Dresdner Kleinwort

Initiating coverage

29 February 2008

Buy

Current €25.6
Target €29.0

Current price equivalent
US$37.9

Market cap
€880.0m
US$1,302m

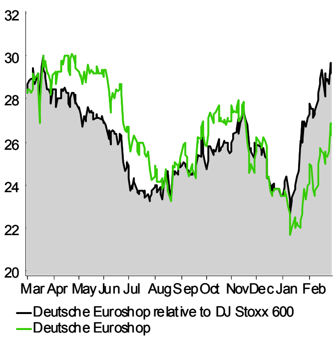
52-week high/low
€30.1/€21.7

Price performance	1M	3M	12M
Price (€)	23.8	25.0	29.9
Absolute (%)	7.5	4.3	-14.7
Rel market (%)	-0.6	2.9	-6.3
EPS change	**1M**	**3M**	**12M**
IBES EPS (%)	16.6	15.0	57.5
Sector EPS (%)	-3.5	-0.8	29.7
Market EPS (%)	-0.1	-1.7	-10.7

Source: DKIB Research, Thomson IBES

Reuters DEQGn.DE
Bloomberg DEQ GR Equity

Price relative



Source: RIMES

Deutsche Euroshop

The only but attractive play on shopping centres in Germany

Deutsche Euroshop (DEQ) is the only listed German property stock focused purely on shopping centres. With long-term contracts and a 99% occupancy rate, the income stream is very stable. Given the high demand for German shopping centres, we think DEQ could be a takeover candidate. Based on three different valuation tools, we derive a €29 target price and initiate coverage with a Buy rating.

- **Valuation upside:** Our target price implies 14% upside potential. The stock is trading at a 12% discount to 2008E NAV08, which we believe is unjustified given our conservative valuation, DEQ's high-quality assets, and the two malls currently being developed.
- **Clear focus:** DEQ follows a clear investment focus on shopping centres located close to city centres or near public transportation. The current portfolio consists of 16 high-quality malls (of which 12 are located in Germany) at a market value of €2.6bn.
- **Highly predictable income stream:** The weighted maturity of rental contracts is more than eight years. Due to the structure on rental contracts, the percentage of turnover-linked rents is ca. 2.5% relatively, which is small compared with other European retail property stocks. However, owing to an "upwards-only"-standard and a full indexation to CPI, the income stream of DEQ is highly predictable, in our view.
- **Pick-up in retail sales:** Underlying fundamentals for the retail markets are stable, in our view. We expect a further rise in employment in Germany and salary increases in 2008, from which DEQ should benefit. Spending levels should be higher in 2008 after being hit by the VAT hike from 16% to 19% in 2007.
- **Takeover target?** Demand for German retail properties remains very strong with prime yields at 4.75%. DEQ, with a 5.4% net initial yield in 2007, is an attractive target, in our view.
- **Shareholder structure:** The Otto family, with a 19% stake, has been DEQ's largest shareholder since the company's IPO. The family recently spent ca. €1bn on buying out the minority partner in Otto-Versand (mail-order house), which is its traditional core business. As a consequence, we assume that the family is reviewing its investments and DEQ is not considered a core holding.
- **Solid financing:** The financing structure is sufficient with a LTV of 50%. We expect further acquisitions in the near future as the two current developments will be opened later this year.

Year to end	Sales	EBIT	EBIT margin	Net profit	EPS	P/E	EV/EBITDA	Dividend yield	P/NAV	FFOyield
Dec	€m	€m	%	€m	€	x	x	%	%	%
2006	93	86	93	100	5.84	4.4	13.0	8.2	10	5.0
2007E	96	75	78	66	1.92	12.3	22.5	4.4	-10	3.8
2008E	112	88	79	60	1.75	14.8	20.8	4.2	-10	2.9
2009E	122	97	80	92	2.67	9.6	20.5	4.2	-15	4.2

Source: Company Data, Dresdner Kleinwort Research estimates

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Please refer to the Disclosure Appendix for all relevant disclosures and our disclaimer.

