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Not the wild East

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It is not a perfect market, but profits can be made in Central and Eastern Europe provided the right strategy is applied. PEREMagazine, September 2014 issue.

The ninth of November marks the 25th anniversary of the fall of the Berlin Wall. Much has changed in a quarter-century – and at a great pace – not least in the real estate markets of the former communist bloc countries of Central and Eastern Europe (CEE).

Over the past two decades or so, the CEE states have transformed their economies from a state-controlled model to a market-driven one. Most of the countries – Poland, the Czech Republic, Slovakia, Hungary, Slovenia, Bulgaria, Romania, Estonia, Latvia and Lithuania – are now fully-fledged EU members. So the question of whether the region still should be considered an 'emerging market' in terms of risk provokes vigorous debate among the roundtable participants.

Rockspring Property Investment Manager's Jose Luis Pellicer believes that it should. "From our investors' perspective, we invest in CEE because that is the emerging part of Europe," he argues. "You have some of the positive things of being part of Europe and some of the positive things of being an emerging market."

Rockspring controls assets in Poland, the Czech Republic, Hungary and Croatia through its TransEuropean family of funds. However, while TransEuropean IV invested in the region, the TransEuropean V fund, which was launched in 2012 with the ability to invest up to €700 million, has yet to do so.

"In a European context, CEE needs to have a risk premium," Pellicer explains. "The first reason is liquidity. You do have some local capital, but most of it is international. So, in order to exit quickly from your investments and make a return, you probably need to be in a period of strong – or at least not weak – capital markets activity."

Pellicer continues: "Secondly, from an urban economics perspective, the depreciation of assets is far quicker than in Western Europe. There is a lot still to be built in places like Warsaw, which has 4 million square meters of office space. Over the next 10 to 15 years that market will go to 8 million square meters. Even in the best location, a building that is 15 to 20 years old is already obsolete. If you look at the risk premiums that Warsaw or Prague offices offer today, also taking into account the amount of supply there is in the market, I find it hard to be compensated for the risks I am running in a pan-European context. On a risk-adjusted basis, we have found better opportunities elsewhere."

Misunderstood markets

Revetas Capital has been investing in the CEE region for more than a decade, and founder Eric Assimakopoulos counters that the exaggerated perception of the risks of investing in the region fails to match reality. He argues that investors that bought overpriced property in 2003 to 2004 in the expectation of seeing swift growth in capital values and subsequently were 'burned' when the market collapsed in 2008 are inclined to blame the characteristics of the region rather than admit to the failure of their strategies.

"We call them emerging markets, notwithstanding that some of these cities have been around longer than the US," Assimakopoulos says. "Maybe in real estate the institutional part is emerging, but the reality is debt-to-GDP ratios are below Western Europe and they don't have the legacy issues that Spain, Portugal, Greece and Italy have. Unemployment is below Western Europe and GDP growth is above it."

With many investors having withdrawn from all but the prime markets in CEE capitals like Prague and Warsaw, Assimakopoulos believes there are good real estate opportunities to be found in secondary cities across a region where economic performance has been strong. "An asset in Krakow or Gdansk has a 10 percent to 12 percent yield today, while Warsaw is 6 percent," he says. "That is going to change as investors move into the secondary cities."

In fact, Assimakopoulos predicts that the coming six months will see several substantial purchases by big-name investors. "People will start to see that the region is investable," he says. "It's not the wild East, but rather a stable market that has seen a blip because it is the first market cycle."

Jos Tromp of global real estate services firm CBRE does not believe that the more-established CEE markets require much of a risk premium either. "Why can't the yield on a high-quality retail asset in Poland be as sharp as something in Germany?" he asks. "Expectations of high returns in these countries also should change because they are becoming a very central part of Europe and, as a consequence, the returns that you can get there will be in line with that. One needs to treat these assets as seriously as one would assets in London or Germany, which too often is not the case and therefore is affecting the performance of investments."

Lee Timmins of Hines, which controls around $3 billion of property in Poland and Russia, adds: "In the not too distant future, people will think of some of the CEE markets – Poland, the Czech Republic and Slovakia – as just Europe. Then, there will be a whole different class of Eastern Europe, including Russia, where there is a different perception of risk."

