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Holland Views – Vonovia – Price: €30.6 MCap: €14.2bn

Concrete Gold[1]

For those new to Vonovia, allow us recap from last year:

> *"It is clear to us that (Vonovia) is a well-run company with an impressive asset base and a management that seems to get capital allocation. Modest rental inflation and its organic investments (i.e. doing-up old flats) are likely to compound its NAV at say c.4-6%. Secular demand drivers are also high. So there is plenty for the specialists to debate and ruminate on, But, and it's a big but, this is all of marginal interest compared to the asset portfolio's sensitivity to interest rates.*
>
> *As a reminder, a -200bp reduction in discount rates (from 5.8% to say, 3.8%) would basically add €11.2bn to Vonovia's NAV i.e. it would double the Dec 2015 adj NAV and equate to* ***75% upside*** *to today's market cap (assuming 1x book value)…as all investors seemingly see Japanese deflation analogies everywhere, just a couple of Fed rate hikes might give us a better entry point once again."* – **Holland Views – Vonovia, Rising Tide – June 2016**

A lot of macro (and political) water has passed under the bridge since last June when we last wrote on Vonovia. Yet, with the stock having since given-up most of its mid-2016 gains, we find ourselves today even more bullish than we were originally. We don't normally attend Capital Markets Days nor write on company quarterly results – yet we found ourselves doing both with this company. That reflects an unusual keenness for us (and indeed, the fast pace with which events are developing).

In summary, this is a business that today (post a Fair Value upward adjustment in Q316), is trading at 0.9x NAV. That is a reasonable margin of safety. Indeed it is a margin of safety that is even further reinforced by replacement building costs, which remain c.75% higher than is implicit in the current NAV. As we said before, Sam Zell in his heyday would have been all over this. We are bullish on the German property market and Vonovia.

Fig.1: NAV[2] rising in the most recent quarter

	Dec-15	Sep-16	Dec-16e
Management's Fair Value est	€24,157	€23,851	€27,857
discount rate assumption	5.8%	5.8%	undisclosed
FV sensitivity to -200bp discount ra	+€11,200		
implied NAV	€12,803	€12,125	€16,131
Jan 2017 Mkt Cap			€14,446
NAV discount			-10%

Source: Vonovia, Holland Advisors

The impact of the c.€4bn (+17%) uplift to the company's Fair Value estimate, announced on November 3rd, i.e. five days before the US election on November 8th, got little attention. It was a very interesting conference call by management too. For example, by its own estimates, more

[1] The increasingly popular German phrase ***betongold*** means **Concrete Gold** and is analogous to the English phrase 'bricks and mortar'. Who said the Germans were not into property investments?!

[2] NAV here is not the balance-sheet derived EPRV NAV routinely cited in the sector. We are more interested in looking at the forward-looking NAV and the implied discount rate it assumes.

than half (€2.4bn specifically) of the fair value uplift was attributed to "yield compression" with the remainder due to operational improvements and also acquisitions as per the table in Fig.2. Please ask us for a copy of the highlighted transcript, it and the accompanying slides are very transparent and detailed.

Fig.2: Q3 2016 NAV drivers

Value driver	Uplift FV (€m)
Performance (rent development, redemption of rent control, etc.)	750 – 950
Investments	450 – 470
Yield compression	2,300 – 2,500
Total	**3,500 - 3,900**

Source: Vonovia

We'll have to wait for the annual report to see the precise discount rate assumption but based on previous sensitivity (more on this later), we suspect in the order of c.5.3% (i.e. 50bp lower). The company has guided to an end of year NAV of €36 per share for the CY16 year-end and €37-38 in December CY17 (the latter notably *not* including any further yield compression – which seems extremely prudent). Yield compression is obviously another way of saying falling discount rate. This NAV/share compares to today's share price of €31.

Management also did an impressive job during the Q3 analyst call in outlining their task at hand which includes; financing the latest Conwert acquisition, the ongoing industrialisation of the core business, the modernisation and expansion of the estate and the general tailwind that is, the German property market with all its nuances.

Margins of Safety

Vonovia's rental yields are currently 6.4% (see Appendix at the end of this report – this yield is calculated as the inverse of 'Fair Value multiple over annualised in-place rent' which is calculated at 15.5x. In essence we are arguing for a reduction in this rental yield (aka the discount rate used in valuing the asset!). Equity investors might see the analogy here in deciding on appropriate PE multiples to use on an earnings stream. Simply put, when the earnings stream is predictable but growing at multiples of inflation – we suggest a lower, not higher discount rate is warranted. Here's an excerpt from our last report:

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