Transcription
9M 2017 Earnings Call
November 8, 2017

Rene Hoffmann

Thank you, Judith, and welcome everybody to the conference call of Vonovia's results for the first nine months of 2017. I assume you have all had a chance to look at the material we published on our IR website this morning, including the presentation for this call. Your hosts today are CEO Rolf Buch and CFO Stefan Kirsten. They will read through this presentation first and then open up for your questions. As we are in different places today please bear with us if we have a slight delay in responding to your questions later in the Q&A. And with that I would like to hand over to Rolf.

Rolf Buch (CEO)

Thank you, Rene, and welcome to everybody. I am very happy that you are in our call. We have actually five highlights, topics, today to discuss. The first is the final guidance for 2017. We are happy to confirm the initially changed guidance onto the upper end from €910 to €920 million. We are happy also to announce that we will expect a rental growth of 4% to the year-end, which is a significant improvement to the previous year, and the intent to propose to the Shareholders Meeting a dividend of €1.32 which is 20 cent more than the previous year.

It is for me very important to underline the second topic. I think since one year now we have shown you that there is an inbuilt organic growth momentum in our company. We will show you this every quarter now until we assume that this is properly reflected in the stock price. So, I will show you some slides about this later. You will see that we have a significant value uplift, a value uplift on fair market value will be between €4 billion and €4.5 billion. This is actually coming from three components; the normal classical yield compression, which means just the buildings are getting more expensive. And the second very important source is the performance, or better rental performance. And the third, which is specific for Vonovia, the third component is our investment program where we are investing actually €1, we are getting a value uplift of above €1.20. Fourth element is our investment program; of course, it is very important for the future of this company. So, I am happy to announce and to show you during the presentation that this program is up and running and we are overachieving our targets of investment which is booked in 2017. We are now sure that we will deliver €1 billion in the following years per year. I was asked today by the press how long and we said at least more than – not forever - but at least the next ten years so I think it was fair to talk about the €10 billion investment program for the next years. And then of course the initial guidance of 2018 based on the good results of 2017 has a promising outlook. We guide 4.6% to 4.8% rental growth next year and FFO, even with a stable topline, because we are still intending to sell our remaining non-core assets. So, the topline is stable but even with a stable topline we will announce, or we think that we will achieve, a significant increase in FFO 1 to €960 to €980 million. And with this I hand over to Stefan, who will guide you through the 2017 final guidance.

Dr. A. Stefan Kirsten (CFO)

Thank you, Rolf. Ladies and gentlemen, also a very warm welcome from me. I am now on page three; our final guidance for 2017. I must say, let us start with the executive summary. Everything is confirmed at the upper end; that is the easy way to understand the guidance. I'm very proud that our operating team was able to scratch the 4% mark on organic; we will come to that later. Vacancy as guided before; rental income, FFO 1, FFO 1 per share, we will tend to the upper end so more towards the €920 million number. We will do this irrespective of the fact that we intend to spend €10 million more on maintenance which is very slightly also driven by conwert who were a bit under-nurtured there in the past. As Rolf just pointed out, we will over achieve on the modernization and investment side, which is of course a major propellant for the rental growth of next year. We will also over achieve on privatizations. Irrespective of the half-year evaluation, we are able to keep the sale market value step-up on privatizations in the 30% range. Bear in mind that we will sell up to 10,000 units of non-core, non-strategic. Of course, when we talk to you in early November everything was notarized, so the question is just: do the transactions close? And, therefore, we are rather sure about the numbers with the respective step-up.

Let us talk a little bit about the dividend. Our dividend proposal to the Supervisory Board and to our shareholders in our Annual General Meeting for next year will be €1.32. That is a cash dividend volume irrespective of any scrip of €640 million. Just as a reminder that is the same volume which we had during our IPO. Since 2013 we had a CAGR of 18% on the dividend which was acquisition-driven; this is again an 18% growth. Do not expect the same level for the next years if no acquisitions are included. We will discuss this when we come to a later stage. And with that I would like to finish on the 2017 guideline. Rolf.

Rolf Buch (CEO)

Thank you, Stefan. So, coming to the next topic; is very important organic in-built growth. As I said, I do not think that this is properly reflected in the stock price yet. What you can see on page four is actually something which we have shown you now quarter after quarter. This actually shows that this company is disposing assets and in the same time we are having rental growth, but overall we do not have the topline growth, so very little topline growth, at least a number of units if you compare the nine months of last year to the nine months of this year. Out of a more or less stable number of units, we generate 8.1% more additional rent, which is an absolute figure of €93.3 million. And you can see that we are able to nearly pass through the €93 million to the EBITDA Operations and due to better re-financing we even pass through more than 100% of the topline. If you compare the nine-month figures, we have the double cost of conwert in this figure which of course distorts the picture a little bit.