Distress and the banks

One might imagine that, in a region that many investors still consider to be an emerging market, it would be easy to pick up realistically-priced assets. That is far from being the case, however. That is partly due to the weight of equity seeking an income-generating home in property.

To underline the point, Tromp reveals: "We did a bit of analysis, which showed us there currently is more equity in the market than in the peak years of 2006 to 2007, and the debt side of the market is only at the start of recovery."

Another factor is the hangover of nonperforming asset-backed loans from the previous cycle, which banks still are reluctant to write down. "The banks don't want to sell at huge discounts, but there are no buyers [at those levels]," Assimakopoulos explains. "The best thing for the market would be for the banks to indeed take big discounts. Big investors subsequently would come in, re-set all pricing and establish a new base, but banks have limited room to maneuver as providing steep discounts could potentially put them out of business."

Revetas Capital is not a distressed investor; rather it is an opportunistic investor that is targeting distress because that is where the value is and where it can get its hands on assets at the right price. "The deals we are seeking today are well-located quality assets that are generating cash flow but in need of investment for building and tenant improvement, where the sponsor has run out of money, the asset is over-leveraged and the bank is unwilling to take a huge haircut," says Assimakopoulos.

In recent months, Revetas Fund I has acquired 14 shopping centres in Sofia, Bulgaria; Bucharest, Romania; and in Hungary, pursuing this exact strategy. Assimakopoulos anticipates packaging those assets together with other regional retail centers and potentially floating them on the equity markets.

Tromp notes that under-investment in buildings by investors that have run out of money is exacerbated by a poor asset management culture across much of the CEE region. "The management of many buildings in Central Europe is of low quality as there is limited attention on the proper maintenance and operation of buildings," he says. "This is a serious issue because CEE as an investment destination is not delivering the results that it should as a consequence. The expectations on what the region can and must deliver should change."

There are not unfounded hopes that the European Central Bank's ongoing Asset Quality Review (AQR) will encourage banks to sell off distressed assets. The AQR aims to shore up confidence by assessing whether the assets held by European banks are properly valued, and there are signs that some banks will seek to write down assets in order to comply with the test. Still, the whole process has yet to yield significant volume, according to the roundtable participants.

"I don't think anyone has seen deal flow on the back of AQR yet," cautions Assimakopoulos. "AQR will undoubtedly imply that banks will have to make further adjustments, provisions and write-downs. It remains unclear if that will translate into assets coming to the market at the right price."

Areas of opportunity

As Hines shifts its emphasis away from acquisitions in Russia due to uncertainty caused by the Ukraine conflict, the firm will concentrate on buying property in Poland, the other CEE market in which it is a big player. As an example, at the end of July, Hines acquired the 15,900-square-meter Ambassador office building in Warsaw from Kronos Real Estate.

Poland is the largest and most well-established of the CEE markets, and its economic strength is underpinned by a close trading relationship with Germany. "We don't feel like we want to be in the 6 percent range for cap rates, but in the mid- to high 7s you get a good location with a nice steady income stream at moderate leverage levels," Timmins says.

Tromp notes that occupier demand for office space in Poland has never been stronger. However, an oversupply of office property in Warsaw has seen headline rents fall from a high point of around €35 per square meter per month to €20 to €25 per square meter. He blames over-development – and the abundance of land set to be redeveloped – on the weight of money in the market. "The pressure is building up again, but the good thing is that yields and rents are more sustainable nowadays," he argues.

Tromp singles out Hungary as a particular area of opportunity. "I don't quite understand why investors do not looking at Hungary, where one can buy some of the best quality city office buildings for just over €2,000 per square meter." Assimakopoulos also likes Hungary as a location to acquire assets, driven in part by a recently introduced subsidy for commercial real estate loans.

The influence of EBRD

As well as markets, the participants discuss the ongoing relevance of the European Bank for Reconstruction and Development (EBRD) as an investor in the region. The EBRD was set up in 1991 with the aim of helping the former communist-bloc countries to become open, stable market economies.

