

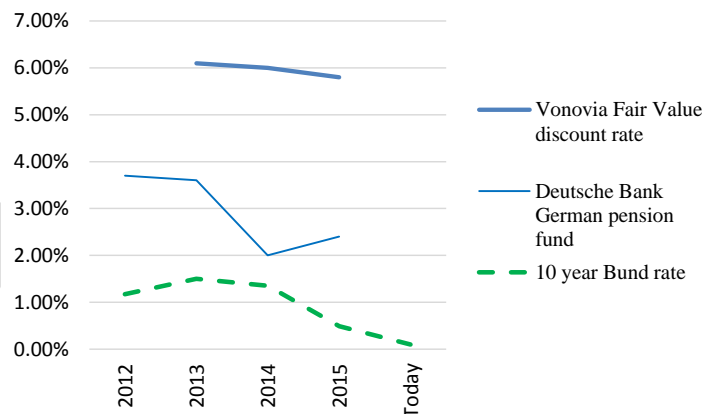
## Holland Views – Vonovia (Price: €31.40; MCap: €14.7bn)

### ‘The’ stock for a zero rate world

Our job is to find valuation anomalies – that is, businesses which are incorrectly priced. Check this out: a regulated business with very secure inflation-beating income streams and a dominant market position in one of the world’s leading economies, whose auditors are continuing to discount its assets off a lofty 5.8% discount rate. Meanwhile, its own Government’s 10 year bonds today yield just 0.15%! The resulting audited valuation of its assets (which the shares trade at) corresponds to only half of their likely replacement cost and the same valuation discounts minimal rental growth – well below recent trends. Oh, and its borrowing costs are falling materially too!

The business is Vonovia, the largest owner and manager of residential property in Germany (and one of the largest in Europe) with some 350,000 residential units for rent. Please do not switch off – the German property market is completely different from the UK market – in a good way. In short, it is highly regulated thereby ensuring a closer match between supply and demand than most markets and therefore enjoys rents that are far more predictable. We suggest that Vonovia is a very-undervalued asset – one to own in a ZIRP world!

Fig.1: Auditors differ! German discount rates vs. Bund yields



Source: Company reports, Bloomberg

#### Three anomalies

We are not property investing experts (except at dinner parties) and there are a lot of nuances to keep the specialists busy on this business. That said, three anomalies prompt our interest:

- **Anomaly #1:** Vonovia’s enterprise value trades at c.1x its portfolio Fair Value (FV). But (and it’s a big but), that FV is calculated with a **5.8% discount rate**. We suggest this discount rate will fall in time (and its FV will rise) as investors correct this anomaly. By contrast, Germany pension liabilities today use discount rates of c.2% (as per Fig.1)
- **Anomaly #2:** Vonovia’s FV is, according to the company, c.66% of its **replacement cost** est (ex land). We postulate it is only 50% of replacement cost **including** land.

*“It starts and ends with replacement cost because that is the ultimate game”* – legendary US real estate investor Sam Zell

- **Anomaly #3:** The subtlety of a regulated rental market is that **average rental income** is a function of the duration of existing tenancy agreements.

Long-standing tenants are incentivised not to move as their rents are materially lower than the rate for new tenants. This fact, combined with investments in modernisation (which allows for rent increases), and events like death of long standing tenants gives a tailwind to rental growth. Last year rents grew 2.9% which looks a sustainable rate – yet the FV valuation assumes only a 1.1% market rent growth – another anomaly.

## The big picture on Vonovia

We understand why many of you might be reluctant to spend time researching a German residential property business. The good news however, is that whilst the German property market is indeed complex for most of us used to unregulated housing markets, we see this asset mispricing as more to do with accountants' treatment of valuing asset prices than it is about understanding the nuances of German rental regulations.

Unlike here in the UK, most German residential property is rented from longstanding landlords – far more than most countries – hence it is quite an illiquid market by most standards. This illiquidity in turn means the auditors of landlord companies have not altered the discount rate used while market interest rates have plummeted in recent years. Thus we suggest, they are using a too-prudent discount rate on these very predictable cash flows in deriving a portfolio fair value. This strikes us as an anomaly and because the listed company's enterprise value tracks closely to the fair value of its portfolio, leads us to conclude that Vonovia is a mispriced asset. Especially mispriced in a world of zero interest rates!

In the bygone days of 10 year Bunds yielding 3.5% to 5.5% (i.e. most of decade leading up to the Great Financial Crisis), it would have been sensible to discount property rents at c.6%, the rate used by the valuers since they started applying a DCF methodology to value Vonovia's portfolio in 2013. However in the intervening years many other assets have been re-priced. It is this auditor psychology and inertia that is interesting to us. We see auditor behaviour in many other industries like banking or insurance that might be a function of the preceding cycle and it is our job as analysts to judge whether their assumptions are too optimistic or too prudent. Fig.2 below shows that Vonovia's auditors take a very, very, prudent stance – not just on discount rates but also on 'rent increases' etc..

Fig.2: Vonovia's Internal €24bn valuation assumptions...are very, very, prudent

Valuation parameters	Average	Holland Comment
Management costs residential	€ 252 per residential unit p.a.	
Ongoing maintenance costs residential	€ 10.11 per m <sup>2</sup> p.a.	
Apartment improvement costs for reletting	€ 3.31 per m <sup>2</sup> p.a.	
Maintenance costs total	€ 13.41 per m <sup>2</sup> p.a.	
Cost increase/inflation	1.5% p.a.	
Market rent	€ 6.28 per m <sup>2</sup> p.a.	
Market rent increase	1.2% p.a.	→ compounded 2.6% 2010-2015
Stabilized vacancy rate	2.7%	
Discount rate	5.8%	→ DB pension fund is c2%
Capitalized interest rate	4.7%	

Source: Vonovia 2015 annual report, Holland Advisors

To view the remainder of this in-depth report, please contact Andrew Hollingworth, [Andrew@hollandadvisors.co.uk](mailto:Andrew@hollandadvisors.co.uk) for a complete PDF copy.

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