)	4.96
Operating margin	63.6%	Share price discount to NAV	23%
Net operating income (€000s)	928	Subscription price (€)	3.77
Marginal administrative costs (€000s)	(75)	New shares (m)	2.7
Cost of borrowing	3.2%	New total shares (m)	56.9
Cost of borrowing (€000s)	(320)	FFO on direct investment (€000s)	533
FFO on direct investment (€000s)	**533**	**FFO on direct investment per share (c)**	**0.9**

Source: DEMIRE data, Edison Investment Research

This illustration is sensitive to gearing, yield and operating margin, as well as to the initial equity investment. A 7pp change in gearing, 0.5% change in yield, or 4% change in margin would move the incremental FFO by 0.2c. The issue price of new equity affects incremental FFO per share much less, but would be significant in terms of NAV per share.

We note that our illustration of the investment of the recently completed equity increase would see the investment portfolio increase to only c €1bn. Management's medium-term target of €2bn therefore implies substantially more, potentially FFO accretive, growth than shown in Exhibit 10. Although this growth target may appear high, the scale demonstrated in the last two years implies that this could be achieved through organic developments, as well as potentially a corporate acquisition. We would expect scale economies to be available as the portfolio grows on top of the efficiencies from further integration of the FVI portfolio and asset/facility management functions. We would consider the illustration to be conservative in terms of FFO accretion therefore.

Sensitivities

The main drivers of DEMIRE's IFRS earnings are rental rates, occupancy, interest costs and revaluation gains. The overall cost base is falling as management of the individual assets is brought in-house.

As detailed above, our forecasts are based on the current portfolio and trends and are likely to change materially as DEMIRE progresses towards its goal of having a portfolio of €2bn in the medium term, as we have illustrated in Exhibit 10. Other sensitivities we would point out are:

- The impact on DEMIRE's NAV and FFO of the expansion of the portfolio will depend on the terms of any acquisitions, the price at which equity can be issued and the cost of debt.
- The average remaining lease term across DEMIRE's portfolio was a relatively healthy 5.3 years at 31 March 2017. Although this will naturally diminish as time passes, the active management of the portfolio should help to maintain both occupancy and lease length (which contributes to value) as well as increase rents.
- Valuations of the directly and indirectly owned property portfolio are undertaken quarterly. We have assumed no valuation gains or losses in our estimates, but given the buoyant property market and relatively low bond yields, property valuation yields may continue to fall, increasing the value of the portfolio.
- As noted above, the German economy is performing well and as yet no effects from the decision by the UK to leave the EU have been felt by DEMIRE. It is unclear what, if any, these will be, but they may include increased demand for office space as companies open EU offices or relocate from the UK to the EU. It is possible that UK demand for German goods will diminish as the pound weakens, but the potential impact of this on logistics property has not yet become clear.

