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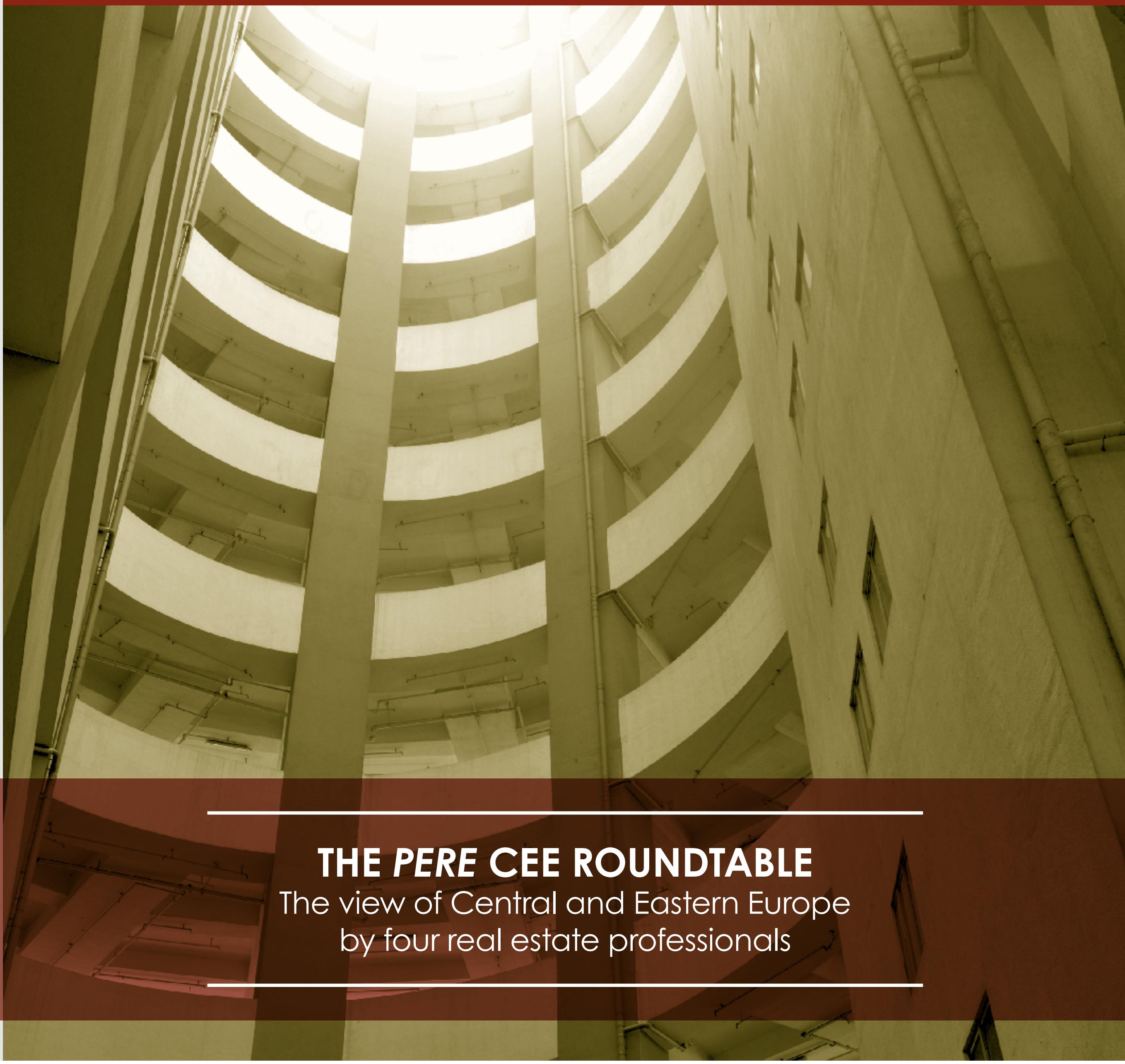
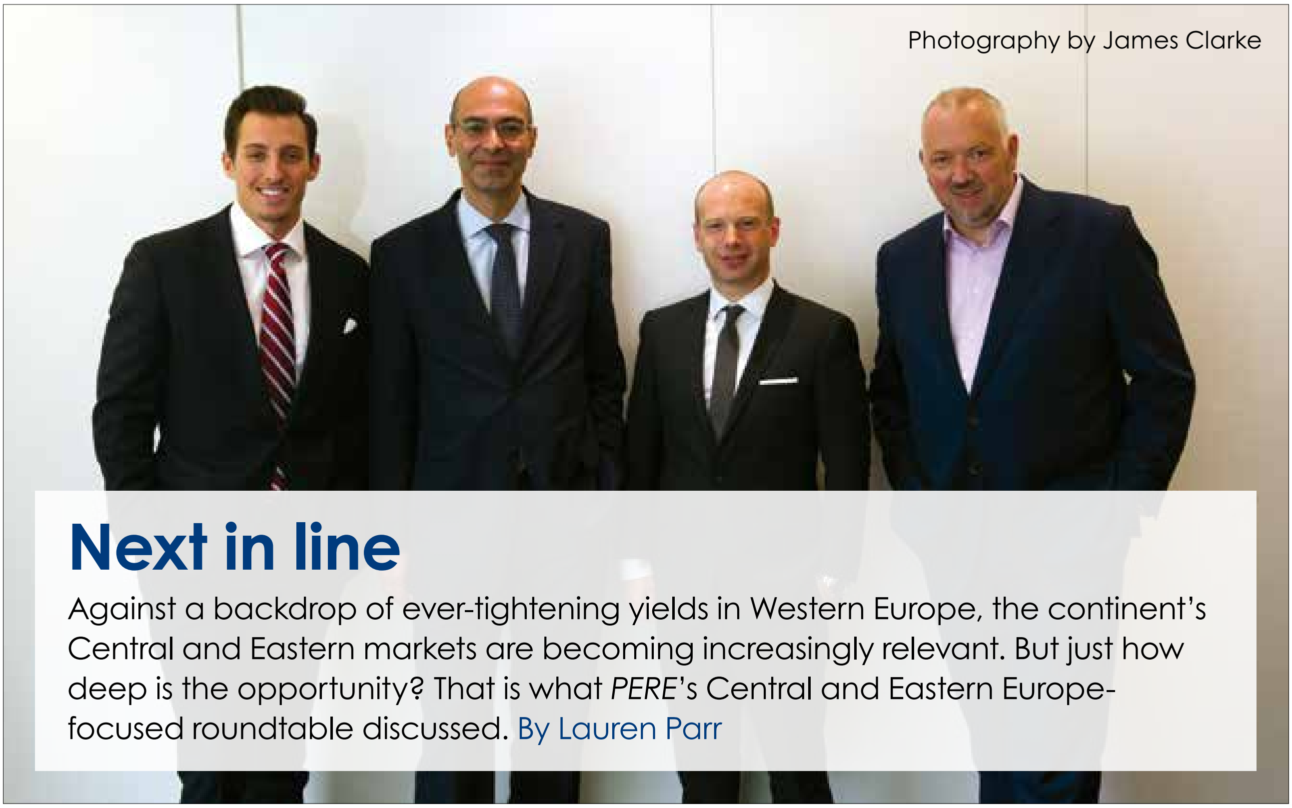
FOR THE WORLD'S PRIVATE REAL ESTATE MARKETS



