29 Jun 2018 14:15:58 ET | 12 pages

REITs
Western Europe | France

Covivio SA (FDR.PA)

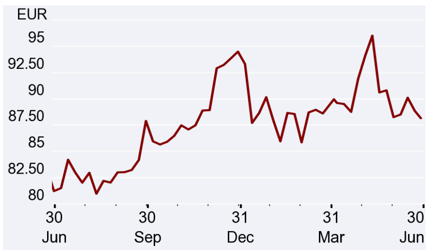
The right portfolio but growth muted

- Estimate Change

- **In all the right places but growth remains muted** — Company's active capital recycling and diversification strategy has created an unmatched pan-European portfolio which, in our view, is operating in all the right markets but is not generating specialist level returns in each market. Growth in all of its individual markets is seemingly strong and expected to continue in the near future, however, has not been translating into growth for the company. Management guidance for EPRA earnings growth is at c+3% for 2018; we expect the company to outperform slightly and estimate +4.4% EPRA earnings growth. However, even on our forecasts, earnings growth remains at the lower end when compared to companies with specialist portfolios. Applying Covivio's portfolio weights to specialist portfolio performance suggests expected EPS growth at c9% compared to c+3% guided by the company for 2018. Management expects LFL valuation gains in 2018 to be lower compared to last year as noise around interest rate increases, which we expect might negatively impact NAV. We retain our Neutral with TP unchanged at €96.1.
- **The way forward** — France offices continue to be the focal point for management. Management view office acquisitions in France as too expensive at present, hence focus is on value creation through developments. The Paris office market seems to be holding up well since the beginning of 2018 with increased take-up and declining vacancies driving our 1.2% LFL rental growth with c17bps yield compression for 2018. Italy office portfolio is being positively impacted by growth momentum, expected to be partly offset by ongoing political uncertainty. Management see market momentum to be more visible in new builds than the LFL portfolio. German residential continues to benefit from strong market momentum. We expect the hotel portfolio to benefit from positive economic momentum in Europe.
- **Valuation provides c13% estimated total return** — Our target price implies c8% upside, underpinning our Neutral. The stock trades at 17.5x 2018E EPS, c13% discount to 2018E NAV with 5.2% dividend yield.
- **With this note we transfer stock coverage to Aakanksha Anand**.

Neutral	**2**
Price (29 Jun 18 09:29)	€88.95
Target price	€96.10
Expected share price return	8.0%
Expected dividend yield	5.2%
Expected total return	**13.2%**
Market Cap	€6,688M
	US$7,737M

Price Performance
(RIC: FDR.PA, BB: COV FP)



Covivio SA (EUR)

Year to 31 Dec	2016A	2017A	2018E	2019E	2020E
Operating Income (€M)	526.3	539.4	588.8	693.5	729.2
Profit Before Tax (€M)	328.4	358.2	399.2	472.3	500.2
Diluted EPS (€)	4.86	4.86	5.08	5.37	5.69
Diluted EPS (Old) (€)	4.86	4.96	5.09	5.33	5.41
PE (x)	18.3	18.3	17.5	16.6	15.6
DPS (€)	4.40	4.50	4.62	4.89	5.17
Net Div Yield (%)	4.9	5.1	5.2	5.5	5.8
NAV per share (€)	86.76	94.52	101.82	110.64	116.51
Disc/Prem to NAV (%)	2.5	-5.9	-12.6	-19.6	-23.7