“For us, they have been a really key partner,” says Timmins. “They were an investor in one of our funds in Russia and are an investor in a new fund we are doing in Poland. While other international capital has pulled out of Russia, the EBRD still is funding our current projects in Russia through their prior investment in our Russia-oriented fund.” Meanwhile, in Poland, Hines’ focus on sustainability has been a key component in persuading the bank to back it.

Pellicer, whose first job was as an economist at the EBRD, notes that the bank’s role has changed within the more established market economies of Central Europe. “The point of the bank is to help in the transition to a market economy,” he explains. “They do that by either getting into markets where private capital is not available or they fulfil a function that private capital cannot due to high risk. Secondly, they try to help to bring transition to the next level. Poland is a totally functioning market economy but, in terms of introducing the first totally green, energy neutral building, that would interest them.”

Timmins adds: “They may be one of the early investors in a fund, but they can’t be the majority investor. They can only take a certain percentage. Other capital has to come in and join. However, when EBRD does come in, they give the good housekeeping seal of approval for a strategy or a fund.”

Continuing transformation

As the discussion winds to a close, the participants take up the theme of the CEE economies’ transition to the next level. Indeed, over the past 10 years, Assimakopoulos has seen the emphasis for inward investment into the region change.

“Many investors went to Central Europe because of the availability of low cost and highly skilled labor, and there was a big first wave of automobile plants moving East because of that,” Assimakopoulos says. “The phenomenon today is shared services offices and business process outsourcing. Krakow, Budapest and Bucharest have moved up the chart for these shared services offices dramatically. Businesses are moving there because there is a low cost, multilingual, young, intelligent workforce.”

That should help the continued development of office product in the region. The ongoing development of transport infrastructure in the region also will have a big influence on its property markets.

“Moscow is an extreme example of a place where everybody who could buy a car bought one and started to drive. As time goes on, you are going to see more and more professional people riding public transportation. That also is true of Warsaw with the expansion of its metro. All those things will begin to create the dynamics of location for the next 10 years,” Timmins predicts.

Tromp suggests investors need to stick to property fundamentals when making investment decisions.

“Warsaw’s Mokotow district is the biggest CEE office destination, but it is lacking a direct access to a metro station,” he notes. “In Western Europe, this would be priced in.”

Pellicer responds that infrastructure development can cut two ways. “Somewhere that you may consider an emerged office cluster today will fade away because of a lack of transport infrastructure and better infrastructure in competing locations,” he says.

Since the fall of the Iron Curtain, the economies of the CEE region have developed at a dizzying pace, but the transformation has not been uniform. It is possible to divide the region into three zones: the stable, developed economies of Central Europe; the shakier ones of southeast Europe, such as Romania and

Bulgaria; and the volatile East, beyond the bounds of the European Union. Each has its own set of risks and rewards that investors must understand if they are to avoid the errors committed by the last wave of capital, but profits certainly can be made for the right strategies.

Eric Assimakopoulos

Founder and managing partner Revetas Capital

Assimakopoulos founded specialist real estate investment manager Revetas Capital, the successor to Bifrost Investment Group, in 2012 to source and manage value-added and opportunistic, overleveraged and underperforming commercial real estate opportunities. The firm currently focuses exclusively on Central European economies, with offices in London, Vienna, Bratislava, Krakow and Bucharest.

Prior to Revetas, Assimakopoulos founded and built the Gnome Group, which became one of the most advanced data center developers across the US and Europe during the mid-1990s. In 1999, he partnered with Morgan Stanley Real Estate Investing to create Metronexus, a technology-driven real estate fund for which he was chairman and CEO.

Jose Luis Pellicer

Head of research Rockspring Property Investment Managers

As head of research at Rockspring, Pellicer provides analysis of the European property market to help fund managers at the London-based firm shape their strategy.

He began his career at the European Bank for Reconstruction and Development before moving to Deutsche Bank, first as an economist and then as part of the real estate research team. He joined Rockspring in 2004 and is a member of the firm's investment and strategy committees.