THE *PERE* CEE ROUNDTABLE

The view of Central and Eastern Europe by four real estate professionals



Photography by James Clarke

Next in line

Against a backdrop of ever-tightening yields in Western Europe, the continent's Central and Eastern markets are becoming increasingly relevant. But just how deep is the opportunity? That is what *PERE*'s Central and Eastern Europe-focused roundtable discussed. By Lauren Parr

The *PERE* roundtable in a row: but there were divergent views

It is always interesting when you get to a point in a market cycle where participants harbor divergent views on its direction. That the central and eastern European markets might even be on course for a correction is a debate that pervades this year's *PERE* Central and Eastern Europe (CEE) Roundtable.

The roundtable's participants, global investment manager Amstar and pan-European fund manager Tristan Capital Partners respectively, clash on the matter of how much 'runway' there is left to go.

Potentially 18 months to 24 months, believes Amstar's Jeffrey Stonger, who leads the firm's CEE efforts. Not necessarily, argues Tristan's managing director of investments, Daniel Harris. In his sphere, there are still considerable opportunities and the cycle has several years left to run, he says.

Bank deleveraging has barely started, points out Miroslav Mitic, chief executive officer of DAV Holding Real Estate, part of Raiffeisen Bank in Hungary. Further, an increasing amount of capital targeting the region, and an anticipated wave of Asian capital in particular, underpins Dentons legal adviser Pawel Debowski's confidence in the bumper €7.5 billion investment estimate floated by Cushman & Wakefield for 2015.