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Prepared for Yu Lan Gu

See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

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Fiscal year end 31-Dec	2016	2017	2018E	2019E	2020E
Valuation Ratios					
P/E adjusted (x)	18.3	18.3	17.5	16.6	15.6
P/E reported (x)	18.3	18.3	17.5	16.6	15.6
P/BV (x)	1.0	0.9	0.9	0.8	0.8
Dividend yield (%)	4.9	5.1	5.2	5.5	5.8
Per Share Data (€)					
EPS adjusted	4.86	4.86	5.08	5.37	5.69
EPS reported	4.86	4.86	5.08	5.37	5.69
BVPS	86.76	94.52	101.82	110.64	116.51
NAVps ordinary	na	na	na	na	na
DPS	4.40	4.50	4.62	4.89	5.17
Profit & Loss (€M)					
Net operating income (NOI)	**526**	**539**	**589**	**694**	**729**
G&A expenses	-62	-64	-66	-74	-76
Other Operating items	12	35	35	28	28
EBIT including associates	**476**	**510**	**558**	**647**	**681**
Non-oper./net int./except.	-148	-152	-159	-175	-180
Pre-tax profit	**328**	**358**	**399**	**472**	**500**
Tax	0	0	0	0	0
Extraord./Min. Int./Pref. Div.	0	0	0	0	0
Reported net income	**328**	**358**	**399**	**472**	**500**
Adjusted earnings	328	358	399	472	500
Adjusted EBIT	476	510	558	647	681
Adjusted EBITDA	476	510	558	647	681
Growth Rates (%)					
NOI	4.3	2.5	9.1	17.8	5.1
EBIT adjusted	-0.9	7.2	9.4	15.9	5.2
EPS adjusted	1.9	0.1	4.4	5.8	5.9
Cash Flow (€M)					
Operating cash flow	**497**	**738**	**399**	**472**	**500**
Depreciation/amortization	0	0	0	0	0
Net working capital	0	0	0	0	0
Investing cash flow	**-148**	**173**	**-838**	**-364**	**-366**
Capital expenditure	0	0	-162	-214	-216
Acquisitions/disposals	-148	173	-676	-150	-150
Financing cash flow	**-119**	**204**	**-263**	**-230**	**-155**
Borrowings	0	0	100	200	300
Dividends paid	-297	-331	-363	-430	-455
Change in cash	**230**	**1,115**	**-702**	**-122**	**-21**
Balance Sheet (€M)					
Total assets	**13,130**	**14,181**	**17,352**	**18,328**	**19,144**
Cash & cash equivalent	991	1,089	365	243	222
Net fixed assets	0	0	0	0	0
Total liabilities	**7,135**	**7,069**	**8,396**	**8,596**	**8,896**
Total Debt	6,879	6,780	7,915	8,115	8,415
Shareholders' funds	**5,995**	**7,112**	**8,956**	**9,731**	**10,247**
Profitability/Solvency Ratios					
EBIT margin adjusted (%)	82.9	86.7	86.8	84.5	84.6
ROE adjusted (%)	5.8	5.5	5.0	5.1	5.0
ROA adjusted (%)	2.6	2.6	2.5	2.6	2.7
Net debt to equity (%)	98.2	80.0	84.3	80.9	79.9
Interest coverage (x)	3.2	3.4	3.5	3.7	3.8

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In all the right places but growth remains muted

Company's active capital recycling and diversification strategy has created an unmatched pan-European portfolio which in our view is operating in all the right markets. Management guidance for EPRA earnings growth is at c+3% for 2018, which we expect the company to outperform slightly and estimate +4.4% EPRA earnings growth. However, earnings growth still remains at the lower end when compared to expected earnings growth for companies with comparable specialist portfolios. The figure below shows how Covivio's earnings growth guidance compares to expected earnings growth for specialist portfolios. We use Citi estimates for France and Italy office peers along with German residential. For Hotels, we have used FY2017 EPS growth for Pandox due to lack of reliable consensus estimates.

If we weigh the expected EPS growth for specialist portfolio companies to Covivio's portfolio split, this gives expected growth of c+9% versus the c+3% EPS growth guided by Covivio for 2018.

Figure 1. Covivios' earnings growth lower than combined specialist portfolios

	FY 2018E Earnings growth	2017 Portfolio weights	Weighted average growth
France office	3.5%	42%	1.5%
Italy office	8.2%	14%	1.1%
German residential	13.1%	24%	3.1%
Hotels	23.2%	14%	3.2%
	12.0%		**9.0%**
Covivio 2018E EPS Guidance			**3.0%**

Source: Citi Research Estimates, Company data
Peers : France office - Gecina, Italy office - Coima and German residential - Average of Vonovia and Deutsche Wohnen, Hotels – Pandox 2017 EPS growth
Portfolio weights do not include Non-strategic activities

Although market growth in all of its individual markets is seemingly strong and we expect these trends to continue in the near future, it seems that the company is unable to extract growth as efficiently as the specialists in respective markets.

France offices holding up well

France offices continue to be the focal point for management; however, some disposals from regional cities are expected. Management view office acquisitions in France as too expensive at present; hence focus is on value creation through developments. Office development pipeline is expected to increase by c900mn over 2018, majority in France. Most of these assets are from the existing portfolio and expected to result in a rental income loss of c€10-12 mn. These developments are expected to aid future valuation uplifts as they complete; however, it is likely that the completions coincide with an interest rate increase and the uplift potential might be lower than expected. The Paris office market seems to be holding up well since the beginning of 2018, with increased take-up (+13% YoY) and declining vacancies (-40bps compared to Q4 2017). However, we continue to see divergent trends with stronger momentum in CBD rents (c+2%) and average growth in rest of the market remaining largely flat (c+0.6%), compared to Q4 2017.

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Italy offices show good signs of recovery, expect some negative impact from political uncertainty

Recovery in Milan has picked up, in line with our expectation, and could accelerate further as lower levels of anticipated supply coupled with improving economic indicators are expected to drive rents up. However, we expect the increased uncertainty from the political situation to have some negative impact on valuations. The proposed acquisition of Beni, once completed would increase the pro-forma portfolio weighting to c21%. Management do not see the positive market momentum translating into LFL growth in their portfolio (+1.5% Q1 2018, +1.8% excl. Telecom Italia), whereas competitors like Coima are able to produce c+3% (Q1 2018) LFL rental income growth. According to Covivio management, the positive market momentum is more visible in new builds than the LFL portfolio. Going forward, we expect Beni's development pipeline to leverage this trend, potentially resulting in positive valuation gains as completions near.

