MIPIM-Special

Central and Eastern Europe – still good value for money

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Die enorme Menge des weltweit Anlage suchenden Kapitals hat nicht nur in den etablierten Immobilienhochburgen Westeuropas, sondern auch in den Ländern Mittel- und Osteuropas die Renditen für Immobilieninvestitionen fallen lassen. Während die Renditen in Polen, Tschechien und Ungarn relativ nah an das westliche Niveau herangekommen sind und sich zu stabilisieren scheinen, ist der Renditeverfall in Rumänien und Bulgarien rasanter verlaufen, gleichwohl hier noch eine höhere Risikoprämie feststellbar und aus Sicht des Autors wohl auch noch eine Weile gerechtfertigt ist. (Red.)

The developments in the banking and financial markets over the last nine months have obviously had a significant impact on real estate markets all over the world. One positive outcome of the credit crisis certainly is that it has reduced the amount of speculative money in the markets. Excessive leverage has gone, and the market is back to real estate fundamentals. Lending margins and loan-to-value ratios have gone back to more normal levels, and buyers of real estate assets need to put in real money once again to acquire good assets. All that put upwards pressure on yields.

However, if one looks across Europe to see how various markets have reacted, there are significant differences. Some real estate markets have already seen a substantial correction, notably the U.K. and Spain. Some other markets are apparently still "in denial" about the effects of the credit crisis on the real estate sector, for example Scandinavia or Italy. Whilst most property analysts agree that prices for commercial real estate in the United Kingdom have fallen some ten to 15 percent at least since last summer and yields have moved out accordingly, there are hardly any price movements in Sweden or Italy.

Part of the reason is that their lending markets are dominated by local lenders who were apparently less affected by the credit crisis than international investment banks who had played a prominent role on the U.K. market, for example. Also, it is fair to say that only a limited number of deals have closed in these markets since last summer as sellers seem to have decided to try and wait the situation out. Compared to "Old Europe", Central and Eastern European (CEE) countries experience for the first time turbulences in their real estate markets and a correction in values. The question arises how these markets are dealing with this unknown situation.

Recent market developments in CEE

The current situation in the CEE markets is somewhat in between the substantial correction seen in the U.K. and Spain and the low impact witnessed so far in Scandinavia and Italy, for example. A number of transactions closed towards the tail end of last year, and interestingly, all of these were for core assets (office buildings in Prague and Warsaw). Net initial yields for these transactions were around the 5.5 percent level, some 50 basis points above the prime yields paid for comparable transactions just before the summer. This shows that whilst some moderate correction has taken place, the fall in prices is limited.

However, a number of transactions for secondary assets seem to have been pulled from the market. Asking yields for non-core shopping center transactions in secondary locations in Central and Eastern Europe, for example, have moved to 6.5 percent, and buyers seem to be willing to transact on these only at yields of seven percent or above, raising quality concerns for the first time in several years. It looks like the gap between prime and secondary products is widening, a phenomenon that can be seen in the CEE markets as well as across Europe.

In order to understand the development of yields, at this stage, it is probably helpful to take a step back and have a quick look back at how we arrived at current yield levels in CEE. The market there is only some twelve years old – the first institutional sale of an office building in the CEE region took place in late 1998 in Prague, at a yield level of around 11.5 percent. Warsaw followed soon, at just above twelve percent. Initially, mainly Austrian property companies took advantage of their geographic proximity and soon they and Anglo-American opportunity funds dominated the market. Following the office sector, investments into the retail and logistic and distribution sector started and German funds arrived.

Within three years, yields had fallen to single digit figures. At the beginning of the 21st century yields were further driven down with the entry of Poland, Hungary, the Czech Republic, Slovakia and Slovenia (core-CEE) into the European Union, together with the Baltic States. The perception grew that the legal risks which had initially been perceived in these new markets were manageable, and that the economic fundamentals were actually quite attractive. Big international companies started to establish not only country but regional headquarters in cities like Prague or Warsaw, and a consolidation in the retail sector took place, especially with respect to major hypermarket operators.

By 2006, prime assets in Warsaw, Prague or Budapest were already trading at yields of six percent or below. This was on par with similar assets in key cities in Western Europe, so it could arguably be concluded that the yield gap between Central Europe and the "old" EU member countries had vanished. This is also underpinned by the emergence of real estate portfolios which are marketed today including properties in, say, Poland with properties in France, Spain, Italy or Germany. Before, assets in Central Europe would have been carved out and sold separately – today the investment community happily treats them as parts of a pan-European portfolio. This shows that core-CEE can no longer count as an emerging market. The figure gives an example for Poland, but the trend is

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representative for the core-CEE markets as a whole. As can be seen, the expectation for prime (not secondary) yields is to remain flat.

The yield development in the CEE markets over the last years however also gives rise to a few matters of concern.

One particular issue is the rapid yield compression in Romania and Bulgaria. The beginning of 2007 saw the accession of these two countries to the European Union, based on political considerations rather than based on economic merits. Both countries are significantly behind those countries which acceded into the European Union in 2004, both in terms of wealth and in terms of stability.