So, if you go on the next page, on page five, and you probably see it much clearer in the comparison between the Q1 and the Q3 figure; Q1 includes, of course, the double cost of the conwert operation while the Q3 figures are actually after realized synergies. And here you can see that even in Q3 we have a little bit less apartments to rent, because we have disposed during the year 2017. Even with less apartments to rent, of course we have some rental increase, so the topline is more or less stable at minus €1 million but with this stable topline we generate actually an additional €14.4 million EBITDA Operations. Not too many refinancing affects in the two quarters; it ends up with €14.6 million of the topline. So, here you see that, even in a quarter where we do not have any topline growth, we can generate value by more efficiency and better optimizing our business, and by the increasing Value-Add business and partly also private financing. And this is, and I would like to underline this, this is not the end of the story. This phenomenon you will see during the whole year of 2018 and even more important because in 2019 we are not going to sell anymore because then we have disposed all our non-core assets, which means that then the effect is even more positive because then the topline growth is not reduced by the disposals. So, this is a long-term phenomenon for Vonovia and I think this is something which we have to explain you better in the future. And with this I hand over to Stefan to give you more details and all of the figures.

Dr. A. Stefan Kirsten (CFO)

Thank you. On page six you can see already the way how we calculate rent growth. I hope you have got used to it; we introduced it with Q1 this year and also a couple of additional indicators. As you can clearly see, the market-driven rent growth is in good shape, even if the new lettings go a little bit down because churn is down, but on the sitting tenants side we are enjoying a good year. We have a company which is most exposed to nearly all Mietspiegel in Germany and therefore this is a work of a lot of people. The key booster, of course is the modernization. Space creation is still relatively low because we are there just feeling ourselves into the market. Nevertheless we are able for the last twelve months to deliver 3.9% and we will deliver around 4% later. Why did we put the rent growth trajectory in? So that you have a feel in which direction the company is kicking and where the underlying businesses are market-driven with our German-wide portfolio; something in the range of 1.5% to 1.7% should be the normal expectation from an investor side. Modernization is the kicker and at the bottom you see the modernization numbers. The 4% which we will deliver this year is based on the 2016 investment numbers which is €472 million. This year we will deliver €750 million; from next year onwards we will deliver €1 billion ongoing. So, if you look at that, it is rather obvious that this is not the end of the flag-post with regard to rental growth.

Let us shift to page seven; what do we make out of this top number? There are a couple of tendencies. The first one is our cost per unit. We reported at the end of 2016 our cost per unit at €570 per year; you see this on the left-hand side. You can assume that we are already €50 lower in the nine-month numbers, but our controlling department envisages that we will deliver something in the range of below €500, let us put it that way. It is the simplest way to look at it. But you can also see that our EBITDA margin is still rising; this is what Rolf just mentioned. Do not flip to page 39; just note it at the moment that page 39 shows you the dislocations of our business and we have shut down 100 locations, or more than a hundred locations, in the last twelve months alone. This process is ongoing. This is the difference, actually, between non-core and non-strategic, we are closing down also small locations which do not make strategic sense for us. And this is of course one of the drivers of operating efficiency. Last but not least, you see the EBITDA in rental; you see the EBITDA in the value add business and the adjusted EBITDA Other. The adjusted EBITDA Other is the flip side of the EBITDA Value-Add business because we have to consolidate some of these inner-company profits out. We will see this later when we talk more about the numbers. In general, we were able to deliver 11% adjusted EBITDA Operations more.

On page eight we discussed a little bit the loan-to-value ratio and I can make this relatively brief. What is important to me is usually, you saw a page there about a balanced maturity profile and a balanced profile of debt measures, et cetera, we're de facto financed through for this year and we're de facto financed through for next year too. We have an interest rate opinion which implies no major rate changes in 2018 and the big part of 2019 and this will be reflected in our financing measures, which is partly secured, partly unsecured on an opportunistic basis. Our stated loan-to-value ratio now is 42.4%. If you add the perpetual hybrid on top here at 45.6%. Between us, going into rounding differences is de facto meaningless. We are in our comfort zone and when we talk later about the year-end valuation, our current simulations show us something south of 40%. So, we will be in 39.9%, 39.8%, that depends on daily performance in the balance sheet. So, loan-to-value is not a major reporting item for us anymore. The company is delivering with the yield compression along these lines.

On page nine I would like to illustrate the FFO 1 per share. You can see that this is for end of period number of shares at 15.4%; if you go on average it is even at 18.7%. What you can also see is that the non-controlling interests in the FFO 1 have increased marginally; the reason is of course conwert. And for me as the CFO, an important number: €640.2 million of AFFO, because that means that, even if we would not go for a scrip dividend, the AFFO will be at year-end in any case bigger than what we push out as a dividend, because that’s the dividend volume we are proposing with our dividend policy.

On the next page we have an adjusted NAV per share. Between us, I believe this is less relevant. You have seen that we have done the half-year evaluation uplift and this was a partial portfolio, so the nine-month number does not really give you a strong indicator, and therefore I would like to go straight to page eleven, which has more relevance; that is our outlook on valuation. If I understand the short commentaries from the sell side right this has been to a certain degree a surprise, so do me a favor and allow me to linger a little bit longer on that page.