Lee Timmins

Senior managing director and co-chief executive officer, Hines

Timmins joined Hines in 1988 and is based in Moscow, where he is country manager for the firm's Russian operations as well as co-chief executive officer of Hines Eurasia. Since 1993, he has developed, acquired and managed more than $2.5 billion of real estate and has been instrumental in establishing development and acquisition funds totaling $1.1 billion of capital, including the Hines Russia & Poland Fund and the HC Russia Long Term Hold Fund.

Jos Tromp

Senior director and head of CEE research and consulting, CBRE

As head of CEE research and consulting at CBRE, Tromp leads a 35-strong team working out of 14 countries across the region. He joined the global real estate services firm in 2008 and is a member of its CEE board of directors. He previously worked as head of research and associate director at Jones Lang LaSalle.

Ruble rumble

Trading volume of Russian real estate has plummeting nearly 60 percent amid tensions with neighboring Ukraine

The political fallout from the ongoing political crisis in Ukraine has hurt the Russian real estate investment market. CBRE's figures for the first half of 2014 show deal volumes in the CEE market excluding Russia were up by 15 percent from last year. However, activity in the Russian market plunged by 58 percent over the same period, from €2.7 billion in the first half of 2013 to just €1.1 billion this year.

"Deal volumes in Russia have fallen off a cliff, although one needs to allow for a high volume traded in the first half of 2013," says Tromp.

Most foreign money coming into the Russian market focuses on Moscow, and Tromp predicts that investors that were considering the location again in the light of the recovery will now pull back for the foreseeable future. "I think foreign investors will take their time to get re-interested again simply because, at the moment, it is being restated where the risks lie in a country like Russia," he says.

Like many other Western firm, Hines, which has been investing in the country for more than 20 years, is adjusting its Russian strategy. "I think we will be scaling back new acquisitions in Russia in the near term," says Timmins. "However, we have a number of large-scale retail developments there, and we will continue with these as tenant demand for our projects remains fairly strong."

Hines will look to complete its developments and hold them until calmer times provide an opportunity to exit. Although holding those investments for longer will affect the internal rate of return, Timmins suggests it also will lead to a higher equity multiple because of the additional income that will accrue due to higher development yields in Russia compared to other CEE markets.

"The big change with the politics in Russia is that North American and Western European investors certainly are uncomfortable, Asian investors are watching and Middle Eastern investors are more comfortable," Timmins notes.

One example of the continued interest from Middle Eastern investors is the $400 million purchase of the Pokrovsky Hills residential development in Moscow by the Qatar Investment Authority. Current owners Goldman Sachs and Hines are expected to complete the sale in the third quarter of this year. Meanwhile, Hines recently closed a deal in Russia with a Middle Eastern sovereign wealth fund and will continue to do separate account business on behalf of investors whose sentiment is unaffected by the political situation.

While foreign investors' confidence has taken a hit, that does not mean the market is dead, argues Tromp. "If you look at what is still trading – and that is a very significant part of the market – it is mainly local money or money coming from neighboring regions or countries," he says.

Has the crisis in Ukraine affected Russian real estate values? Tromp believes the impact has been limited so far, but he warns: "The longer the cross-border capital stays out of the market, the greater the impact because it is a question of supply and demand."

Tromp adds: "The effect of the crisis on the foreign exchange markets will be an important factor. The fall in the value of the ruble has not really impacted office rents yet, which are frequently paid in US dollars or euros, but an indirect effect is looming as local business is in rubles. If the value of the currency continues to decline, it will hurt the profitability of retailers that procure their goods in euros or dollars."

REVETAS CAPITAL

- Revetas Capital is a real estate investment manager focused on value added and opportunistic commercial real estate investments in Central European Economies ("CEE")
- Over 12 years of experience in the CEE region
- Pursues an active asset management approach providing full transparency and alignment of interests with all stakeholders
- Acquired and managed over 380,000 m^2 of properties across multiple assets classes and through a number of cycles
- One of the most active managers in the CEE region, having acquired over 15 assets in four countries over the past 12 months
- Long-standing personal relationships with key leading banks, operators, advisors, and government officials in the region

Eric Assimakopoulos, CEO of Revetas Capital, interviewed on expert panel by CNBC Squawkbox on 03/04/2014 to discuss developments in Central and Eastern Europe

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