Equity Markets

Company update

Belgium

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Befimmo

Finally among the big boys

Maintained

Buy

28 December 2006

Real estate

26/12/06
€83.55

Target price (12 mth): Maintained
€93.5

Reuters
BEFIT.BR

The disappointing earnings guidance that pushed the stock down is likely to be overshadowed by the Fedimmo acquisition. Alongside the positive financial impact, this should dramatically increase Befimmo's size and visibility.

Fedimmo acquisition. Befimmo has won the Fedimmo auction and has acquired 90% of the eponymous company, which owns office property leased on a long-term basis to the Belgian State. Alongside its expected positive financial impact (€0.20-0.30 per share as from the current fiscal year), the Fedimmo acquisition should dramatically increase Befimmo's size and visibility. Its property portfolio nearly doubles to €1.8bn as a result, not far short of Cofinimmo's (€2.2bn).

Attractive valuation. The share trades at a sizeable discount versus our current pre-Fedimmo target price (€93.5 per share). Our eventual new target price and earnings scenario will depend on the terms of the planned capital increase, but we expect a positive financial impact from the Fedimmo operation.

Forecasts and ratios

Yr to Sep (€m)	2006	2007F	2008F	2009F
Turnover	76.3	76.3	74.8	80.2
EBITDA	62.6	61.6	59.5	64.6
Net profit	84.5	56.4	55.8	57.1
Adj EPS (€)	4.85	4.46	4.09	4.28
Adj PER (x)	17.2	18.7	20.4	19.5
Dividend yield (%)	5.9	5.3	5.4	5.4
EV/EBITDA (x)	19.3	20.3	21.4	21.7
Price/NAV (x)	1.2	1.2	1.2	1.2
ROE (%)	10.1	7.6	7.2	7.4

Source: Company data, ING estimates

12-month forecast returns (%)

Share price	11.9
Dividend	5.3
12m f'cst total return	**17.2**

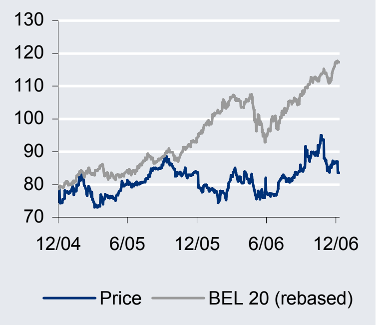
Key ratios (%)

	2006	2007F
Turnover growth	(3.7)	0.1
EBITDA margin	82.1	80.7
Operating margin	81.9	80.5
Net debt/equity	59.7	65.1
ROACE	7.6	6.1

Share data

No. of shares (m)	9.8
Daily turnover (shares)	9,509.0
Free float (%)	83.8
Enterprise value (€m)	1,209.7
Market cap (€m)	818.3

Share price performance



Source: ING

Investment case

Valuation

Our DCF-based target price is maintained at €93.5 per share. It was recently raised from €91 (see Report of 12 December 2006) based on a combination of a depressed short-term outlook, with company guidance for 2007-09 showing CFPS down 14% versus the previous 17% guidance, but with a sharp catch-up expected as from FY09/10. Actually, the main culprits of the lower guidance are the poor timing of several important projects and an unexpected vacancy[1]. These refurbishment works result, in the medium term, in tangible value creation (higher rents, better occupancy) further consolidated by the recent acquisition in Luxembourg. The latter is included in our earnings guidance, but not Fedimmo, given the lack of financial details at this stage.

The stock trades at a sizeable discount versus its rival Cofinimmo (€151.8, Sell, TP €138).

The stock has been duly penalised since the release of the lacklustre 2007-09 guidance (-10.8%) leaving the share with an interesting potential upside of 11.9% and a total return of 17.2% including the lower FY07F dividend.

Positive newsflow

After an admittedly laconic financial disclosure on crucial refurbishment works, we believe the company's current earnings guidance addresses all possible negative outcomes. The usual three-year earnings guidance covers the crucial transitional fiscal years 2007-09, but misses the likely strong recovery afterwards as refurbished buildings start to generate income again. It also obviously misses the impact of the recently-announced acquisition in Luxemburg (full impact expected during FY09/10) and the Fedimmo acquisition.

In its press release relating to the Luxembourg acquisition, Befimmo strongly hints that the recent acquisition might be followed by others. Alongside the positive impact of this acquisition (Luxembourg is one of the few European locations still offering decent office yields), we believe this move and the quantum leap from the Fedimmo operation should at last enable the Befimmo share to shrug-off its image as a 'sleeping partner' versus the more 'exciting' Cofinimmo.