The four firms were on the same page about what investors consider to be the CEE markets of most current relevance: Poland, Czech Republic and Slovakia; edging out into Romania and Bulgaria; followed by "the rest". The unanimous view on Russia and Ukraine, on the other hand, was that, given the serious nature of their conflict, their real estate markets remain completely off the radar and would likely remain so for a very long time to come.

PERE: *If there is one single thing that concerns you most about the CEE private real estate marketplace, what is it?*

Daniel Harris: For me, I'd say the market is typified by development and there is a continuous supply of new stock that comes in, whether in the logistics, office, retail or residential sector. That has strengths and weaknesses, but it's something you need to be aware of when investing in developing markets.

In terms of location, what was good yesterday might not be right for tomorrow. Look at Poland's logistics sector; if you go back many years you had to have huge hypermarkets with distribution centers very nearby because there was no road network. Now you've got huge hypermarkets with enormous storage space that they don't need any more.

Jeffrey Stonger: For me, it is macro concerns; the things you can't really control but that have a large impact on business.

You've got the Russia-Ukraine conflict and other geopolitical issues, the global impact of fluctuating oil prices and the uncertainty surrounding interest rates and the impact that ultimately has on investment trends.

DH: I don't see any bubbles being formed by oil. Countries that have benefited most are big net importers of oil and gas like Poland. For the moment, it has only been positive.

PERE: *In terms of conflict, do you need to see Russia and Ukraine resolved in a tangible way before they can be included in the investment equation or is there opportunity there?*

JS: As I see it, Poland and the Czech Republic are more the focus since they have largely stayed out of the conflict, they both have robust economies and there are generally more opportunities within these markets. Russia and Ukraine are not among our target markets despite a number of attractive opportunities in Russia. We've seen potential investments that can generate 20 percent to 30 percent cash-on-cash returns, but is there an exit? It comes down to liquidity and overall political stability.

Pawel Debowski: The real estate sector has fallen off the radar of Western investors for at least another five to seven years. These two markets need to regain credibility. This doesn't mean they will stop functioning. They will keep going, but the large investments will either come locally or possibly from other regions like the Middle East or China.

PERE: *There are headline examples of international groups that invested serious amounts of capital into Russian shopping centers through limited life vehicles before the crisis. What do you do in a scenario like that?*

JS: We previously invested in Russia and fortunately we sold in time. We developed a 655,000 square foot shopping center in Novosibirsk that we sold to a domestic investor in 2013. That sale is still the largest ever retail transaction in Russia outside of Moscow and St Petersburg. Despite possibly leaving some value on the table, we knew it

Miroslav Mitic

Chief executive officer

DAV Holding Real Estate

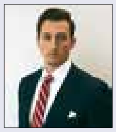
Based in Hungary for the last three years, Miroslav Mitic is responsible for having created special purpose vehicles for Raiffeisen Bank after the crisis that helped it minimize losses from commercial real estate asets. The bank has €2.2 billion of nonperforming loans in Ukraine and €1.4 billion in Hungary and its priority is cleaning the books. It also has some real estate funds in various countries including Poland, the Czech Republic, Slovakia and Romania.

Pawel Debowski

Chairman, real estate Europe

Dentons

The head of Dentons' European real estate group, Debowski runs the largest real estate team in Europe of any law firm with more than 250 real estate lawyers – over 100 of whom are in CEE. Last year, Dentons acted as legal counsel on over 60 percent of the acquisition and disposal transactions across the CEE region, advising clients on projects with a total value of €4.8 billion.



Jeffrey Stonger

Vice president

Amstar

Leading Amstar's CEE efforts, Stonger relocated to Europe in 2014 tasked with growing the global investment manager's footprint in Poland and CEE. Amstar entered that market last year through the acquisition of Zlota 44, a premier residential tower in Warsaw. Having leapfrogged Western Europe when it expanded from the US into Europe almost ten years ago, Amstar has invested in Turkey (its largest footprint outside the US), Russia, India and most recently, Poland. It has $2.3 billion of assets under management, half of which are in the US.

Daniel Harris

Managing director, investments

Tristan Capital Partners

Under managing director for investments, Daniel Harris, Tristan Capital Partners has invested €1.4 billion in Poland and the Czech Republic over the past four and a half years, including disposals such as a large logistics portfolio it sold to P3 last year. It recently acquired three office buildings and a parcel of land in Krakow through which it will deliver a total 646,000 square feet of office space. The UK-based pan European international fund manager currently has six funds under management with AUM of between €5 billion and €6 billion.

was the right time to sell given that exit windows open and close quickly in emerging markets, and when they're closed, they are really closed.