Hotels

Strategy for hotels is focused on obtaining critical mass in major European cities, which puts the recent acquisition in UK from Starwood capital in perspective. LFL rental income in Q1 2018 was up +3% for lease properties and +2.4% for operating properties and we expect the hotel portfolio to benefit from positive economic momentum in Europe.

German residential super cycle continues

The German resi super cycle continues where we expect values in Berlin (c55% of German resi portfolio) to almost double over the next 5 years. LFL rental income growth in 1H 2018 is expected to be positively impacted by Mietspiegel increments last year (+5.1% LFL growth in Q1 2018).

Estimates update

We update our forecasts for FY 2017 results and the proposed Beni Stabili merger. Our model balance sheet is now based on a group share basis (100% share earlier), which we think allows us to forecast more accurately as it excludes the share of minority interests. Our LFL rental growth estimates are slightly lower at an average 1.3% (c2% earlier) driven by our view on the company's difficulty in generating LFL growth. Our yield compression estimates remain largely unchanged and we expect c43bps until 2020, post which we expect the yields to expand by c21bps, in line with our expectation of rate rises. Average NAV growth over the forecast period is at c4.1%. Our EPS estimates have increased by an average c3% and we expect average EPS growth of 4.5% p.a. over the forecast period. Capital recycling through disposals is expected to continue.

In our economic profit valuation, we have reduced our risk premium to reflect positive momentum in regions the company operates in. Our beta is in line with Bloomberg and the cost of debt reduced by c33bps over 2017. These changes have led to a reduction in our WACC to 4.2%. Our TP remains unchanged at 96.1.

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Figure 2. Economic profit valuation

Valuation	
Opening invested capital	11,580.00
+ Sum of discounted economic profit	1,309.72
- Net Debt	(5,691.00)
+/- Other net assets	474.00
+/- NAV adjustments	749.20
NAV	8,421.92
Adjust to valuation date	8,449.24
No shares issued	87.95
Economic profit per share	96.1
Current share price	88.9
Upside to current share price	8.1%

Source: Citi Research Estimates, Company data. Price as at 29 Jun 18, 09:29 UKT

Companies Mentioned

(FDR.PA; €88.15; 2; 28 Jun 18; 17:30); (PANDXb.ST; SKr152.00; Not Rated; 28 Jun 18; 17:30); (DWNG.DE; €41.12; 1; 28 Jun 18; 17:30); (VNAn.DE; €40.22; 1; 28 Jun 18; 17:30); (CRES.MI; €7.80; 1; 28 Jun 18; 17:30); (GFCP.PA; €143.00; 2; 28 Jun 18; 17:30); (BNSI.MI; €0.74; 1; 28 Jun 18; 17:30); (TLIT.MI; €0.64; 3; 28 Jun 18; 17:30)

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Covivio SA

Company description

Covivio manages a diversified real estate portfolio including offices, residential building, hotels and car parking lots. The company opted for SIIC legal status in 2003.

Investment strategy

We rate Covivio Neutral. Positive momentum from investments in German residential and high quality hotel portfolios along with sooner than expected recovery of Milan office market drive positive LFL growth in our Covivio estimates. This should more than offset future supply driven weakness we estimate in 2018-19 for their French office portfolio. However, the portfolio's limited exposure to CBD provides some respite as that is where our estimates suggest the maximum decline. We estimate average rental growth of c.1.3% over our forecast period with c.43bps of yield compression until FY20, with expansion thereafter.

Valuation

We value real estate stocks using an economic profit model where the key drivers are the stock’s rental value growth, yield compression and development profit. The sum of the discounted 5-year future economic profit provides the basis for our valuation.

For Covivio the key assumptions underpinning our €96.1 target price are: average rental value growth of 1.3%, yield compression of c22bps and a weighted average cost of capital (WACC) of 4.2%.

Risks

The key downside risk to our TP, in our view, is the next cyclical turning point and while the catalyst will be unknown and a shock, the effect is likely to cause rent decline and valuation yield expansion, both causing property valuations to fall dragging stock prices lower and potentially testing debt covenants. Types of risk inherent to property include tenant risk, location risk, sector risk, planning risk, legal risk, taxation risk, structural risk, liquidity risk, development risk, valuation and pricing risk, and listed securities have in addition the risk inherent with stock markets. Key upside risks to our target price are significantly higher than anticipated property yield compression, significantly greater than estimated rental value growth and development site valuations that are reported well ahead of our estimates.

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Appendix A-1

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Covivio SA (FDR.PA)

Ratings and Target Price History
Fundamental Research

Analyst: Gareth M Phillips
Covered since July 17 2017

	Date	Rating	Target Price	Closing Price
1	21-Jul-15 11:31:39	*2	*87.80	82.74
2	01-Feb-16 00:23:08	2	*80.50	78.60
3	19-Dec-16 00:00:00	*3	*71.50	80.58
4	17-Jul-17 00:00:00	*2	*79.80	84.70
5	13-Sep-17 05:53:47	2	*81.30	83.70
6	24-Jan-18 01:23:33	2	*96.10	89.00

*Indicates Change

Rating/target price changes above reflect Eastern Time

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Prepared for Yu Lan Gu

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