Excellent quality

The property portfolio of Befimmo shows excellent quality on all counts, even compared with the excellent Cofinimmo portfolio. Close to 50% of Befimmo's rental income is generated by public institutions (European and Belgian State bodies), often on a long-term basis. Assets owned are fairly recent and well located. In all districts, Befimmo consistently shows occupancy above market levels.

This picture is likely to be further bolstered by the Fedimmo acquisition as assets owned by the latter are mostly leased to the Belgian State on a long-term basis.

[1] The negative impact of the WTC operation was already detailed by the company.

Guidance and outlook

Since the latest company guidance was released, Befimmo has acquired a new asset in Luxembourg and a 90% stake in Fedimmo. However, the impact of the Luxembourg acquisition will only be felt as from FY09/10, and the expected impact of the Fedimmo operation (see *infra*) is modest in comparison with the sharply lower earnings guidance released last November by Befimmo, together with its FY06 yearly figures.

As a reminder, Befimmo has already slightly lowered its earnings guidance following the agreement with the State on the WTC building. Nevertheless, the latest company guidance came as a surprise as, putting aside the WTC issue and higher interest rates, a wave of refurbishments and the vacancy at Woluwe Garden D were complete surprises not mentioned by the company until now. Befimmo reckons that alongside slightly less favourable occupancy and inflation forecasts (1.75% pa versus 2.0% previously), the main culprit is a less rosy interest rate environment. Overall, new earnings guidance is 14-17% lower in terms of CFPS. In terms of DPS, the fall is less sharp but still, for the first time in its history, Befimmo will let its dividend per share fall whereas in the past Befimmo has hinted that future dividend growth might be 'covered' by the capital gains from the Borschette building.

Fig 1 Befimmo: company earnings guidance (€/share)

	FY06	FY07	FY08	FY09
Guidance December 2005				
Net current CFPS	4.88	5.24	5.33	
Net CFPS	4.93	5.24	5.33	
Gross DPS	4.92	5.04	5.17	
Inflation** (%)	2.0	2.0	2.0	
Average occupancy (%)	91.9	92.7	93.7	
3M Euribor (%)	2.5	2.7	3.0	
Guidance February 2006				
Net current CFPS	4.82	5.11	4.96	
Net CFPS	4.87	5.11	4.96	
Gross DPS	4.92	5.04	5.17	
Guidance December 2006				
Net current CFPS	4.88*	4.42	4.10	4.42
diff. versus February guidance	*0.06*	*-0.69*	*-0.86*	
Net CFPS	4.84*	4.42	4.10	4.42
diff. versus February guidance	*-0.03*	*-0.69*	*-0.86*	
Gross DPS	4.92*	4.45	4.50	4.55
diff. versus February guidance	*0.00*	*-0.59*	*-0.67*	
Inflation** (%)	1.85*	1.8	1.8	1.8
Average occupancy (%)	91.0*	91.1	91.1	91.4
3m Euribor (%)	2.8*	3.7	3.7	3.7

* Actual
** 'Health' index
Source: Company data

A new investment in Luxemburg

Befimmo recently announced, at last, a new investment in Luxembourg and more precisely in the sought-after Kirchberg business district[2], its first since end 2003 and its first outside Belgium. It consists of an office building to be completed in the first half of 2009. No immediate impact of the operation is therefore expected in the short run. The

[2] Current vacancy below 2% versus 5.6% for the Luxembourg-city overall office market (source: Jones Lang LaSalle)

total investment amounts to c.€95m[3]. No financial details were disclosed but Befimmo reckons that the operation should add €0.15 to CFPS. According to our calculations, this is equivalent to a property yield slightly below 6%. We have assumed rental income as from April 2009 (six months during FY09). Befimmo was granted an 18-month rent guarantee by the seller; we believe this is more than enough to find a first class tenant should the building not be leased before completion.

The Fedimmo deal brings the total portfolio value to €1.8bn (+68%)

Our current earnings estimates do not include the Fedimmo operation closed in the last days of December. Befimmo and the Ministry of Finance have announced that Befimmo has won the Fedimmo auction. Fedimmo is a company set up by the Belgian State, which owns 62 office buildings (c.382,000m^2), mostly leased to the Belgian federal state. Befimmo paid €576m for a 90% stake in Fedimmo (the Belgian State has retained 10%). Befimmo will finance this acquisition with debt, bringing its indebtedness ratio to 62% (the legal ceiling is 65%, the current pre-deal level is 40%). The company has also hinted that a capital increase is likely in the next couple of months. Befimmo has announced a gross rental yield of 5.5% on the total portfolio value (€730 including several long leases) and reckons that the operation will have a relutive effect from year one of c.€0.20 to €0.30 per share.