Valuation leads to a clear Buy

We have run several valuation scenarios for DEQ, all of which suggest upside potential for the share price. We prefer a standalone valuation first, to better reflect the specific situation of the company. Finally, a peer group overview is attached, primarily for illustrative reasons.

Focusing on cash flow

The starting point for the valuation of real estate companies with a standing portfolio is the Net Asset Value (NAV). We regard it as the “economic equity” and it is the basis for the RoE and for the EVA calculation. For a cash flow-related figure, we focus on Funds From Operations (FFO) where we subtract revaluation gains net of deferred taxes. However, if DEQ sells a shopping centre in the previous 12 months as it did in 2006, we will retain the capital gains in our valuation as part of an active portfolio management.

We forecast strong growth in DEQ’s NAV, as the current valuation of the malls is conservative and the two new malls will be externally valued only after their opening in 2008.

NAV of Deutsche Euroshop

(€m)	2006	2007E	2008E	2009E	2010E
Non-current assets	1,652.9	1,806.4	2,134.6	2,369.6	2,482.1
Current assets	143.3	134.7	127.0	128.2	129.3
Total assets	1,796.2	1,941.1	2,261.6	2,497.8	2,611.4
Non-current liabilities	854.1	980.7	1,217.6	1,390.9	1,485.7
Current liabilities	64.6	59.5	57.4	57.9	58.5
Total Liabilities	918.8	1,040.2	1,275.0	1,448.8	1,544.3
Net assets	877.4	900.9	986.7	1,049.1	1,067.1
Minority interest	0.0	0.0	0.0	0.0	0.0
Net asset value	877.4	900.9	986.7	1,049.1	1,067.1
Number of shares	34.4	34.4	34.4	34.4	34.4
Net asset value per share (€)	25.53	26.21	28.70	30.52	31.05

Source: Company data, Dresdner Kleinwort Research estimates

Based on the FFO, we estimate the stock is trading on a 4.3% yield for 2009.

Deutsche Euroshop – Funds From Operations (FFO)

(€m)	2006	2007E	2008E	2009E	2010E
Net profit	100.31	66.09	60.09	91.89	67.55
+ Depreciation	0.46	0.48	0.50	0.52	0.54
- Revaluation gains	-72.3	-42.5	-41.5	-65.5	-40.0
+ Taxes on revaluation gains	19.5	6.8	6.64	10.48	6.4
FFO	47.99	30.87	25.72	37.39	34.49
FFO per share (€)	1.40	0.90	0.75	1.09	1.00
FFO yield	5.5%	3.5%	2.9%	4.3%	3.9%

Source: Dresdner Kleinwort Research estimates

Low risk profile = low cost of capital

Owing to the low-risk profile of DEQ, we calculate a WACC of 5.0%. For a cost of capital/return on equity approach, we calculate the ROE on NAV in 2009 as described. Including the NPV of the dividend payments until 2010, we derive a valuation of €26.94.

Valuation of Deutsche Euroshop

Return on NAV 2009E	9.0%
COE in %	6.6%
Long term growth	1.2%
Price-NAV multiplier	1.5
NAV 2009e	1,049
Discounted NAV2009e in 2008	923.2
Discounted dividends 2008-2010e	3.0
Adjusted NAV2009e by dividend payments	926.2
NOSH 2008	34.4
Fair value (€)	26.94

Source: Dresdner Kleinwort Research estimates

We forecast stable dividend growth

With a tax-free dividend, DEQ already displays some "REIT-like" characteristics though a conversion into a REIT is not intended. The dividend policy of DEQ is very stable, with an increase occurring normally every two years. For 2007, the company proposes a dividend of €1.05, which is also our forecast for 2008. This leads to a current dividend yield of 4.1%. Our Dividend Discount Model (DDM) points to €30.72 as fair value.