I would like to start with a total year number. We will be somewhere between €4 billion and €4.5 billion, which means our model point is at 4.250 and we have to see that we get the confidence intervals correctly structured. You have seen the first half-year valuation. I would ignore that for the moment. Rolf has mentioned the different components. So, if you say we have let us say between €4 billion and €4.5 billion of value uplift. Approximately €1 billion comes from performance. This is rental development and this is the uplift of investments which go disproportionately higher than the invested amounts, so our modernization does not yield for a euro a euro; it yields for a euro €1.20 within two years, and that is of course a very helpful little effect. You then see the investments which also include two amounts; the investment cash out and of course the profits of our craftsmen service, which we have to deduct from the P&L, but which of course shows up in the valuations. So, if you take the two circles, €130 million and €20 million, so if you take these €150 million you can see that we have approximately a 20% uplift on our investment programs in the respective year. You then have the investment itself and if you deduct all of this from the €4 billion to €4.5 billion you end up with the yield compression of €2.3 billion to €2.6 billion.

I have seen some comments today about our last three lines here, so allow me to give you indications from our models where we say, alright, the first deviation of growth has either increased or declined. What we can clearly tell you is that the value, in fact, in 2017 is everywhere positive. So, we do not see in our portfolio, in our top, let us say 30 locations, anything which has a negative mark there but the growth is slowing down. Let me illustrate this in the case of Berlin. The value effect in 2016 was, let us say, 25% and the value effect in our models for this year still preliminary, still early stages, at let us say 14% so that is an 11% drop in Berlin. Hamburg, from 18% to 3%, 15% drop, Munich from 23% to 5%, 18% drop. Stuttgart 14% to 8%, 6% drop; it is always the first deviation. We have a couple of very positive surprises; Dortmund from 3% to 10%, Essen from 2% to 10%. Unfortunately, Cologne from 10% to 8%, so not really working, Dusseldorf from 8% to 5%. So, if you add all these things, Potsdam from 4% to 12%, what you see is the party still goes on, but in the A locations at a slower speed. That is a very clear indication we see at the moment. What you can also see is that the ancillary locations, the Potsdams of the world, plus the B locations, Essen, Dortmund, are significantly catching up. This is something we feel throughout our whole portfolio at the moment. And if you add all these things together you are still getting a sizeable effect. Keep in mind we had last year €3.8 billion and this year we will have, whatever, €500 million more in valuation but we also have more assets. So, in principle, the valuation models indicate that we will now fine tune this because, in the end, our SAP system has to put this onto every house and every flat for the year-end, but this is the valuation trend which we see at the moment. We were not surprised by the size of it, because we felt in the market that particularly the Essens, the Dortmunds and the Dresdens of the world are moving nicely forward. Also supported, of course, by our investment program, and with that I would like to hand back to Rolf.

Rolf Buch (CEO)

Thank you, Stefan. Please keep in mind, Stefan, talked about our locations which are after our portfolio clean-up mainly A and B locations. That is why we do not have too much data about the C and D locations. What we have is the impression that the yield compression in the C and D locations is not meaningful. This actually confirms our portfolio optimization strategy that we started in 2013.

And let us come to page twelve. You know that our investment program is a very important part of this company. We have evaluated and we have shown to you, we have developed this program further, and you know in 2013 we started actually with our Optimize Apartments, it was elderly apartments and the Upgrade Buildings which was an energetic modernization. Since then we have developed new programs; the first is the new initiatives, these famous bathrooms, if you all remember, which then led us to the famous kitchens and new heating systems for the tenants. The next step was the space creation, so the creation of buildings in between buildings or adding an additional floor on the existing buildings, often in combination with the Upgrade Building program. And two years ago, or one and a half years ago, on the capital marketplace in Essen we showed you our pilot for the neighborhood development. So, today we have a very sophisticated program of investment possibilities which are all more or less standardized today so we are running this program as standardized as the original Optimize Apartments and Upgrade Building program. All the way on the right side you can see that this sums up to the €1 billion investment in the year 2018 and the following years. And you know from 2013 we measured the success of the Upgrade Buildings and Optimize Apartments by a specific yield, the yield on cost. We took actually the additional rent and divided the additional rents by the investment and this was the yield on cost. What we figured out now after a few years is that these apartments that were once Upgrade Buildings and Optimize Apartments do not only deliver a higher rent in the beginning, but their further development is even better than an apartment that was not touched by investment. So, this means that the IRR calculated on this is higher than the 7%. The more sophisticated program, especially in the neighborhood development, there we see investment not only in one investment year, but over several investment years, so that is why taking yield to cost is not an appropriate way to measure the success of these programs. That is why we took the decision in summer to change our model of measuring the success of our programs to an IRR model. Having said this, for practical reasons we stick, for the Upgrade Building and Optimize Apartment on the operational level, with the yield-to-cost model, because it is always delivering less results in the IRR, so the IRR is always better. So, if we achieve our targets of 7% in yield-to-cost in Optimize Apartment and Upgrade Building, we definitely will achieve the 8% IRR in the future.

So, this is what we wanted to share with you, because this is a change how we measure the success, it is related to the fact that the program is getting more sophisticated. I do not think that this is changing dramatically your model, but I think this is a question of transparency, because the investment program is so important for Vonovia that we want to be very transparent to you. On the next page, you can see that we are also advancing in this neighborhood development program. So we will now touch in the year 2018 around 4,000 apartments in the neighborhood development program. You can see here in green the programs which we now have started. You can see some of these programs have a duration of more than one year, and you will see in the lower side on the page in blue that we also have a long pipeline of additional programs which we can put in the neighborhood program, which will be a very attractive value increase, as you see a part of the value increase in our Essen valuation is coming especially from the Eltingviertel.