Fedimmo will be fully consolidated in the Befimmo accounts. The consolidated property portfolio value goes up to €1,811m, ie, very close to Cofinimmo's portfolio (€2.2bn as of end September). A capital increase is as good as certain as the new indebtedness ratio is admittedly below the legal ceiling, but Befimmo will have to cope with refurbishments worth c.€50m within three years at Fedimmo buildings and its own renovations programme (see our most recent report, 12 December 2006, an additional €55m in the next three fiscal years). The expected positive impact on CFPS (€0.20 to €0.30 for nine months starting in January) is likely to be closer to €0.20, as a capital increase is very likely (€0.30 if no capital increase takes place).

The operation, a 'simple' auction with the price offered being the single criterium, is expected to be final, with no major risk of litigation, as was the case for the 'Belgian SICAFI' (Cofinimmo has already declared that it will not challenge the auction outcome). When compared to the aborted 'State SICAFI' operation, this deal looks both simpler and more efficient (no additional listing, higher stake). Fedimmo is not a SICAFI itself and thus normally pays taxes, but Befimmo reckons there will hardly be any taxes to pay given the so-called 'notional interest' mechanism. Although not a bargain, the price paid (5.5%) is market-conforming, as office market long-term leases command yields well below 6% (the average lease duration of leases for Fedimmo is 17 years). The effect on its size is dramatic for Befimmo but the financial impact is more modest (c.4% of pre-deal EPS) given the low property yield and the expected capital increase. The final effect will depend on the timing and the size of the planned capital increase. Befimmo eyes an indebtedness ratio of c.50%, hence a capital increase of c.€200m to €300m is likely. We expect a positive market reaction to this deal, especially bearing in mind the lack of new investments and the 'sleeping' image of the company prior to the recent Luxembourg acquisition.

[3] Investment value of Axento SA, the company owning the building

Valuation

At current market prices, the Befimmo shares trades at a 24% premium to its NAV as of end September 2006. Still, we believe it has been unduly punished since the full-year results (and the uninspiring guidance) published last November (-10.8%).

Undervalued versus Cofinimmo

Even the lower dividend projections still offer an attractive 5.3% gross yield (FY07F). This can be compared with Cofinimmo's gross yield at 4.8%. The premium versus NAV is also much lower than the one boasted by its major peer (23.6% versus 43.6% expected as of end 2006F for Cofinimmo). As a result of its higher profile, the Cofinimmo share may have commanded a (hefty) premium versus Befimmo given its more exciting activity in recent years and larger size. We believe this should gradually change given the recent acquisition in Luxemburg and the Fedimmo operation.

Fig 2 Befimmo discounted cash flow model (€m)

	FY07F	FY08F	FY09F	FY10F
Operating cash flow	**54.9**	**34.5**	**-58.3**	**65.6**
Discount factor	0.96	0.90	0.85	0.80
Present value of free cash flow	52.5	31.0	-49.3	52.2
Cumulative present value of free cash flow	86.4			
+ Present value of terminal value	1,168.2			
+ Other financial assets (e)	0.9			
= Enterprise value	1,255.5			
- Net financial debt (group share)	-393.8			
= Theoretical market capitalisation	861.6			
Fair value per share	88.0			
12m price target	93.5			

Source: ING estimates

Our main assumptions are detailed below. Note the very conservative credit margin at 100bp whereas actual margins are below 50bp. We also recall that our earnings projections do not include the Fedimmo operation nor any additional acquisition. The actual impact of the Fedimmo operation will depend on the terms of the planned capital increase, but a higher target price is likely given the expected positive financial impact of the operation.

Fig 3 DCF assumptions (%)

Gearing*	46.5
Tax rate	0.00
Cost of debt before tax	4.75
Cost of debt after tax	4.75
Medium-term growth rate	2.79
Long-term growth rate	1.50
Risk free 10Y rate	3.75
Risk premium	5.30
Beta	0.73
Cost of equity	7.62
WACC	6.29

* Gross gearing

Source: ING estimates

A target price of €93.5 emerges.

Risk factors

Market risk: Befimmo is mainly exposed to the Brussels office market but this is mitigated by long-term leases and top tenants. This will be further improved by the integration of the Fedimmo portfolio, which is leased to the Belgian federal state on a long-term basis.