Deutsche Euroshop – Dividend Discount valuation

(€)	2008E	2009E	2010E	2011E	2012E	2013E	2014E	2015E	2016E	Terminal
Dividend per share / Terminal value	1.05	1.08	1.08	1.11	1.14	1.16	1.19	1.22	1.25	36.89
Year	1	2	3	4	5	6	7	8	9	10
Discounted dividend / Terminal value	1.00	0.98	0.93	0.91	0.89	0.87	0.85	0.83	0.81	22.65
Fair value	30.72									

Source: Dresdner Kleinwort Research estimates

The EVA model is an appropriate valuation tool, especially for capital-intensive property companies as it shows the value creation based on the invested capital. As equity, we take again the NAV. Our fair value based on the EVA model comes out at €26.50.

Deutsche Euroshop – EVA calculation

(€m)	2006	2007E	2008E	2009E	2010E
Invested Capital					
Long-term financial debt	752.1	853.3	1,008.3	1,171.1	1,264.5
+ Short-term financial debt	28.5	29.9	25.5	24.2	23.0
- Cash	95.9	86.3	77.7	77.8	77.8
= Net Debt	684.7	796.9	956.0	1,117.5	1,209.7
+ Provisions	18.5	19.5	20.4	21.5	22.5
+ NAV	877.4	900.9	986.7	1,049.1	1,067.1
= Capital employed	1,580.7	1,717.2	1,963.1	2,188.0	2,299.4
Total return	100.3	66.1	60.1	91.9	67.5
Average Capital employed	1,580.7	1,648.9	1,840.2	2,075.6	2,243.7
Capital charge	77.9	81.3	90.7	102.3	110.6
ROIC	6.3%	4.0%	3.3%	4.4%	3.0%
WACC	4.93%	4.93%	4.93%	4.93%	4.93%
Spread	1.4%	-0.9%	-1.7%	-0.5%	-1.9%
EVA	22.4	-15.2	-30.6	-10.4	-43.0
Years			1.0	2.0	3.0
NPV EVA			-29.2	-9.4	-37.2
Terminal Value					
Total NPV of EVA until 2010	-75.8				
+ NAV 2008E	986.7				
Fair Value	910.9				
Fair Value per share	26.50				

Source: Company data, Dresdner Kleinwort Research estimates

Three valuation approaches

For the derivation of the target price of €29 we put greater emphasis on the DDM (50%) and weight the EVA and cost-of-capital approach with 25% each.

At an estimated 12% discount to 2008 NAV, DEQ is trading almost in-line with European peers on a median basis while the differences are significant.

Comparative valuation

Name	Country	Currency	Price	Market Cap	YTD	PE 2008E	PE 2009E	EV/ EBITDA 2008E	EV/ EBITDA 2009E	DY	P/NAV 08E
UNIBAIL-RODAMCO	FR	€	163.88	13,485.9	-27%	19.4	17.6	20.7	19.1	4.7%	-14%
CORIO NV	NE	€	59.4	3,969.2	-17%	19.7	18.9	21.5	19.4	4.6%	-13%
VASTNED RETAIL NV	NE	€	67.88	1,148.1	-10%	17.3	16.9	15.6	14.5	5.8%	-2%
EUROCOMMERCIAL PROPERTI-CVA	NE	€	37.13	1,316.6	-13%	21.2	20.1	21.2	19.1	4.7%	-18%
KLEPIERRE	FR	€	39.3	5,498.2	-22%	30.9	27.1	17.2	15.0	3.4%	-48%
SEGRO PLC	GB	p	515	2,250.2	-31%	17.5	17.9	19.7	20.0	4.8%	-32%
DAWNAY DAY TREVERIA PLC	GB	€	0.77	472.4	-45%	13.1	12.0	n.a.	n.a.	7.6%	-31%
CITYCON OYJ	FI	€	3.86	853.0	-28%	21.6	17.5	18.6	16.1	3.8%	-11%
MEINL EUROPEAN LAND LTD-CERT	JE	€	7.84	2,366.4	-61%	8.0	6.7	11.9	8.9	0.0%	-48%
DEUTSCHE EUROSHOP AG	GE	€	25.44	873.8	-12%	14.6	9.5	20.7	20.4	4.4%	-11%
					Average*	18.7	17.2	18.3	16.5	4.4%	-23.0%
					Median*	19.4	17.6	19.2	17.6	4.7%	-18.4%

Source: Dresdner Kleinwort Research estimates, Thomson IBES (* excluding Deutsche Euroshop)

Preliminary figures reflect growth momentum

Headline figures above our estimates

DEQ published headline figures for 2007 that came in above our estimates. In particular, net profit of €93m was driven by higher-than-expected revaluation gains while we focus especially on EBIT to reflect ascertain operational strength of the company.