On the next page, on page 14, you see the second element of our in-built growth element which I have discussed previous. This is our Value-Add business. For the ones who are attending first or a second time in this call, let me briefly explain the value add. We believe that we can sell additional services to the tenant which leads actually to additional external income. In the same time, we also assume that we have internal savings: the craftsmen and the environment services. So, we have external additional topline growth for internal cost savings. We are continuously developing new solutions, but we are following a very prudent approach so we have first a prototype development, so this is a test in one apartment or in one house, then we are having a proof of concept where we test if we can also handle it en masse, and then only we start to roll it out. The consequence is that the FFO effect you will see only with a long delay, because we have to go through this process, so actually from this idea to the end it technically can take us three years. Keep in mind that this Value-Add business is not reflected in the NAV; it is zero value in the NAV. At the lower part of the chart, you can see it; we are delivering 100 million of FFO which actually have in our books a value of zero. Since it has the same stability as other cash flows, it is why we assume the same value for this €100 million. That is why it is fair to assume the same. It would lead to €5 per share more in NAV. And now keep in mind that this business is faster growing than the underlying business, so I even would doubt it would not be fair to put even a little bit more than €5 in addition to the NAV. As you can see from the penetration table, you see that in all our big programs which we started a few years ago, we still have a significant potential to increase the volume, so that is why even in this program we do not see the end of the story. But please also keep in mind that it would not be fair to assume a €50 million increase every year in this Value-Add business, so for your models something around 20% would be a fair assumption for the next year.

Coming now to page 15, it is very short; as Stefan already said, we continued to dispose our non-core assets and we will continue until the end of the year, and of course we are continuing to do our privatization. Even if we have seen significant value uplift in the privatization, the fair value step-up keeps more or less the same in the first nine months of 2017 compared to 2016, so you see that this value uplift is not only a book value uplift, but it is a real value uplift in the market. Even more impressive is the non-core and non-strategic disposal where we have achieved actually a higher margin than in the previous year, so still 7% of fair market value uplift. Keep in mind these are buildings which are normally located in C and D locations, so even there we can realize better profits as in the fair market value. Overall the total profit is shown in FFO 2. EBITDA sales is significantly higher than the previous year. And with this I would like to ask Stefan to give you now the promising guidance for 2018.

Dr. A. Stefan Kirsten (CFO)

Yes, thank you, Rolf. Okay. Let us talk about 2018. At first, let us talk with the disclosure page and footnotes. There are no major acquisitions in close and also no major developments. Of course, our privatization program is in, and some small technical stuff is in, but in principle this is an acquisition-free pure organic portfolio development and guidance. You have seen that we were able to accelerate our investment program further between 2016 and 2017, so it is fair to assume that we will be at 4.6% to 4.8% organic rental growth. The driver will again be the modernization and for the first time in a meaningful way, space creation. Vacancies around 2.5%; that is the physiological level. It is always a little bit influenced also by things like non-core sales, how much vacancies do you sell away in some portfolios but around 2.5%. This is not the driver of our topline anymore. Our rental income will therefore be stable irrespective of the lower number of units; we will come to that in the next chart when we do a reconciliation. We believe that our FFO 1 will be at €960 million to €980 million which is driven by three factors. The first factor is a general increase in our operating efficiency; the second factor is of course that we had in the first half year still a conwert overhead in there which is not existing in the first half-year of the next year.

And, last but not least, we are still picking out financings, for instance. Let me give you an example. A secured loan at the moment, which we closed in 2012, 2013, we get at the moment 200 basis points cheaper for the next ten years. So, these in fact will all accumulate in FFO 1. This leads to an FFO 1 per share of approximately €2, plus-minus. This is done with an increased maintenance level; again, we are keeping our maintenance levels high. Less to work on backlogs because at the moment we can really invest into our housing stock and therefore into future cash flows. The next number is the number which fills us with pride; we truly believe that we can deliver €1 billion of investments next year and therefore reach in 2018 as promised our run rate. Privatizations, 2,300 units is always a safe bet, even if we can do 2,600 this year. Same step up as in the past. We do not see in a major way that these step-ups are endangered at the moment. On the non-core bit, Rolf mentioned it; we are trying to get rid of all our non-core next year; nevertheless, it is always opportunistic and therefore in the guidance; mentioned it is opportunistic the same with the value step-ups there. Our dividend policy is unchanged; 70% of FFO 1. If we assume the same number of shares, this will lead to a dividend and imply the dividend of €1.40 or a 6% growth only on internal growth. So, keep in mind the 18% is of course influenced by conwert and the respective moves there. So, we are very happy that we can show you that level of guidance because it shows that a) the operating momentum is intact; b) the party in the financial markets for refinancing is not over; and c) our very ambitious programs to fuel the topline for the future is on track and that fills up, of course, with a certain level of pride.

On page seventeen, where do we come from? And this is very important to understand because I see some analyses out there which forget that we are selling. €48 million alone...this is the biggest negative deviation, €48 million alone is just the FFO effect from sales. And these €48 million if this is a fixed number in there and what we can see is that this is approximately, three quarters comes from Vonovia, one quarter comes from conwert. Then you see the €65 million organic rent growth that is based on the mid value on 4.7% of course.