Interest rate risk: 80% of the financial debt is at floating rates, but most of it is hedged. The hedging only works at high interest rates (current cap for €368m at 5%) but the trigger will be lowered as from January 2009 (twin caps at 3.5%-5.0% for €200m).

Equity markets risk: The Fedimmo acquisition will raise the consolidated indebtedness ratio of Befimmo to c.62% of total assets, ie, barely below the legal ceiling. Befimmo wants to reduce this to a desired 50% for strategic reasons but also considering refurbishments already planned in its own portfolio and works in the Fedimmo portfolio. Hence, the company is likely to raise c.€200m to €300m fresh capital in the market in the next few months and relies therefore on equity markets remaining favourable.

Comments on financials

- As a registered SICAFI (Belgian REIT-like closed-end property investment company), Befimmo does not pay taxes on recurrent income. Property is booked at market value and appraised by external appraisers; unrealised gains are booked as 'portfolio results' (included in exceptional items). Hence, no depreciation is booked on property. Minimum payout stands at 80% of recurrent earnings.
- Since FY06, Befimmo publishes its results under IFRS (FY05 figures restated).
- Properties are now booked at 'fair value' (IAS40) which is the investment value minus 2.5%; the latter is a compromise figure lower than official transfer costs in Belgium (10% to 12.5%) as most SICAFIS do not actually pay full transfer costs.
- Most of the financial debt is financed at short-term rates. However, Befimmo hedges its interest rate exposure. The hedging only works at high interest rates (current cap for €368m at 5%) but the trigger will be lowered from January 2009 (twin caps at 3.5-5.0% for €200m).

Income statement (€m)

Yr to Sep	2006	2007F	2008F	2009F
Turnover	76.3	76.3	74.8	80.2
Total operating revenues	76.3	76.3	74.8	80.2
Costs of goods sold	(76.3)	(76.3)	(74.8)	(80.2)
Other operating costs	(13.3)	(14.4)	(15.0)	(15.4)
Depreciation	(0.2)	(0.2)	(0.2)	(0.2)
Total operating costs	(13.5)	(14.6)	(15.1)	(15.5)
EBIT before exceptionals	62.5	61.4	59.4	64.4
Operating exceptionals	18.0	6.3	7.9	7.6
Profit/loss on sale of tangible fixed assets	0.5	0.0	0.0	0.0
EBITA	**62.5**	**61.4**	**59.4**	**64.4**
Operating profit	**62.5**	**61.4**	**59.4**	**64.4**
EBITDA	**62.6**	**61.6**	**59.5**	**64.6**
Net interest income	(14.3)	(17.1)	(18.8)	(21.9)
Net financial charges	(14.3)	(17.1)	(18.8)	(21.9)
Adj pre-tax profit	48.1	44.3	40.6	42.5
Exceptionals & GW	18.5	6.3	7.9	7.6
Pre-tax profit	**66.6**	**50.6**	**48.4**	**50.1**
Taxes	(0.6)	(0.6)	(0.5)	(0.6)
Extraordinary items (net)	18.5	6.3	7.9	7.6
Group profit	84.5	56.4	55.8	57.1
Net profit	**84.5**	**56.4**	**55.8**	**57.1**
Net attributable profit	84.5	56.4	55.8	57.1
Adj net attributable profit	47.5	43.7	40.1	41.9
Net attributable profit from ordinary ops	66.0	50.0	47.9	49.5
Dividend on ordinary shares	(48.2)	(43.6)	(44.1)	(44.6)
Retained earnings	36.3	12.8	11.7	12.5

Source: Company data, ING estimates

Cash flow (€m)

Yr to Sep	2006	2007F	2008F	2009F
EBITDA (CF)	63.1	61.6	59.5	64.6
Change in working capital	3.5	0.7	(3.5)	1.4
Change in provisions	0.0	0.0	0.0	0.0
Operating cash flow (pre-tax)	66.6	62.2	56.0	66.0
Cash taxes	(0.6)	(0.6)	(0.5)	(0.6)
Operating cash flow (after-tax)	66.0	61.6	55.5	65.4
Net financial charges	(14.3)	(17.1)	(18.8)	(21.9)
Capital expenditure (net of disposals)	2.4	(6.5)	(20.8)	(123.4)
Free cash flow	**54.1**	**38.0**	**15.9**	**(79.9)**

Source: Company data, ING estimates

Balance sheet (€m)