Preliminary figures 2007 vs DKIB estimates

	DEQ	DKIB	%
Revenues	95.7	95.8	-0.1%
EBIT	76.0	74.8	1.7%
Net profit	93.0	66.1	40.7%
NAV	26.90	26.21	2.6%

Source: Company Data, Dresdner Kleinwort Research estimates

For 2008, DEQ forecasts revenues of €110-113m and EBIT of €90-92m. Given the company's guidance policy we would regard these figures as very conservative.

Pure focus and attractive tenant base

Solid tenant base, high-quality assets

DEQ follows a long-term, value-enhancing strategy with a clear focus on shopping centres. The company runs a buy-and-hold strategy, which includes the development of new malls or the extension of existing properties. The centre management is outsourced to ECE, which in return is rewarded with 8% of the collected gross rents.

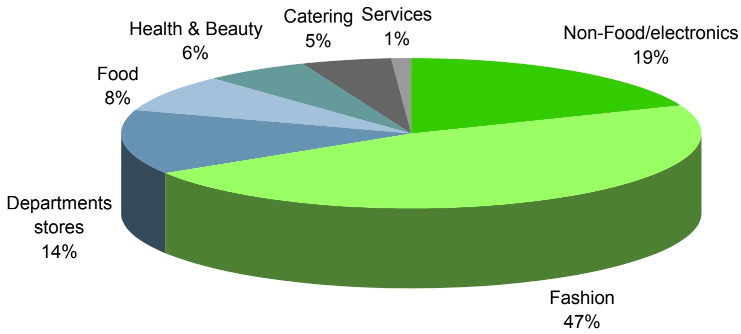
DEQ has increased its exposure to Germany after the disposal of the French and Italian malls in 2006, while the two developments are also located in Hameln and Passau (Germany). The market value of the total portfolio points to €2.6bn and the participation of DEQ ranges from 33.3% to 94.9%.

DEQ's investment criteria are straightforward and have been strictly followed:

- large catchment area;
- inner-city locations preferred or on the outskirts with good transport connections;
- lettable space of 20 – 40,000 sqm;
- new construction or recent refurbishment; and
- sound tenant mix.

The variety of different stores is one of the most important advantages of shopping centres compared with department stores, which was reflected in the outperformance of this asset class compared to total retail sales. An electronic store (e.g. Media-Markt) acts normally as anchor tenant but DEQ's malls cover almost every sector. Well-known international retailers have opened shops in many of DEQ's malls. Also DEQ benefits from the diversified tenant structure, as the top 10 tenants contribute only 25% of the total rents.

Diversified tenant structure



Source: Company data

The weighted maturity of the rental contracts is above eight years. It is a good match with DEQ's financial liabilities, where 82% have a maturity of more than five years. The average rent/sqm comes out at €21, but differs significantly according to tenants.

High and predictable income stream

The standard lease contract has a maturity of ten years without a break-up option. All contracts are fully indexed to the CPI, which minimizes the risk for DEQ only in case of tenants' insolvency. The base rent is dependant on the tenant's sector and the location in the mall.

The stake of turnover-linked rents in Germany is much smaller than in other European countries so that for 2007 we expect only 2.3% of turnover-based rents for DEQ. Every contract contains an upward-only clause when it is being extended. For 9M 2007, rents increased on a like-for-like base by 2.9%.

Takeover scenario now more realistic

High demand for German retail properties

Investment in domestic retail properties amounted to €11bn in 2007. Demand was focussed again on shopping centres so that prime yields, despite of the subprime crisis, increased only moderately by 25 bp to 4.75%. Given DEQ's strict investment criteria and also because of an average effective interest rate of 5.5%, it did not make any acquisitions in 2007.

