Grand City Properties

Q214 results

Growth continues ahead of forecasts

Real estate

Grand City Properties (GCP) continues to grow its portfolio ahead of expectations. At end July it owned c 35k units, up from 30k at end March and 26k at end 2013. Its core strategy of buying undermanaged properties, and with financial and human investment improving occupancy and rental levels, continues to deliver good revaluation gains. We have raised estimates to reflect the above-expected growth in H114.

Year end	Revenue (€m)	PBT* (€m)	EPS* (c)	DPS (c)	P/E (x)	EPRA NAV (€/share)
12/12	60.4	13.8	27.2	0.0	35.0	3.98
12/13	169.6	51.8	50.6	0.0	18.8	6.90
12/14e	235.8	85.5	66.4	0.0	14.3	8.98
12/15e	326.9	122.5	95.9	0.0	9.9	10.54

Note: *PBT and EPS are normalised, excluding intangible amortisation, exceptional items and share-based payments.

Q214 key features

GCP has continued to grow its portfolio (now 35k units up from 30k at end Q114) through the acquisition of undermanaged properties. Rental and operating income grew to €49.1m (from €17.6m in Q213 and €45.7m in Q114) with the year-on-year increase also aided by the acquisition of a modest property management company. Q214 did not see any properties sold (the policy is to sell up to 10% acquired). Property expenses grew to €21.7m, largely unchanged on Q114 (€21.6m), albeit well up on Q213 (€8.1m). Finance costs grew to €6.6m (Q213 €2.5m, Q114 €5.2m) reflecting higher volumes of finance and the mix including long-term bonds (coupon 6.25%) against the average cost of bank funding of just 3%. The group also issued €290m of convertible bonds (€150m in February and €140m in June) at a coupon of 1.25% and a strike price of €9.72. The end-June loan to value was 46% (32% if the convertible is exercised). Funds from operation (FFO) were €17.4m (Q114 €16.4m) and the EPRA NAV was up to €1bn (from €941m at end March).

Outlook

The core strategy continues to deliver good gains and good growth. For the foreseeable future this is likely to continue and we have modestly raised estimates to reflect the faster than expected growth. Relative to most property companies, GCP has an attractive countercyclical quality as the number of undermanaged properties in periods of economic weakness tends to increase.

Valuation: Approach average €12.6

Our discounted "funds from operation" model indicates a value of €12.9 (from €9.2), while our Gordon's growth model (GGM) is unchanged at €12.2. The former has increased since our May report with the higher earnings feeding through the better cash generation. The impact on our 2015 NAV is modest and so the GGM is less affected.

20 August 2014

Price	**€9.51**
Market cap	**€1,097m**
Net debt (€m) at June 2014	865
Shares in issue	115.4m
Free float	62%
Code	GYC
Primary exchange	Frankfurt
Secondary exchange	N/A

Share price performance

%	1m	3m	12m
Abs	2.7	17.2	77.2
Rel (local)	6.9	21.3	58.9
52-week high/low		€9.6	€5.2

Business description

Grand City Properties is a specialist turnaround company focused primarily on investing in and managing German residential properties. As of end July 2014, the group's real estate portfolio consisted of c 35,000 units offering 2.75m square metres of lettable space.

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H114: Results in more detail

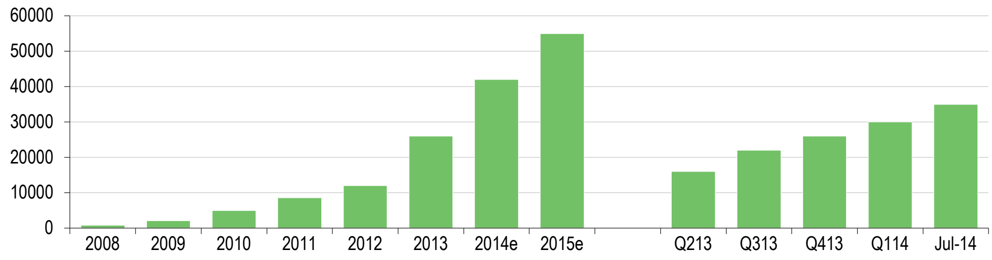
Some other key financial and operational issues are:

- Rental and operating income increased with unit growth (end May 31,000, end March 30,000, end July 35,000); a 3.1% like-for-like increase in occupancy; and a 2.7% like-for-like increase in rent per square metre. The proportion of the portfolio that is now stabilised (ie vacancy below 5%) is now 37%. The annualised run rate for rental and operating income (from July) is now over €200m.
- Property operating costs were stable on Q114 and administration expenses were €1.36m, against Q114 €1.3m, showing the operational gearing in portfolio.
- Revaluation gains. By its nature this line will be volatile and unpredictable. The key business message for us is that the group continues to see significant revaluation gains supporting the proposition that its regeneration model is working. Q114 saw an exceptional large €49.7m, while Q214 was €29.1m (our full year estimate of €150m implies €37.5m per quarter). We also note that the bargain purchase (profit arising when buying property companies) was stable in nominal terms (Q114 €6.8m, Q214 €7.1m), but fell sharply as a percentage of investment properties added through business combination (Q114 20%, Q214 7%, Edison FY14 estimate 18%). This number is highly volatile and no one quarter should be taken as indicative of trend.
- Finance expenses were €6.6m in Q214 vs €5.2m in Q114. Gross finance expenses grew primarily to fund the larger portfolio. The cost of the series B is reduced to an effective 3.8% as the 6.25% coupon is significantly offset by the amortisation of the premium on issue (7.25%). There is also a reduction to the 1.5% coupon paid on the convertible bonds.
- Q214 saw a further large credit in the other finance results (€2.5m, Q114 €2.8m) driven by a positive gain on derivatives (in the balance sheet, non-current liabilities derivatives fell from €14.8m to €11.0m). GCP manages a portfolio of pay fixed, receive variable swaps, which see a gain when the relevant interest rate falls. This line also includes market gains on the traded securities portfolio but these positive features were offset by the amortised bond expenses.
- The adjusted EBITDA increased from €23.0m in Q114 to €26.3m in Q214.
- FFO I was €17.4m (Q114 €16.4m) or 15c per share (Q114 14c), while FFO II (which includes property disposal gains) was €17.4m (Q114 €18.0m).
- The EPRA NAV saw a further increase to €1bn (6%) in Q214, having increased 10% in Q114.
- Gearing, using the company-defined loan to value, increased to 46% (Q114 39%), but this falls to 32% if the convertible bond is exercised. The company has a conservative trigger of 50% LTV. 43% of assets are unencumbered.
- The mix of the portfolio continues to show a greater proportion in the stabilised category (ie where vacancy is under 5%) with that part now accounting for 37% of the portfolio (end March 35%, end 2013 33%). This is an important metric as the company values its acquired properties on the assumption that there will be an improvement in occupancy under its management. The assumptions used have been conservative as evidenced by ongoing revaluation gains. The overall average vacancy is 14.5%.
- The company issued €150m in a convertible bond Series C issue in February and made a further €125m (nominal value) issue in June. The June issue was at 111.25% of face value (strike price kept at €9.72), resulting in a gain to equity of €7.3m (based on an external valuer's calculation) and deferred income in other long-term liabilities of €6.7m. The coupon on this debt is 1.5%.
- In the quarter, the group also made a tap issue with a nominal value of €150m in its Series B bonds. These were issued at 107.25% of principal and carry a yield to call of 3.85%. The above par issuance sees a deferred income in other long-term liabilities.

Growth in portfolio

As can be seen in Exhibit 1, GCP has delivered strong sequential growth in a controlled manner. We believe it is very important that this growth has been steady and in line with control functions and central processing capacity to ensure that new acquisitions can be effectively integrated. We note that the centralised call centre means that sales are highly scalable and with the acquisition of a property management company, GCP has further built its expertise in this area.

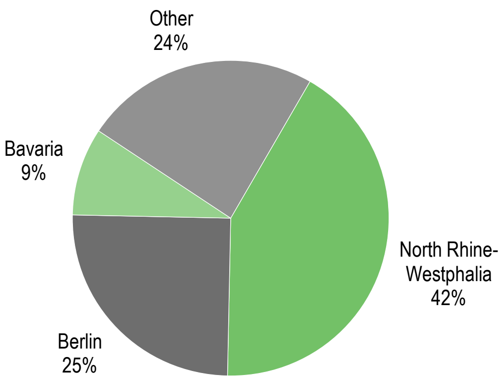
Exhibit 1: Number of units owned by GCP



Source: GCP, Edison Investment Research.