You see the further realization of synergies and cost savings, this is mainly falling away of the conwert overhead. You see the 20% which Rolf just mentioned on the Value-Add business. Unfortunately, we always have to take the unrealized profits, because they are within our own balance sheet, off again, so that is half of it, that is the next €10 million.

And we believe that we can deliver on interest, less on taxes but more on interest, with two or three refinancings in the next year, the goal is to come to a €970 million versus the mid range again. So all in all, we are very happy with our own budget and put this in for approval in December to our Supervisory Board.

Some housekeeping on page eighteen. GAGFAH, all done and all dealt with. If you try to get onto the GAGFAH webpage at the moment, you end up at Vonovia's investor relations page; GAGFAH does not exist anymore.

Conwert, we had a squeeze out EGM, this squeeze out became effective October 25th and got announced on October 31st in the official papers, so we will have to pay out €115 million in cash at the 31st of December.

The company is delisted, it is out of the ATX, so we own 100% of the shares. And what we are intending to do is, of course, to avoid costs in the future and therefore lower the governance by transferring this company out of the Société Européenne over various steps down to a private limited company. What you can see is that we will deliver more synergies, this is our current view, at less costs.

The less costs is easy to explain because we cannot deliver the financial synergies and therefore the prepayments do not become due, therefore we have less cost in the synergy realization. So that is the housekeeping bit and I am quite happy that we had a year where we had the time to simply tie down these things, because you touch more than 100 of legal entities just to get this one done. With that, back to Rolf, please.

Rolf Buch (CEO)

Thank you, Stefan. So I do not have a separate slide for Europe today, even if we have comments due, but we have talked about the Europe options for Vonovia about two weeks ago, so I am using page 19 to illustrate our future and existing strategy.

As you know, we have the core strategy. I have always said this is the engine; these are the four pillars or the four cylinders of the engine. This is our core strategy; this is a must. And I think we have shown you in this presentation where we think that this core strategy will still deliver significant value increase in forms of FFO growth and NAV growth per share.

As you know, we also had an opportunistic strategy for acquisitions, and nothing has changed there, but we have now a second opportunistic pillar, which is European activities, where we are trying actually to lever our knowledge and our capabilities in other European markets.

As you know, we have signed an agreement with SNI, the working teams have already met last week in Montpellier the first time. It is a very constructive working environment, I think we will come out with very interesting results probably. To give you a flavor of what I think is the case with the French market, today we know that the legal framework is very comparable to the legal framework we had in Germany before the privatization, before the creation of companies like Deutsche Annington and LEG and GAGFAH, or the private versions of the GAGFAH, at least. And we have now the impression also today that how SNI is organized is very similar to the way these companies were organized in Germany prior to the privatization, which is, of course, a very different environment. And now I think we have to find out if there is a possibility legally to apply the working procedures which we have developed in the last years here in Vonovia which, of course, then could have a significant value uplift for this type of business.

So, this is actually what I have to say about the European environment today: coming to page 20, let me summarize what I think we have told you today. We confirmed the guidance 2017 on the upper guidance with a significant rental increase, which is probably a bit more than expected at 4%. We have shown you again that we have an in-built organic growth momentum in the company which will not go away in the foreseeable future. Our first indication for the valuation will lead to a full-year value uplift of €4.0 billion to €4.5 billion of fair market value.

Our investment program which is very significant, important part of this company is fully intact, is getting more sophisticated and we see positive effects on this program, and because it is more sophisticated we have to measure it now by IRR and not only by static yield. And Stefan has shown you that we are very confident and give you a guidance for 2018 which is coming close to the €1 billion and then we will see when we will pass the €1 billion probably in 2019. Thank you very much and with this I hand over to Rene.

Rene Hoffmann

Thank you very much. Operator, we can go to Q&A now, please.

QUESTION AND ANSWER SECTION

Operator

Yes, the first question is from Thomas Neuhold, Kepler Cheuvreux, your line is now open.

Thomas Neuhold

Yes, thank you very much. I have three questions. First, on your guidance slide 17 - thank you very much for the FFO bridge - I was just wondering as it seems to me that some positions are on the net basis, what kind of cost inflation you have modeled in for key cost items in 2018?

Then, the second question would be on your LTV and balance sheet. You pointed out that you will most likely end up this year below 40%, taking into consideration the planned disposals for next year and likely further revaluation gains, the balance sheet will become strong again also in 2018. Maybe you can elaborate a little bit on your plans in terms of if this LTV target range of 40 – 45% is something you want to reach in the midterm or would you be happy also to further decrease. Then if you do not find enough attractive investment opportunities down the road, if your balance sheet becomes stronger, would you also consider maybe increasing the dividend payout ratio, doing a share buyback if the balance sheet becomes too strong?

And the last question would be on your Value-Add business. I was wondering if you can give us an update on the status of additional Value-Add businesses which are currently in the prototype of development. Thank you.

Rolf Buch (CEO)

So, Stefan, do you start with the balance sheet probably and then...