PERE: *Ok, let's move on from Russia-Ukraine. Is private real estate in the CEE region understood well enough as a proposition among institutions or is there a significant information gap?*

DH: There is a lot of continued expansion of capital to come into the market. The market has been dominated by locally based developers; you've got core German open-ended funds, which are very big buyers; you've got private equity real estate funds; you don't yet have a lot of the larger capital pools you see in more mature markets like France, Germany and the UK. Asian groups haven't really made a splash yet in CEE markets.

There hasn't been an influx of Chinese capital so far, but I expect it will come in the future because there are some sizeable assets to acquire. As the markets are development-based, the number of assets to buy will be greater in five years than today because significantly more will be built. If you take that as the basis, the region will have to expand its investment pool and that will come from larger sovereign wealth and Asian investors.

JS: There is an abundance of capital, but primarily for income-producing assets. There isn't a ton of capital chasing development. The question is: do investors truly understand the market? Many investors consider CEE to be riskier than Western Europe, but the perceived risk is much higher than the actual risk – that leads to investment opportunities. Translating that to return expectations, I'd say there is 150 basis points to 250 basis points of misalignment.

PERE: *There is a wall of money chasing gateway cities and income-producing assets. Eventually, does the spread between prime yields available in gateway cities in Western Europe and government bond returns become too tight that investors start looking further east to deploy capital? Do you sense there is going to be a surge of investment?*

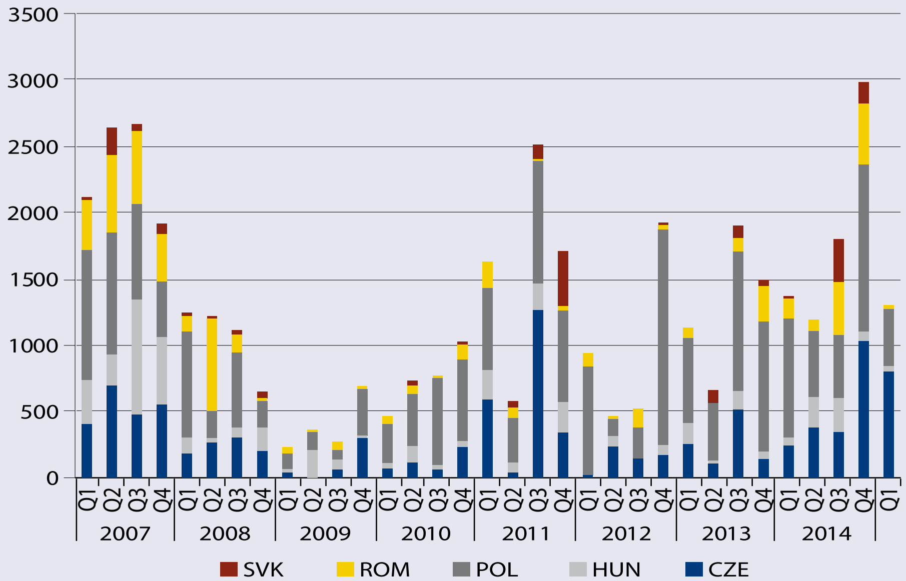
DH: I think so. We're a holder of Warsaw offices, a market which has had its ups and down over the last couple of years, but take up and demand are at record levels for new space – so is supply which is part of the uncertainty. Yet the best buildings are pushing sub-6 percent yields now. The equivalent buildings in Frankfurt would be 150 basis points lower. If you assume Warsaw to be the only real gateway city in central Europe, prime yields have not hit their peak. In the previous cycle prime yields were 5.25 percent to 5.5 percent. They haven't traced anywhere near that this cycle.

PERE: *So once Western Europe is done for investors, what's the window of opportunity and how do you position yourself? Is there a small window to deploy capital but ultimately a wave of exiting coming up?*

JS: There is a lot of competition for prime real estate and now is a good time to be a seller of core. Low interest rates and an increasing availability of debt have probably elongated this cycle but I'm not sure how much runway we have left. I question if you can get in and out in the remainder of this cycle for CEE as a whole, although it may be possible in Poland and the Czech Republic.