Exhibit 11: Financial summary

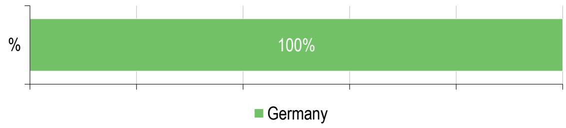
Year ending 31 December (€000s)	2014*	2015	2016	2017e	2018e
PROFIT & LOSS					
Net rents	3,375	33,320	76,371	72,615	72,631
Service charge income	374	10,024	15,746	22,879	22,337
Rental income	3,749	43,344	92,117	95,494	94,967
Property operating expenses	(1,459)	(19,664)	(33,547)	(40,225)	(39,242)
Net rental income	2,290	23,680	58,570	55,269	55,726
Administrative expenses	(3,649)	(11,332)	(14,505)	(11,014)	(9,888)
EBITDA	(1,358)	12,348	44,065	44,255	45,838
Gains/(losses) from sales	69	743	4,924	(194)	0
Gains/(losses) from equity accounted investments	(1,014)	(500)	(359)	6	0
Fair value gains/(losses) on real estate	63,915	18,471	38,414	155	0
Net other income & expenses	(3,178)	27,678	(3,875)	(1,056)	0
EBIT	58,434	58,740	83,169	43,166	45,838
Net finance income/(expense)	(2,938)	(25,728)	(37,981)	(21,041)	(19,060)
Interest of minority shareholders	0	0	(5,226)	(4,612)	(4,774)
Pre-tax profit/(loss)	55,496	33,012	39,962	17,512	22,004
Tax	(9,789)	(4,139)	(12,313)	(3,508)	(1,850)
Non-controlling interest	(2,405)	(756)	(2,979)	(4,310)	(4,774)
Net income attributable to shareholders (IFRS)	43,302	28,117	24,670	9,694	15,380
FFO					
Net rental income	2,290	23,680	60,468	55,269	55,726
Profit/(loss) from disposals & measurement & other operating income	62,706	51,657	1,910	(1,962)	0
General & administrative expenses	(3,648)	(11,332)	(11,861)	(11,014)	(9,888)
Other operating expenses	(2,914)	(5,265)	(3,427)	(2,663)	0
Financial result	(2,938)	(25,728)	(36,142)	(24,379)	(21,867)
Interest of FVI minority shareholders	0	0	0	(3,498)	(4,774)
Income taxes	(9,789)	(4,139)	(2,853)	(3,508)	(1,850)
Non-controlling interest	(2,405)	(756)	(5,416)	(4,352)	(4,774)
FFO net attributable profit	43,302	28,117	2,679	3,892	12,573
Average Number of Shares Outstanding (m)	14.3	25.9	51.4	54.2	54.2
Average Diluted Number of Shares Outstanding (m)	25.2	40.6	65.0	67.9	67.9
EPS basic (€)	3.03	1.09	0.48	0.18	0.28
EPS diluted (€)	1.74	0.71	0.39	0.15	0.24
FFO per share/EPRA EPS (€)	3.03	1.09	0.05	0.07	0.23
FFO1 per share	3.19	1.12	0.16	0.15	0.32
Dividend per share (€)	0.0	0.0	0.0	0.0	0.0
BALANCE SHEET					
Non-current assets	350,926	948,597	1,001,486	978,665	978,665
Intangible assets	0	6,961	7,005	6,998	6,998
Investment property	333,070	915,089	981,274	958,408	958,408
Other non-current assets	17,856	26,547	13,207	13,259	13,259
Current Assets	22,086	84,348	92,520	135,491	155,646
Cash & equivalents	4,397	28,467	31,289	92,347	112,502
Assets held as available for sale	0	13,005	24,291	0	0
Other current assets	17,689	42,876	36,940	43,144	43,144
Current Liabilities	(60,259)	(71,297)	(66,029)	(77,412)	(77,412)
Financial liabilities	(47,573)	(46,443)	(42,020)	(50,000)	(50,000)
Other current liabilities	(12,686)	(24,854)	(24,009)	(27,412)	(27,412)
Non-current liabilities	(258,124)	(696,746)	(719,340)	(714,716)	(714,716)
Financial liabilities	(248,092)	(608,796)	(620,623)	(615,206)	(615,206)
Other non-current liabilities	(10,032)	(87,950)	(98,717)	(99,510)	(99,510)
Net Assets	54,629	264,902	308,637	322,028	342,183
Non-controlling interests	(2,945)	(34,205)	(36,692)	(37,479)	(37,479)
Shareholders' equity	51,684	230,697	271,945	284,549	304,704
EPRA adjustments:					
Fair value of derivative financial instruments	0	0	(1,778)	0	0
Deferred tax	9,312	25,570	30,292	37,099	37,099
EPRA adjusted NAV	60,996	256,267	300,459	321,648	341,803
Period end number of shares (m)	14.3	49.3	54.2	54.2	54.2
Diluted period end number of shares	25.2	64.0	64.0	64.0	64.0
IFRS NAV per share (€)	3.82	5.37	5.01	5.25	5.62
Diluted EPRA NAV per share (€)	2.84	4.25	4.88	5.22	5.53
CASH FLOW					
Operating Cash Flow	5,803	14,954	36,670	77,955	45,838
Net Interest	(1,607)	(21,255)	(33,487)	(28,468)	(23,834)
Tax	(9,789)	(4,139)	(1,318)	(858)	(1,850)
Acquisitions/disposals	(255,307)	(30,815)	5,726	11,780	0
Financing	0	9,644	15,822	0	0
Dividends	0	0	0	0	0
Other	102	(303,893)	(27,994)	0	0
Net Cash Flow	(260,799)	(335,504)	(4,581)	60,409	20,154
Opening net debt	(30,470)	(291,269)	(626,772)	(631,353)	(570,944)
Closing net debt	(291,269)	(626,772)	(631,353)	(570,944)	(550,790)