Dr A. Stefan Kirsten (CFO)

I will do some. Okay, let us talk about cost inflation. Something in the 2% range makes sense except for construction costs, and construction costs you're always at 4 to 5% at the moment.

That should be the basic assumptions, and our internal drive is always to take cost inflation and get this compensated with performance improvements; you always find little things. These are not easy budget meetings but this is the normal way how we run through these things.

Rolf Buch (CEO)

I can add one point, the construction costs in that is something around 4% and 5% next year. Our cost index for our internal costs and TGS is around 2%.

Dr A. Stefan Kirsten (CFO)

Yes, it is lower because of our own people and, of course, it is because of purchasing efficiencies.

On the loan-to-value, you know what, let us assume we reach 40%. I am with you, I do not expect the yield compression party to be over.

On the other hand, I still have three points' head room alone in the perpetual. So from that point of view I do not see that we have, at the moment, to go into significant steps that we, for instance, over lever or re-lever as you have seen in the market to a certain degree with some equity-linked issues. We are still comfortable, let us see that we really reach the number at year-end. And keep in mind you have 300 basis points on top or 3 percentage points on top for the equity hybrid and this is not due before 2021, so from that point of view. This is nothing which is at the forefront of our thinking at the moment. I hope that answers your question.

Thomas Neuhold

Yes, thank you.

Rolf Buch (CEO)

To your third question about the value-add, if you go on page fourteen again you will see that the four big pillars today are the multimedia, the craftsmen, the residential environment and the smart metering. You also see that in all these four we still have a lot of way to go until we have completed the potential.

And to give you a flavor, we just recently started - and this was in the German press today - to offer security items to our tenants. This is a very specific topic in Germany at the moment; of course, this is not a dramatically meaningful investment, but this is of course also adding into a new program.

The much bigger program is, also much bigger than the craftsmen, but longer term is providing energy to the tenants and electro mobility. We are doing pilots here at the moment, so the first phase which we will do in 2018, and then the outcome of these pilots then we will decide if we do a rollout in 2019 and following.

This is massive. As I have declared already, we have a bill of €0.5 billion on energy costs today, which we are not using at all. We are producing energy with solar collectors today on our roofs and literally are putting into the net for nearly nothing, so if we find a way how we can sell the energy which we produce to our tenants, it is a very attractive business model and the same with electric cars.

If we are able to rent electric cars for our tenants, this will be a very important part, keep in mind that if a tenant of ours wants to have an electric car, without us he is not able to have one, because if you want to run an electric car you need a dedicated parking place, there is a charger, and these are normally the parking places which we own. So we see a big potential there, but we have not put anything in the guidance because this will be the pilot phase for 2018.

Thomas Neuhold

Ok, thank you.

Operator

The next question is from Robert Verdemann, Kempen, your line is now open.

Robert Woerdeman

Good afternoon, this is Robert Woerdeman from Kempen. You mentioned that you see a number of opportunities for SNI after your first meeting with them where they can potentially learn from you. In the meanwhile, have you learnt anything from them and is there anything that was brought to your attention that you could potentially improve at Vonovia that will be meaningful to the members?

Rolf Buch (CEO)

No, our first focus was more on that we were in France looking at what they are doing, of course it is true if you are talking here about neutral learning experience, the knowledge transfer is not for free. So if we are coming to the conclusion that the way how we operate our business is a value for the French business, we actually, for example we are talking about licensing our systems to them which will have a significant EBITDA impact for our business. So we are now in the model where we exchange knowledge for free, if we find that knowledge and procedures have a value for the other party, we have to find ways how the party who is delivering the knowledge is compensated.

Robert Woerdeman

Okay, that is clear. And is there also a part in the agreement where you could potentially say, well, the knowledge is not for free but we are willing to take a stake into the company so that Vonovia and its shareholders can benefit from that as well? Is CDC willing to sell?

Rolf Buch (CEO)

You are completely right, nothing is excluded. If you follow the situation and the French market there is a very comprehensive discussion in France at the moment in the social housing sector which is, as you know, the original Vonovia as well in Germany. So if I understand the discussion correctly, the President and his government have taken the decision that they cannot go on as how they are doing it today. This means that there are changes and this is why, of course, we would never exclude all the possibilities of investment, but I think it is too early.

The step is now that we have to learn that we can do then after the learning. After we understand the French system completely, then we can decide and discuss about investment opportunities.

I would not go for investment opportunities today, because it is important that we have to understand clearly how this market is working and very clear questions are, what is in the top line, what has to be covered by the top line, so all these small detailed things we have to understand first before we decide to go for co-investment or do investment also. The SNI agreement does not have any exclusivity clause in it, so we are able to do also independent on SNI everything that we want to do.

Robert Woerdeman

Okay, fully understood. Just out of curiosity, after the announcement, were you proactively approached by European resident platforms that said, well, you could consider us because we are up for sale?

Rolf Buch (CEO)

Even if it would be the case, I think I would not answer those questions on the line, but normally you would have discussions on this confidentiality agreement. But in general it could be very clear there is not too many platforms out there, most probably I would guess five or six in the whole European market, so the number of platforms today is limited, meaning platforms which can be acquired or can be co-invested. And that is why it is a very limited number, this is why I am thinking that there is a long-term big potential for the capital market, because you cannot invest today in residential platforms on the capital market in Germany and Sweden.