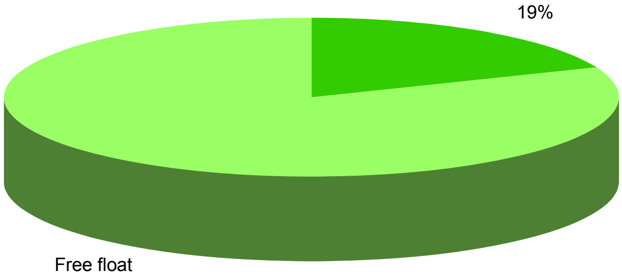
DEQ's shopping centres have been valued at a 5.4% average yield in 2007. In addition to the high quality of the assets and prime location, we believe DEQ is an attractive takeover target for private equity investors or European retail property companies who have avoided Germany owing to significant restrictions on the construction of new malls and to the previous gloomy consumer confidence (some companies also suffered in the rush to capitalise from the reunification with Eastern Germany).

Attractive disposal price for DEQ realistic, in our view

Until now DEQ, was "protected" against takeovers owing to its close ties with the largest shareholder, the Otto family who has a 19% holding. In addition, Otto owns ECE, the largest European developer of shopping centres. DEQ has first option on ECE current projects and thus has access to new malls while avoiding tender offers. Consequently, DEQ has bought its recent developments from ECE, although this is not an exclusive agreement. We would assume that DEQ benefits most from the cooperation, as we believe ECE could easily sell its shopping centres to third parties at attractive prices, which has also happened several times.

It is worth mentioning that there is currently no indication that the Otto-family could sell its stakes in the market, meaning we do not foresee a potential share overhang. But given the high demand for retail assets we regard DEQ as a whole as an interesting proposition for investors looking to enter the German retail market.

Shareholder structure of DEQ



Source: Company Data

We assume that this situation will change soon. As reported in January 2008, the Otto family bought the 25% stake of the minority shareholder in the mail order business "Otto Versand" for an estimated price of €1bn. More details on the financing were not announced as this business is not listed. Mail order is the family's traditional business.

We would assume that a review of the Otto family's investments will follow and in our view DEQ is not a core investment. The tax-free dividend payments were "nice to have" ultimately not essential, given the large own real estate portfolio, ECE as shopping centre developer and the necessity to focus attention on the mail order business in view of increasing competition from the internet.

No "deal fever" but more activity is expected

Broadening the investment scheme

DEQ is targeting annual investments of €100-150m – a level that was exceeded significantly in 2006. In 2007, the company did not acquire new shopping centres or development projects, not because of any financing problems, but rather because it felt prices were too expensive. As the last two development projects in Hameln and Passau will be opened in this year, DEQ should give the market an indication about its further growth outlook.

We see at least three opportunities for DEQ's future growth:

- Increasing stakes in existing shopping centres and expanding lettable space via developments. Both are currently being considered, e.g. for the Main-Taunus-Zentrum in Frankfurt. However, we would regard this only as a form of consolidation of the existing portfolio.
- Focusing on foreign acquisitions, primarily in Eastern Europe. DEQ sold its last malls in Italy and France in 2006 and now owns two malls in Poland and one in Hungary and one in Austria. As the yield compression in Eastern Europe has been strong, however, the underlying fundamentals in these markets continue to improve and the move by Western European retailers into that region is strong. The demand for shopping centre space is growing, esp. in second-tier cities, and we would appreciate if DEQ targets Eastern Europe so as to reach the intended exposure of 25% compared with only 13% of the group asset base today.
- Converting "old-fashioned" department stores into shopping centres. Consumers in Germany prefer shopping centres and pedestrian zones in city centre, especially because of the rising number of flagship stores of international retailers. Classical department stores on the other hand suffer, especially in smaller cities. We know that it is difficult from a technical point of view to convert a department store into a multi-tenant shopping centre, but it is not impossible. These properties are normally of smaller size and it could be an option for DEQ to enter into a new segment where the competition is low. In addition, the company has a strong network of potential tenants for such properties.