Whereas countries like the Czech Republic, Slovakia, Hungary or Slovenia have achieved a GDP per capita level of 10 000 to 12 000 Euro or even more – about half the level of Western European nations – Romania and Bulgaria still rank far behind at 50 percent of the core CEE level. Granted, these countries are catching up quickly – for example, Romania's GDP per capita has more than doubled over the last three years. Also, both Romania and Bulgaria are now rated at investment grade. Certainly the EU accession treaty has helped to speed up the process of reforms.

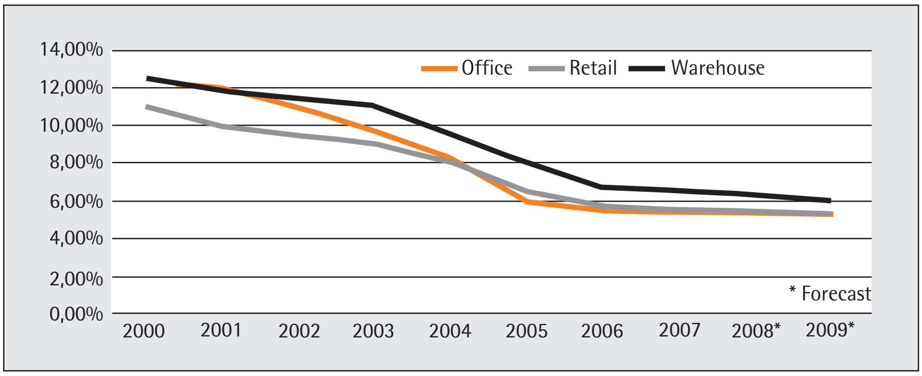
Given all this, it is not surprising that a number of investors have discovered Romania and Bulgaria as attractive investment markets. Having said all that, deals on the Bucharest office market have been done in 2007 at net initial yields below six percent. This represents a yield compression of more than 350 basis points over the last three or four years. Overall, we are witnessing a "time lapse" development with respect to investor confidence in the Romanian and Bulgarian markets. A process that took some seven years in Poland, the Czech Republic or Hungary took place in less than half that time in Romania and Bulgaria. Coupled with the significant current account deficit that Romania and Bulgaria run, one might expect yields to move out much quicker and wider than in core-CEE in the near future.

The second area of concern is the yield gap between prime and secondary products which is still too narrow. One should not forget that historically, well before the arrival of highly leveraged financial transactions on European real estate markets, a much wider gap existed between these two product classes than can be seen today. Prime assets in key European cities used to attract a much wider range of buyer interest and consequently traded at much higher prices than secondary offices or retail assets in secondary cities, where buyers' interest used to be predominantly local.

The globalisation of the real estate markets combined with the significant overhang of demand over supply in recent years has led to big international players now competing in the provincial backwaters. This is not a CEE phenomenon per se but a Europe-wide development. However, spread of yields would be expected to be wider in CEE as the spread of wealth (and consequently purchasing power) between the capitals and the regions is much more disproportionate than in more mature western European countries, and this ought to be reflected in an even bigger yield gap.

As a summary, whilst prime yields in core CEE are expected to remain relatively stable, secondary yields and those in Romania, Bulgaria and indeed the Baltic states are likely to face upward pressure.

The market – prime yields by sector



Source: DTZ Research

A look at the fundamentals

To back up the previous statement, one needs have a look at fundamentals. So far, the credit and liquidity crisis in the US sub-prime mortgage market had only moderate repercussions of the Central and Eastern European economies. There are a number of reasons for this:

Firstly, CEE banks' exposure to the sub-prime and CDO markets in the US was very limited, as they are concentrating on financing the growth in their own home markets, which provides them with sufficient opportunities for growing their own business. Also, most of them operate retail banking networks, and their funding base is therefore less dependent on the inter-banking market. Secondly, strong economic fundamentals, first and foremost strong GDP growth, continue to have a positive stabilizing effect. The strong economic growth has also helped occupational demand and growing purchasing power.

With the exception of Hungary, all countries forecast significant economic growth, well above double the rate of western European economies, with inflation well under control. Hungary carries a bit of concern, but the fiscal correction plan there seems to work, albeit at the expense of GDP growth. Importantly, growth in core-CEE is driven by both consumption and production, with the caveat that some countries, notably Poland, face some constraints in terms of production capacity.

The CEE property markets present a good opportunity to acquire good yielding real estate investments, with strong rental growth opportunities driven by sound economic fundamentals. The right property selection is important, as property fundamentals take a key role in determining future yield development. Prime property in core CEE is likely to remain relatively stable, secondary product in fringe locations will be much more volatile and certain markets – especially South Eastern Europe and the Baltic states – will need to be closely monitored, both for their economic performance and consequently the development of property yields in these markets. After all, it was arguably the economic fundamentals that have helped preserve investor confidence in Central and Eastern Europe so far.