Robert Woerdeman

Okay, clear. Then also, purely out of curiosity, given the fact that you have significantly lowered the cost per unit to €500, just out of curiosity, where is SNI at this point in time?

Rolf Buch (CEO)

I do not know, I only know one figure because it is disclosed, they have a 20 percentage points lower EBITDA margin.

Robert Woerdeman

Okay, clear. Last question, capital markets obviously have reacted pretty positive on your potential adventure across borders. Do you feel the urge now to make it happen, i.e. that it is difficult to withdraw this European strategy?

Rolf Buch (CEO)

Two things. First of all, we have asked the market not to put this in the models and technically it is on page 19. We declared that the European component is purely opportunistic so we have no target, we do not give us a target, we also do not have a hidden target, we are looking on this, this can be a big opportunity or it can be nothing. And that is why, I repeat, I would not advise investors to put anything in the models today because it is too early.

Robert Woerdeman

Okay, this is perfectly clear, many thanks.

Operator

The next question is from Marios Pastou, Credit Suisse, your line is now open.

Marios Pastou

Hi, good afternoon, I just have a question around the 4.6% - 4.8% rental growth you have guided for 2018. If we are assuming that market-driven rental growth is pretty stable, how much are you taking in for the hikes of modernization and space creation? And secondary to that, as we move into 2019 as both of those pick up, would you be assuming, say, a 5% plus rental growth?

Dr A. Stefan Kirsten (CFO)

Marios, two points: a) you can safely assume that in 2018 the market-driven rental growth is de facto constant to 2017, so the rest has to come from modernization and new space creation.

New space creation in 2018 is based on the 2017 number, which is not more than €100 to €150 million, let us say €100 million only. So from that point of view it will still be less meaningful than in future.

You are absolutely right, 2019 we will have all big-shot and well located rent indices becoming due, so you can see a slight uplift then in our market-driven rent. But if we can in 2018 deliver the €1 billion, everything below 5% would be a disappointment, of course, which we do not intend to do.

Marios Pastou

Okay, very useful, thank you very much. Just secondly, just on general market, I mean, as discussions were happening from a government level, do you see any calling off of any regulations and sort of rental controls or opening up of land pockets for developments et cetera, in the market?

Rolf Buch (CEO)

No, the situation is that we still are fighting for the Jamaica coalition in Germany, as you know, so the topic of housing is culturally not the hottest topic at the moment, especially the rental regulation is not the hottest topic.

As environmental protection topic is hotter, it is actually a positive sign because it is our modernization we are contributing to the environmental health of our buildings, so I expect that we get a positive support there.

I do not see if the Jamaica coalition is coming that we will see any additional rental regulations. I am in contact with actually all leaders in this field and the negotiation but it is not a big topic today, of the negotiation, there are other issues to solve.

Marios Pastou

Okay, very useful, thank you very much.

Operator

The next question is from Georg Kanders, Bankhaus Lampe, your line is now open.

Georg Kanders

Good afternoon. I have one question regarding the acquisition, the sales that reduce your potential, I assume that the bulk of them will happen in the course of Q4 or at least are effective at the beginning of the year, otherwise I think there would be a lot of units to be sold because this makes up your 4.7% rent increases, it is eaten up more or less by the sales.

Rolf Buch (CEO)

To be very clear, the impact what we have seen on the slides by Stefan is actually reflecting the full-year effect also of the disposals which we have done in 2017.

Dr A. Stefan Kirsten (CFO)

Absolutely.

Rolf Buch (CEO)

We are planning to constantly over the year, like this year, to sell every quarter a part of it. Of course this is not really exactly by quarter, we do not care so much about the timing, we care more about sites. So also here is a completely opportunistic approach, we are not forced to sell, these are not portfolios in which we will lose money next year but where we believe that long term they are not the best of them.

Georg Kanders

But if I take the rental income from Q3, multiply it by four, then we are at the guidance. So this more or less means that from sales the organic growth would more or less be eaten up. This is correct?

Dr A. Stefan Kirsten (CFO)

Where do you see this? At the top line?

Georg Kanders

Yes.

Dr A. Stefan Kirsten (CFO)

Top line is constant with the organic growth which is in there. And again, I can only reiterate what Rolf just said: we are selling, whatever, 12,000/13,000 units this year which have a full-year effect. You have a tendency of selling more in the later end of the year but, again, this type of seasonality does not really count if you go over the two years.

Georg Kanders

Ok.

Dr A. Stefan Kirsten (CFO)

Georg, if you need more details for that, please talk to Rene and his team and I am sure we can fill the gap in the process.

Reason why we wanted to show you how we come from one FFO to the other is because we see quite frequently on the sell side that our sales program is not always reflected in the numbers, and we do not want you to come with numbers which are deviating too strongly from our own internal protection.

Rolf Buch (CEO)

To add, as we already pointed out, in 2019 onward we do not see significant disposals anymore because then it is changing the mechanic.

Georg Kanders

Yes, so you just use the current good market environment, it will fulfill your strategic goals.

Dr A. Stefan Kirsten (CFO)

That is a very good fit and fair summary.