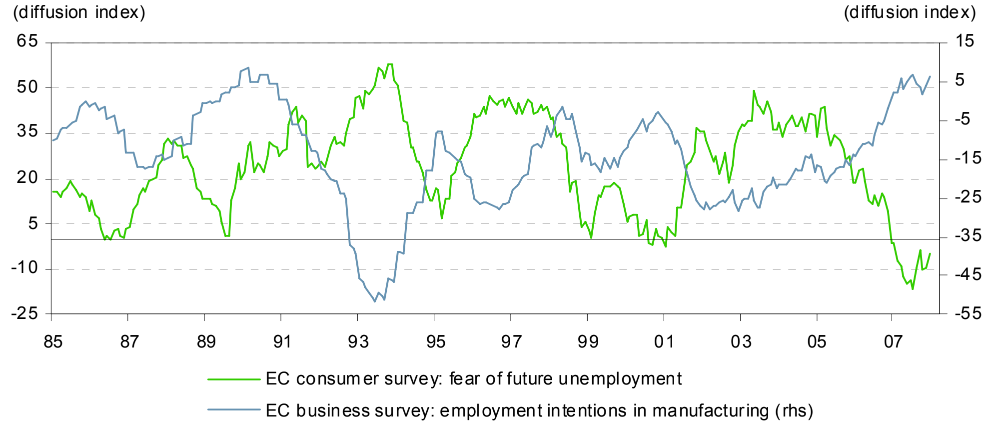
Fundamentals in Germany remain stable

Stable fundamentals

The prospects for a stronger growth contribution from private consumption are positive, in our view. As income and employment conditions have suffered in recent years we have seen an impressive recovery during the latest upswing. Apart from the significant fall in the unemployment rate, the soft indicators have improved even more impressively.

Consumer fears of future unemployment, for instance, have fallen to a level not seen during the past 20-25 years (the respective surveys start in 1985). At the same time, firms' hiring intentions also remain at high levels. In recent months, there has been some consolidation, but against the backdrop of heightened economic and financial market uncertainty, the stabilisation on these extremely buoyant levels remains impressive.

German labour market conditions have improved significantly



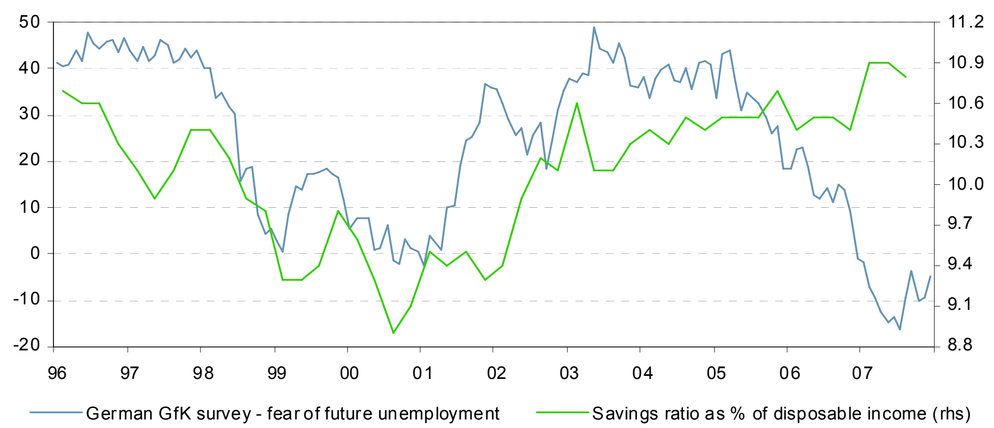
Source: Thomson Datastream

Higher wages = higher consumption

Nominal wages have also started to pick-up lately, largely for cyclical reasons, which will help to foster the normalisation in private consumption. The missing link has been the real spending activity. However, we should not forget that 2007 saw a significant rise in the consumption taxes: the regular VAT rate was hiked from 16% to 19% in January 2007. While the measure was announced well in advance and thereby had relatively little impact on overall sentiment, it still depressed the trend in real consumer spending last year. The adverse price shock to energy and food prices added to the surprise rise in inflation.