CEE investment volumes

The €1.3 billion invested in CEE in Q1 2015 mirrors Q1 activity in 2014, but broker Cushman & Wakefield believes 2015 will nonetheless turn out to be a record year with €7.5 billion of sales



Source: *Cushman & Wakefield*

PERE: *What will generate inflation and where will higher interest rates come from? I don't think anybody can pinpoint a specific reason interest rates will go up in the next 12 months to 24 months.*

JS: Saying there are no reasons why interest rates will go up in the next 12 months to 24 months reminds me of 2006 when the consensus view was that there was no reason real estate values wouldn't continue to increase. The point at which you realize that's not necessarily true is usually too late. I am almost certain there will be some event we are not yet aware of that will cause interest to rise.

Grilled: *PERE*'s Jonathan Brasse asks whether the market will broaden

DH: I don't necessarily agree; there is always an opportunity in all markets. If you look at central Europe, excluding Warsaw offices, the supply pipeline is nowhere near the point at where it was the last cycle. You don't have banks providing speculative development financing and most of the major capital markets are very tight. A lot of our business is effectively taking buildings that have one or two issues, solving them, and at the end of an asset management plan, having a more core asset to sell. In central Europe the core market is very strong. We're still seeing considerable opportunities in the cycle; we think it has got several more years to run.

PERE: *If the banks were ready to finance on a 'normal' level, do you think more parties would be open to investing in more markets?*

DH: People talk about just three transactions in Hungary; that's not enough to make the market. In Romania a few people have been buying. There have been one or two transactions over the last few year; interest is starting to pick up. But we don't know where liquidity is going to be in three to four years' time.

Miroslav Mitic: Investors have been ready to step into Hungary and Romania, which is a little bit bigger; that's why there have been three deals. Putting that into context, in the last seven years there have been zero deals.

PD: People talk about Poland, Czech Republic, Slovakia, slowly going out to Romania and Hungary. The other countries in the region fall into another basket. They will not be of interest to investors for many years to come.

MM: I can't see people buying in Bulgaria for the foreseeable future, not because there is something wrong with it but because it is a small market. We tried to sell a shopping center in Bulgaria and were ready to make a huge haircut but did not receive one single offer.

DH: If you're going to go to those countries you need one of two views: you either need to believe in a short exit window and that you can come in and can buy something today and sell at a different price in a short space of time and hope you get it right, or have a very long-term cash flow driven view. People that have been buying in those markets are typically much longer term holders.

However big the discount is I still sit there and think 'who am I going to sell this to'?

PERE: *Cushman & Wakefield reported €1.3 billion of deals across Poland, Czech, Slovakia, Hungary and Romania in Q1 2015 – around the same as the corresponding period last year. It predicts €7.5 billion of transactions across the region by the end of this year – a huge increase on the year before. Do you agree?*

PD: Yes. Looking at the number of projects that our real estate team in CEE is currently involved in, I am confident this will be a record year in terms of transaction volume.

MM: I think we'll see a little more than €1.3 billion this year

View from the sidelines

Mike Atwell, head of capital markets for Central and Eastern Europe at property services firm CBRE, reviews the roundtable's belief that a wall of capital is coming to the region.

Central and Eastern Europe (CEE) has always been on the target list for global international capital and I do not see this changing. The region offers a different perspective to Western Europe with higher returns given the perceived higher risk.

The increased global capital flows into European real estate has resulted in considerable yield compression in the Western European markets which we have not yet seen in Central Europe, which makes CEE ever more appealing and which has resulted in new sources of capital looking. I am, however, starting to see this trend change and yields are starting to compress in the core CEE markets such as Poland and also in Prague for absolute prime stock where there is limited risk.


Atwell: Seeing a wider array of investors

Historically the market has been dominated more by the German funds and European investment managers and private equity players, but I have seen this change over the last 18 months. We are seeing new sources of capital from China, Korea, the Middle East, South Africa and Israel to name a few. Sometimes this capital is aligned with experienced and established CEE investment managers and sometimes invested directly.

Also, due to the limited size of the markets in CEE, the likelihood of investment through platform deals and corporate acquisitions is increasing and a number of large scale opportunities are out in the market already, which are proving to be of particular interest to the US private equity players.

Investment volumes are always difficult to predict early on in the year, but we have seen reduced volumes in Poland than in previous years. Conversely, we have seen strong increases in Hungary and Romania and the CEE region will be far more balanced than in previous years.

Due to the challenging situation in Russia and Ukraine, CEE investment volume was under pressure. Together with Poland, Russia is the largest investment market in CEE, and a year-on-year drop of close to 60 percent did have a substantial impact on the region as a whole. However, excluding Russia, volumes increased by 25 percent.