Rolf Buch (CEO)

I think I would like to draw to your attention on this to page 39. I think you see what we have achieved and what we will achieve, you see that the portfolio of Vonovia if you compare the 3/2015 to 9/2017, which is more at the end of the year 2017, you see that we have gone a long way to a much better and much more attractive portfolio, which again we show this slide also to show you that probably the assumptions you still have in the model of our portfolio quality, which is coming from the IPO is by far not right anymore. We have worked very hard in the last years by optimizing the portfolio. By the way, I repeat, we have sold one third of the old Deutsche Annington portfolio.

Georg Kanders

And have you made any progress on the decision on Vienna?

Rolf Buch (CEO)

I think Stefan may have explained you the housekeeping and after all the housekeeping is done we will have to decide if we want to sell Vienna and then, of course, it is all a question of price.

Georg Kanders

Okay, thanks a lot.

Rolf Buch (CEO)

But please allow me, I do not want to make a sales negotiation while we are on the phone.

Operator

The next question is from Thomas Rothäusler, Jefferies, your line is now open.

Thomas Rothäusler

Hi, good afternoon, just one follow-up on the FFO guidance you show on page 17, the €19 million from interest and taxes, I guess it is mainly interest, is that right or can we expect any tax changes?

Dr A. Stefan Kirsten (CFO)

No, I believe it is something like €25 million or €26 million from interest and a negative effect from tax. If you acquire less, your one-offs, which are tax deductible, are less.

Thomas Rothäusler

Okay and just one short one on GBW, the Bavarian portfolio which is rumored as a potential deal for next year, is that a realistic option for you or can you share something on that?

Rolf Buch (CEO)

I openly say this is an attractive portfolio, very well-located and well managed, you know we own the sister portfolio, but I have understood that Patrizia is not going to sell it.

Thomas Rothäusler

Okay, thank you.

Operator

The next question is from Bernd Janssen, Victoria Partners, your line is open.

Bernd Janssen

Good afternoon, I have got a question on long-term rental growth. I would like to use the page 38 for my question. I think we discussed the systematics of CBRE growth forecast in the past. So if I understand this correctly, their assumption of the top locations, 2.9% average rental growth for the next five years, that includes some capex during reletting so that could probably be compared to a market-driven rental growth of 1.5% - 1.7% and then some capex measures, probably that is the first part of the question, is that correct?

Rolf Buch (CEO)

Sounds fair.

Bernd Janssen

Then generally, as CBRE is obviously quite confident that this quite nice rental growth will continue for the next few years, and you are obviously very convinced of your €1 billion modernization spend: any views, any experience from rent increases you have transacted/executed this year on affordability, because if I look at the compound 3% leading to...I do not know what it is in five years, probably 20% in total, that is quite a lot and I have got at least some worries on longer-term affordability.

Rolf Buch (CEO)

Of course, keep in mind it is not 20% per one tenant. So it is 20% and our top line is of course not 20% that every tenant is paying because modernization is not always by definition next year. But you are right, it is not an issue, we do not see any problems at the moment, we have no major litigation because we have found a way how we can manage this modernization which not all of our peers are doing the same way. So we are not doing it against the tenants but we have found a way how we motivate the tenants that the majority of the tenants supported. An important effect of this is that we are also not using the 11% but only a smaller number, which means that some tenants are even paying less than 7%. So that is why we have developed the ability to let it happen, which is a very important ability, so I do not see any issue. On the other side, I see more an issue if we continue in Germany only with the speed of modernization which we have to do, we will have the next discussion on the climate agreement because then we will fail a second time in our climate target and I do not think that a coalition will accept that Germany constantly will fail the climate target. And that is why I will probably more expect more compensation if the politicians come to the conclusion that this is getting too expensive for the tenants and they probably will tend to help the tenants to pay for environmentally correct buildings. I don’t see politicians, not even the AfD is saying we should stay with our old buildings and put in heat and CO2 emissions in there, nobody is going for this way.

Bernd Janssen

I mean that would be certainly one way of mitigating the impact on rental growth. I do not know whether that is too much of a macro question but when I think about affordability, I certainly have in mind that we had pretty nice real wage settlements in the last few years. I guess we will get another one or two good years of real wage growth, certainly of record employment, but this is almost like the best of all worlds that at least Germany has seen over the last decade, so in this environment it should probably be no problem to increase rents across the portfolio. But I am not sure to what extent one can assume that this very positive scenario will last forever.

Rolf Buch (CEO)

What I can tell you is that, of course, the quality of our tenants is shifting to the better. And what I can tell you, our major problem today is that we have too many people who are asking for our apartments. At this time in 2013 we had in some parts issues to rent out apartments; today we have issues because in the majority of the cities where we are located we have to handle too many applicants. It is a cost issue today because you have at least to answer the call and so I do not see any change in demand for our product today. And if there would not be rental regulation, people would pay much more today. So the limiting factor of my rental course is the rental regulation, it is not the demand.

Bernd Janssen

Okay, thank you.

Operator

There are no further questions, I would like to hand back to you Rene.

Rene Hoffmann

Thank you Judith and thanks everyone for joining us on this call, we hope to see you on the road over the coming weeks and months and, as always, if you have questions or comments please reach out to me or my colleagues, have a good day everyone.