Against this backdrop it is easy to see that consumption growth will strengthen in line with the expected improvement in real disposable income from -0.3%y/y growth in 2007 to around 1.25% in 2008. A possible sharper drop in the savings ratio would leave upside risks to consumption growth forecast.

German savings ratio and consumers' assessment of the labour market

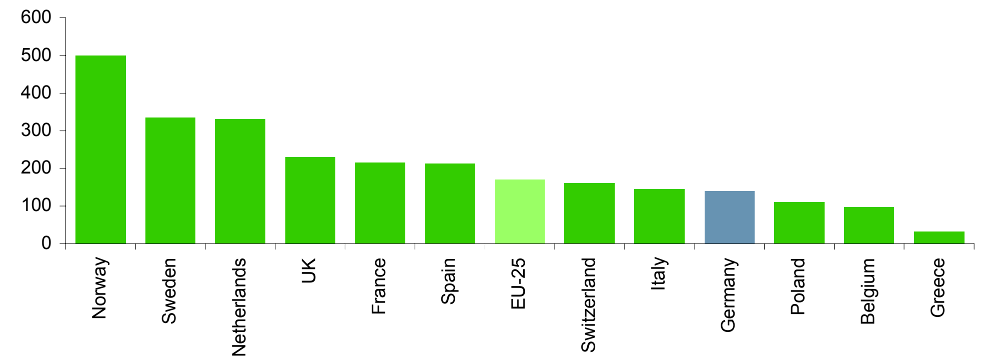


Source: Thomson Datastream

German shopping centre market still small…

Shopping centres account for 140sqm per 1,000 of overall shopping space in Germany, which is below the European average of about 171sqm per 1,000 capita. The reason for this development can be seen in a different consumer pattern that gives preference to local supermarkets or mid-size shops in the pedestrian areas. In addition, approval to start construction on a shopping centre has been very strict, as the local authorities wanted to "protect" the local retailers, so that first malls were opened "on the green fields".

Shopping centre space in Germany below European average

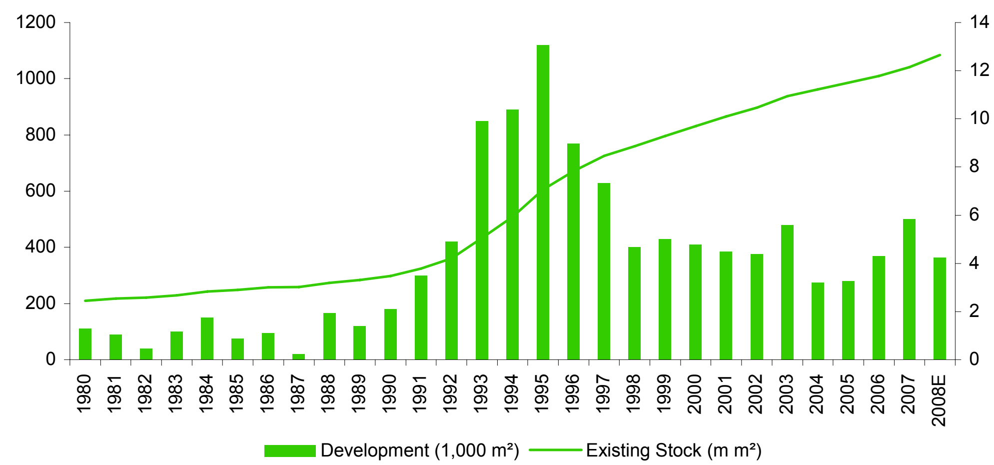


Source: Cushman&Wakefield

…but sought after by consumers

Both consumer behaviour and the attitude of many local authorities towards shopping centres have changed, as they are regarded in many cases as an attraction for the city centres. However, construction activities remain moderate, which is why we are positive about shopping centre markets.

Development pipeline of shopping centres in Germany



Source: Cushman&Wakefield

Disclosure appendix

Disclosures under US regulations

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Recommendation history charts

Past performance is not an indicator of future performance.