Yr to Sep	2006	2007F	2008F	2009F
Investment properties	1,078.4	1,118.2	1,146.8	1,277.8
Non-interest liabilities	40.0	39.3	34.9	37.0
Group equity	660.2	662.1	666.4	671.9
Net debt	393.8	431.1	459.0	583.1
Capital employed	1,054.1	1,093.2	1,125.4	1,255.0
L/T debt	91.4	101.4	111.4	121.4
S/T debt	317.4	344.7	362.5	476.7
Shareholders equity	660.2	662.1	666.4	671.9

Source: Company data, ING estimates

Per share and other data

Yr to Sep	2006	2007F	2008F	2009F
Per share data (€)				
Adj EPS	4.85	4.46	4.09	4.28
DPS	4.92	4.45	4.50	4.55
NAV	67.41	67.60	68.04	68.60
Ratios (%)				
EBITDA margin	82.1	80.7	79.6	80.4
Operating margin	81.9	80.5	79.4	80.3
EBITDA growth	(5.6)	(1.7)	(3.3)	8.5
Operating profit growth	(5.6)	(1.7)	(3.3)	8.5
Adj tax rate	1.3	1.4	1.2	1.3
ROE	10.1	7.6	7.2	7.4
ROACE	7.6	6.1	5.9	5.9
Net debt/equity	59.7	65.1	68.9	86.8
Valuation (x)				
EV/turnover	15.9	16.3	17.0	17.4
EV/EBITDA	19.3	20.3	21.4	21.7
Adj PER	17.2	18.7	20.4	19.5
Price/NAV	1.2	1.2	1.2	1.2
P/FCFPS	15.1	21.5	51.6	(10.2)
Adj PEG	(3.5)	(2.3)	(2.4)	4.2
Dividend yield (%)	5.9	5.3	5.4	5.4

Source: Company data, ING estimates

Company profile

Listed in 1995, Befimmo is the first closed-end property investment company established under the SICAFI/V-BEVAK legislation (ex-ServiceFlats). Assets consist mainly of properties formerly held by Bernheim-Comofi (now part of Fortis), which, as statutory manager, retains the managing control of Befimmo despite the dilution of its stake.

In 2001, Befimmo merged with Cibix, resulting in further marginalisation of non-office assets and a higher weight of offices in central Brussels versus the Brussels periphery, not a bad thing as the latter continues to suffer in the current economic context. Since the acquisition of the Poelaert building (December 2003), a 14,000m^2 office building fully leased to the Belgian state for 18 years, no new acquisitions have taken place, reflecting the lack of investment opportunities. However, Befimmo has not been idle; several important issues were addressed recently, such as the disposal of non-strategic assets (Charleroi), the sale of the huge Borschette conference centre and an agreement on the allegedly asbestos-plagued WTC building (the state took over the Belgian Post lease and extended it until end-2018). With a vacancy rate above 25%, the Central Gate (ex-Shell) building remains the main challenge in the short term, but its excellent location and the planned refurbishment should eventually help it reach full occupancy at higher rents. Other issues are the planned refurbishments of the Bréderode 2 & Extension Justice buildings and the expected vacancy at the Woluwe Garden D building.

Disclosures Appendix

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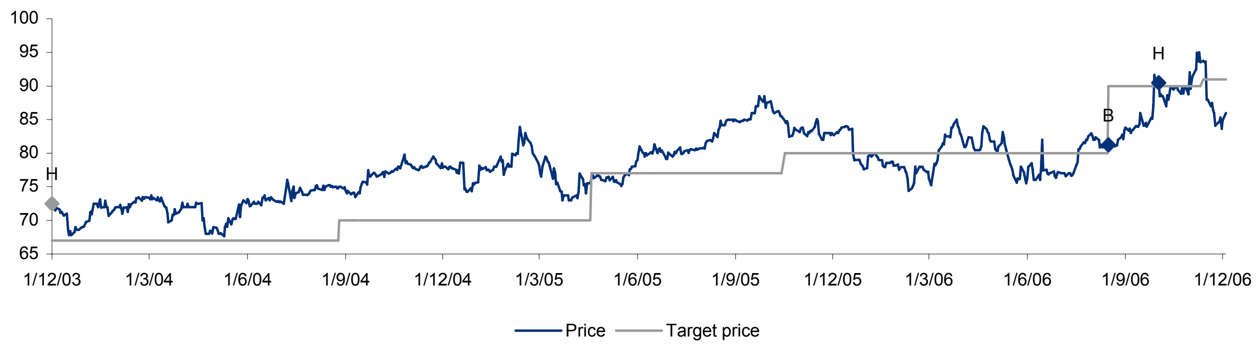

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