Equity research

DEUTSCHE EUROSHOP: Upgraded on valuation grounds **ADD** (↑)

Property • Germany

				Date	16 November 2004
Fiscal year:	**2004e**	**2005e**	**2006e**	Price	€ 36.5
EPS (€)	0.18	0.40	0.43	Price target	€ 38.0
NNAV	40.4	39.9	40.1	Market Cap	€ 572m
P/NNAV-1	-10%	-9%	-10%	Bloomberg	DEQ GR

Key message: Deutsche EuroShop (DES) posted firm 9M 2004 results. The main driver of the sharp EPS rise was the sale of the Italian shopping centre *Friuli* at a 5% net capital gain. The company's cash reserve (€ 30m) will be spent in FY 2005, likely in Central or Eastern Europe. Based on European peer valuations we increase our price target from € 35 to € 38, implying a 5% target discount to our FY 2006E NNAV. Our new price target translates into a 10% total return expectation and justifies an upgrade from Neutral to **Add**. It is in our view not unthinkable that DES could become a takeover target in the medium term, for instance when the outlook on a recovery of the German retail sector becomes less hazy.

Modest top-line growth Turnover increased by 0.4% y-o-y (9M 2004: € 36.8m; 9M 2003: € 36.7m). Adjusting for the rents derived from the (sold) shopping centre in Udine (Italy), turnover increased by 3% y-o-y. A helpful driver in this respect was that retail sales in DES' German shopping centre portfolio improved by 3.8% (+4.4% for the entire portfolio) whereas German retail sales in general posted -1.1%. Approximately half of DES' asset base consists of minority investments in shopping centre companies. Particularly the shopping centres in Dresden and Kassel generated markedly higher income due to improved occupancy and reletting activity; new equity interests in Wroclaw and Pécs contributed to earnings for the first time. As a result, the item Participations increased from € 5.1m to € 7.5m.

Net profit boosted by property sales Net profit amounted to € 4.1m (9M 2003: € 1.1m). The sharp increase is a result of the disposal of the Italian shopping centre *Friuli* (located in Udine) in view of the targeted portfolio optimisation. The net capital gain on the sale amounts to 5% or € 3.0m. On a recurring basis, net profit was therefore flat on a y-o-y basis keeping in mind that the investment in *Forum Wetzlar* (opening scheduled for mid-February 2005) resulted in a stand-alone rise in costs of € 1.4m. As of mid-October 2004 the occupancy rate of *Forum Wetzlar* amounted to 93%. No negative impact was felt from the recent insolvency of department store chain KarstadtQuelle (KQ; owning and operating most of its outlets), although the issue marks a concern for the German retail sector in general. KQ's survival is based on a restructuring plan, mainly addressing cost savings. While this is needed, we do think that a competitive plan to beat the competition (individual clothing stores, smaller and major chains like Anson's, P&C, H&M, Breuninger and Kaufhof) is needed just as much. This situation will likely trigger a substantial part of DES' tenant base to start looking at the competitive edge of their offerings/formulas.

Outlook Management expects DES' earnings situation to improve further in Q4 2004 and to amount to € 4.5m (FY 2003: € -0.5m) as at 31 December 2004. *Phoenix-Center* (Hamburg, opened in September 2004) will contribute as of Q4 2004. Construction work has also started on DES' most recent acquisition: the *City-Arkaden* in Klagenfurt (Austria, opening scheduled for Q1 2006). More than 50% of the retail space in Klagenfurt is currently prelet. The company's remaining cash reserve (€ 30m) will be spent in FY 2005, most likely in opportunistic Central or Eastern Europe (probably Czech Republic or Hungary). DES is confident that it will slightly exceed its target of generating a distributable free cash flow of € 30m (9M 2004: € 22.5m) or € 1.92 per share as at 31 December 2004. On this basis, FY 2004 DPS will again amount to € 1.92 per share. This situation implies no more equity burden related to a possible withdrawal from the reserves in order to cover the dividend payments. Note that in accordance with German tax law, tax-free withdrawals from the capital reserve are possible at DES for another 6 years, i.e., until FY 2010.

Investment conclusion Management stated that it considers an equity issue within the next 24 months (no target size disclosed). This is no priority and subject to interesting investment opportunities arising, should these involve a bigger consideration than the current cash position. Based on the firm 9M 2004 results and valuations of European peers (DES: 10% discount to spot NNAV; European retail peers: 7% premium to NNAV), we increase our price target from € 35 to € 38, implying a 5% target discount to our FY 2006E NNAV. The reasons for the average discount posed on DES in a European context are (i) the risks related to the troubled situation in the German retail sector (9 out of DES' 14 shopping centres) and (ii) the fact that 40-45% of DES's asset base concerns equity stakes of $\leq$50%, which are less liquid (and thus less valuable) than majority stakes in shopping centre companies. Our new price target translates into a 10% total return expectation for the next 12 months and justifies an upgrade from Neutral to **Add**. When it comes to absolute share trading liquidity we think that DES still has to show improvement. It is, however, in our view not unthinkable that DES could become a takeover target in the medium term, for instance when the outlook on a recovery of the German retail sector becomes less hazy.

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