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Buy:	10% or greater increase in share price	Sell:	10% or more decrease in share price
Add:	5-10% increase in share price	Reduce:	5-10% decrease in share price
Hold:	+5%/-5% variation in share price		

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Hold	165	26%	34	21%
Sell/Reduce	77	12%	14	18%
Total	**625**		**190**	

Source: Dresdner Kleinwort Research

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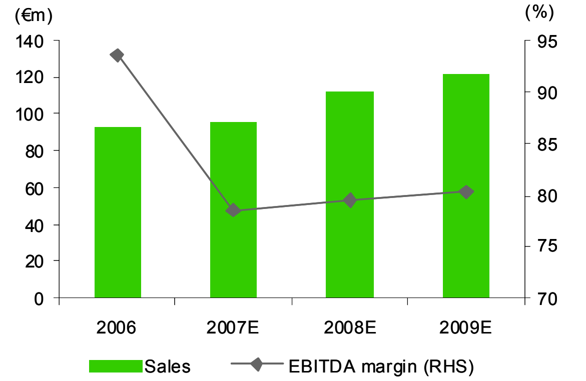
Summary financials and key valuations

Profit and loss statement

		2006	2007E	2008E	2009E
Sales	€m	93	96	112	122
Gross margin	%	NM	NM	NM	NM
EBITDA	€m	87	75	89	98
EBITDA margin	%	93.5	78.5	79.4	80.3
EBITA incl associates	€m	161	119	132	165
EBITA margin	%	NM	NM	NM	NM
Pre-tax profit excl except	€m	118	75	78	110
Tax	€m	(17)	(9)	(18)	(18)
Tax rate	%	14.8	11.6	23.3	16.3
Attrib profit excl except	€m	100	66	60	92
Attrib profit margin	%	NM	69.0	53.7	75.4
EPS	€	5.84	1.92	1.75	2.67
EPS growth	%	106.0	(67.1)	(9.1)	52.9
Ave diluted no shares	t	17,187	34,374	34,374	34,374

Sales and EBITDA margin



Source: Company data, Dresdner Kleinwort Research estimates

Balance sheet

		2006	2007E	2008E	2009E
Total fixed assets	€m	1,653	1,806	2,135	2,370
Goodwill	€m	0	0	0	0
Working capital	€m	84	82	72	72
Total assets	€m	1,796	1,941	2,262	2,498
Net (debt)/cash	€m	(685)	(797)	(956)	(1,118)
Equity & min int	€m	796	817	901	960

Investment view: Deutsche Euroshop (DEQ) is the only listed German property stock focused purely on shopping centres. With long-term contracts and a 99% occupancy rate, the income stream is very stable. Given the high demand for German shopping centres, we think DEQ could be a takeover candidate. Based on three different valuation tools, we derive a €29 target price and initiate coverage with a Buy rating

Cash flow

		2006	2007E	2008E	2009E
Net capex	€m	0	0	0	0
Gross cash flow	€m	29	36	41	48
Free cash flow	€m	24	26	31	38

Ratios

		2006	2007E	2008E	2009E
P/E	x	4.4	13.3	14.6	9.6
PEG ratio	x	0.0	(0.2)	(1.6)	0.2
P/FCF	x	18.4	33.4	28.8	23.1
P/CF	x	15.3	24.2	21.7	18.3
P/B	x	0.6	1.1	1.0	0.9
EV/ sales	x	12.1	17.5	16.4	16.4
EV/ EBITDA	x	13.0	22.3	20.7	20.4
EV/ EBITA	x	7.0	14.1	13.9	12.1
Post tax ROCE	%	9.2	6.5	5.4	6.6
ROE	%	12.6	8.1	6.7	9.6
Net debt/ equity	%	86.0	97.5	106.2	116.4
Interest cover	x	2.0	1.7	1.6	1.8
Dividend cover	x	2.8	1.8	1.6	2.5
Equity/ assets	%	44.3	42.1	39.8	38.4
Working capital/ sales	%	90.7	85.8	64.7	59.1

Key share data

Total no. of shares	t	34,374
Free float	%	81
Major shareholders		
Otto-family	%	19