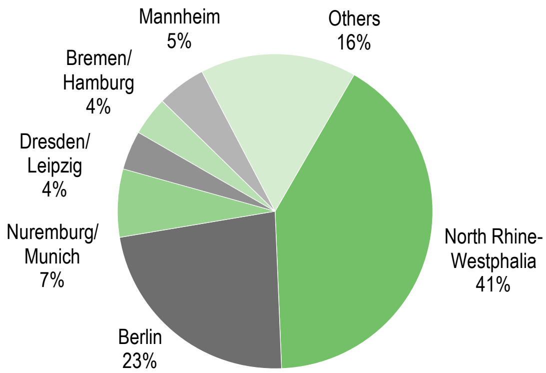
The geographic mix also shows the portfolio is managed closely and that growth has been in line with the historic portfolio mix, ie c two-thirds focus on North Rhine Westphalia and Berlin.

Exhibit 2: Geographic mix end 2013



Source: GCP, Edison Investment Research

Exhibit 3: Geographic mix H114



Source: GCP, Edison Investment Research

Valuation

EPRA NAV

The increase in fair value gains sees the EPRA NAV increase. We now forecast an end-2014 EPRA NAV of €8.98 per share against out previous estimate of €8.81. Given the growth of the company, this rises rapidly (2015e EPRA NAV per share €10.54). The current share price is in line with our expected EPRA by summer next year.

Discounted funds from operations

We use our 2014/15 explicit funds from operation forecasts, grow them at 5% for 10 years, apply a 10x multiple for terminal value and discount back at cost of equity (we estimate 9.5%). On these assumptions the fair value would be €12.9 per share (up from €9.2 in our last report, reflecting the higher cash generation from increased earnings).

Gordon's growth model (GGM)

We use a GGM to capture both the likely value added by the business (ie its returns above cost of capital) and the growth. Assuming a 10.5% sustained long-term return on equity, a 9.5% cost of equity and growth at 5%, GCP should trade at 1.2x book value. 2014/15 ROE is below the long-term assumptions, leading to a modest (5%) discount to this implied value. Using the end-2015 EPRA NAV, this methodology leads to a fair value of €12.2 per share. This is only marginally raised from our last report – the increase in EPRA NAV is small and the increase in valuation is thus lost in the roundings.

Financials

Changes to estimates – summary

Exhibit 4: Changes to forecasts

	Revenue (€m)		%	Adjusted pre-tax profit (€m)		%	Adjusted EPS (€)		%	FFO 2 per share (€)		%
	Old	New	Change	Old	New	Change	Old	New	Change	Old	New	Change
FY14e	224.5	235.8	5%	75.7	85.5	13%	0.60	0.66	11%	0.64	0.68	6%
FY15e	300.7	326.9	9%	103.5	122.5	18%	0.82	0.96	17%	0.85	0.98	15%

Source: Edison Investment Research

Exhibit 5: Changes to forecasts

	Portfolio units (no 000s)		%	Investment Properties (€m)		%	EPRA NAV per share (€)		%	Loan to value		%
	Old	New	Change	Old	New	Change	Old	New	Change	Old	New	Change
FY14e	38	42	11%	2,013	2,021	0%	8.81	8.98	2%	43.6	45.7	5%
FY15e	50	55	10%	2,613	2,616	0%	10.40	10.54	1%	47.0	48.0	2%

Source: Edison Investment Research

Changes to estimates – detail

The detail of changes in estimates is given below:

- Rent: We have increased 2014 rent and other income to €206m from €194m. Our revised estimate is in line with the annualised run rate at the end of July. 2015 has been increased from €270m to €297m. We have left our sale proceeds unchanged at €30m in each year. The increase is driven by the higher number of units now forecast following above run rate growth through Q114 and Q214.

- There has been a reduction in the average property value based on our simple mathematical average over the period. We have carried this forward so the growth in the value of the portfolio is lower than the growth in the number of units. This has resulted in an increase in the rental yield (2014 was 10.7%, now forecast at 11.3%) as we forecast rent income from the number of units not their value.
- Revaluation gains are unchanged for 2014. The slightly larger portfolio sees a slight increase in this in 2015 (€118m to €123m). Profit arising on business combinations has been cut by a similar amount given the H114 mix of business being weighted more to property purchase than company purchase.
- We have corrected our treatment of (i) the amortised premium on issue (now a credit to interest expense) and (ii) the amortised expenses related to bond issues (ie in “other finance expense” not “finance expense”). Finance expense thus reflects the effective rate of 3.8% on Series B bonds not the coupon of 6.25%. Amortised expenses are now included in “other finance expense”, which is a negative going forward as we continue to assume no change in derivative values or trading gains from the debt securities portfolio.
- Property expenses have been increased to reflect the higher portfolio (2014 up from €78m to €82m and 2015 €107m to €117m).
- Relative to our previous estimates we have also reduced our gross cash and securities balances for end 2015, thus reducing the need for incremental financing at a negative spread. We still forecast over €100m (previously c €200m), a level that should prove quite comfortable in terms of giving potential sellers certainty that GCP can complete further acquisitions.