Source: DEMIRE accounts, Edison Investment Research. Note: *Period from 1 April 2014 to 31 December 2014.

Contact details

DEMIRE Deutsche Mittelstand Real Estate
Robert-Bosch-Straße 11
D-63225 Langen
Germany
+49 (0) 6103 372 49-0
www.demire.ag

Revenue by geography



Management team

Chairman of the supervisory board: Professor Dr Hermann Anton Wagner

Professor Wagner is a chartered accountant. He joined the banking audit department of Peat, Amrwick Mitchell in 1983. Following its merger with KPMG in 1993 he was managing partner in Frankfurt before joining Arthur Andersen in 1999, later becoming a board member of Ernst & Young AG after another merger. He is a professor of financial management at the Frankfurt School of Finance and Management and holds several other directorships.

CEO: Markus Drews

Mr Drews has over 20 years' experience in real estate, having established and sold a listed property company with a market cap of €1.5bn and taken part in property transactions totalling over €2bn for companies such as Haniel and RWE.

Vice Chairman of the supervisory board: Frank Hölzle

Mr Hölzle graduated with a degree in economics from the University of Freiburg and subsequently worked in venture capital businesses for over 10 years. He is a board member of several companies including Westgrund AG, a €500m listed residential real estate company. He is the CEO of Care4 AG, the management company of Wecken & Cie, and has significant experience in investment management and business coaching.

CFO: Ralf Kind

Mr Kind was appointed to the executive board in February 2017 having been CEO of Abireo Capital, an independent real estate investment management and advisory company in Frankfurt, and managing partner of Dr Lübke & Kelber. He was previously a director at Barclays Bank in Frankfurt and graduated from Nürtingen University.

Supervisory Board Director: Dr Thomas Wetzel

Dr Wetzel is a specialist in construction and property law at Wenger Plattner. Having studied law at the University of Zurich he qualified as a Doctor of Law at the UNiveristy of Basel in 1983 before joining Frick and Frick in 1985. From 1988 to 1997 he worked at Intershop Holding AG becoming deputy chairman of the management board. He then joined Diener & Wetzel as a partner in 1997, moving to Wenger Plattner in 2003. He is on the boards of Energy 360 AG and VERIT Investment Management AG as well as some smaller Swiss companies. He lectures at the Centre for Urban & Real Estate Management at the University of Zurich.

Principal shareholders	(%)
Wecken & Cie.	26.53
Obotritia Capital KGaA and subsidiaries	11.89
Alpine Real Estate Invest GmbH	6.01

Companies named in this report

Fair Value REIT (FVI), Alstria Office (AOX), Deutsche EuroShop (DEQ), TLG Immobilien (TLG), DIC Asset (DIC), Hamborner REIT (HAB), VIB Vermögen (VIH), WCM (WCMK), Vonovia SE (VNA), Deutsche Wohnen (DWNI).