Exhibit 6: Financial summary (€000s)

Year end December	2012	2013	2014e	2015e
Rent & ancillary income	39,872	99,580	192,798	281,896
Revenue from sale of buildings	19,989	70,000	30,000	30,000
Other operating income	511	50	13,000	15,000
Revenue	60,372	169,630	235,798	326,896
Total Capital gains, property revaluations, & other income	98,043	236,846	176,266	150,828
Share of profit from equity accounted investments	8,384	470	200	200
Maintenance and refurbishment	(2,195)	(5,463)	(11,900)	(16,975)
Total property operating expenses	(21,709)	(37,248)	(82,047)	(118,318)
Cost of buildings sold	(18,301)	(54,914)	(24,090)	(24,090)
Administrative & other expenses	(2,228)	(3,339)	(5,300)	(6,430)
Operating profit	122,366	305,982	288,927	312,111
Net finance expense	(13,284)	(3,542)	(24,142)	(38,736)
PBT	109,082	302,440	264,785	273,375
Adjusted PBT	13,841	51,791	85,519	122,547
Tax	(16,166)	(36,388)	(36,800)	(37,073)
Profit after tax	92,916	266,052	227,985	236,302
Non-controlling interests	(11,085)	(39,777)	(18,239)	(18,904)
Net attributable profit	81,831	226,275	209,746	217,398
Average number of shares in issue (m)	43.97	76.12	115.43	115.43
Reported EPS - diluted (€)	1.890	2.972	1.817	1.883
Adjusted EPS - diluted (€)	0.272	0.506	0.664	0.959
Balance sheet:				
Equipment & intangible assets	55	4,383	8,500	10,000
Investment property	407,086	1,368,281	2,023,636	2,615,695
Advanced payments for investment property	2,422	7,169	0	0
Equity accounted investments	20,162	7,354	0	0
Other LT assets (inc def tax)	7,314	15,308	17,817	17,817
Total non-current assets	437,039	1,402,495	2,049,953	2,643,512
Cash & equivalents	80,977	132,542	230,631	50,167
Traded securities at fair value through P&L	4,875	34,258	65,000	65,000
Trade & other receivables	21,108	81,792	140,801	184,595
Assets held for sale	10,721	0	0	0
Total current assets	117,681	248,592	436,431	299,762
Total assets	554,720	1,651,087	2,486,384	2,943,274
Liabilities				
Loans & borrowings	(171,752)	(461,753)	(600,000)	(750,000)
Convertible bond	(95,920)	0	(270,985)	(270,985)
Bond series B	0	(194,676)	(344,367)	(344,367)
Other LT liabilities (inc def tax)	(48,959)	(115,456)	(142,046)	(163,771)
Total non-current liabilities	(316,631)	(771,885)	(1,357,398)	(1,529,123)
Trade & other payables	(21,822)	(92,357)	(108,679)	(155,028)
Total current debt	(4,249)	(10,563)	(7,137)	(7,137)
Other current liabilities	(9,075)	(8,357)	(10,833)	(13,347)
Total current liabilities	(35,146)	(111,277)	(126,649)	(175,512)
Total liabilities	(351,777)	(883,162)	(1,484,047)	(1,704,635)
Net assets	202,943	767,925	1,002,337	1,238,639
Non-controlling interests	(18,685)	(63,001)	(91,240)	(120,144)
Shareholders' equity	184,258	704,924	911,097	1,118,495
LTV company basis	43%	36%	46%	48%
Net debt (co basis)	(186,069)	(500,192)	(926,858)	(1,257,322)
Cash flow from operations	34,437	61,401	120,551	149,029
Cash flow from investing activity	(51,739)	(410,863)	(478,318)	(386,120)
Cash flow from financing activity	90,132	401,016	455,855	56,627
Other (inc debt on acquisition)	(126,309)	(365,677)	(524,755)	(150,000)
Change in net debt	(53,479)	(314,123)	(426,666)	(330,464)
FFO per share (€)	0.22	0.30	0.62	0.93
FFO II per share (€)	0.62	0.50	0.68	0.98
FF0 (€)	9,753	23,058	72,053	106,833
FFO II (€)	27,162	38,143	77,963	112,743

Source: Grand City Properties, Edison Investment Research

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