The Czech Republic has seen a significant uplift, but that was predominantly driven by the Palladium deal in Q1 2015. Poland will still remain the dominant and leading market and we expect investment volumes of €3 billion in Poland alone.

We saw an overall investment volume into CEE in 2014 of €7.5bn and I would expect 2015 to be similar, or perhaps in excess of that, as we are seeing numerous large scale transactions that will possibly all close this year and push volumes higher.

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and between €6 billion and €7 billion in 2016, a lot of which will take place in Poland.

DH: There is an increasing amount of capital that wants to come in. If there was more supply of product the number would be bigger. What holds investment volumes back is the amount of supply which is why I think the number is going to continually grow.

JS: It is not unrealistic that investment volume will continue to grow. Right now, there's an increasing availability of debt and an abundance of capital chasing deals. But with prices going up investors are now stretching for yield by moving into secondary assets and tertiary markets. Unfortunately, when interest rates inevitably rise, those are the first assets to be negatively impacted. So we're cautious about where we're headed, as it feels like a correction may be coming in the next two years.

PERE: *At what point do you see CEE-specific real estate vehicles emerging versus strategies for the region being part of wider pool of strategies?*

DH: What we're hearing from our investors is that they want to invest on a pan-European basis because there are different opportunities to invest in the UK to Germany to France to the Nordics to Spain and Italy. There were specific CEE funds previously because there was a real story about EU membership and a reason to raise a specific fund. Today, Poland and Czech are pretty much core countries within Europe therefore why limit yourself to just investing in those? You should be free to invest in those countries when the opportunity exists, and not when opportunity doesn't. I think €7.5 billion is still a relatively small volume compared to the entire European investment market. We still see future pan-Europe funds and those countries being accepted as core markets.

JS: We prefer country-specific funds in larger markets such as Turkey and Poland. But it's really driven by what LPs want to achieve with their investment goals, which is often to diversify their investments.

They may invest with one manager to get broad European investment exposure, or with multiple managers targeting specific markets through single-country funds. Ultimately, I think you end up with both.

PD: We are seeing more pan-European portfolio transactions with Polish assets being part of the package together with assets in Western Europe. So, from the perspective of sellers and prospective purchasers these markets then fall into one basket, even though they present different risks.

PERE: *Which deals best tell the story of the region in the past 12 months?*

MM: In the next three or four months a non-performing loan (NPL) portfolio worth over €1 billion gross in Romania will have been traded. Some smaller loan books below €1 billion have been completed and the haircuts have been huge – more than half – on single cases. However the banks are still clogged up with NPLs. Their biggest problem is that they can't find an internal strategy.

These things start with a non-disclosure agreement (NDA) yet you'd be lucky to close a simple NDA after three months. Investors can wait two years for a solution even if there is money on the table.

Everybody is under-provisioned and now comes Basel III which means banks have to put in more capital. The money is expensive and their books are full with NPLs. At the moment banks are overloaded with problems so they can't come back to normal business.

DH: One of the interesting things going on at the moment is a significant investment in Polish secondary cities for offices. We've been investing in Warsaw offices but weren't particularly fond of secondary cities. We weren't sure they were deep enough in terms of occupiers and liquidity. But we've seen there has been that depth since last summer. Yields are at record levels in terms of acquisitions – pushing close to Warsaw levels now. We saw huge demand in Krakow last year where the net absorption rate was 102 percent.

That demand is a result of outsourcing. A couple of years ago people wanted to outsource to India, but there are control issues when you have an outsourcing business so far away from you so now we're seeing outsourcing coming back to Europe with Poland the number one location. These tenants are high quality, worldwide companies that sign long-term ten-year leases, or at least seven.

PERE: *If we were to meet this time next year what are some of the salient things you would expect we might discuss?*

JS: Rising interest rates and a possible correction that is not far off.

DH: Record volumes and significant new capital entrants to the market. €7.5 billion of transactions will have happened, and we will have seen big investors come into central Europe that haven't been the typical buyers of the last five years to eight years.

PD: We'll see Chinese money just breaking into the market this or next year.

The wrap

Participants at this year's roundtable acknowledge an abundance of capital targeting CEE markets, driven partly by investors' search for yield. The general feeling is that both international and domestic investment will continue to grow as the built environment expands, with the investor universe beginning to open up beyond the typical players.

Poland is seen as the region's shining star, where the opportunities are greatest, thanks to its robust economy and stable political environment. Institutional capital is focused on Poland and Czech, yet the window of opportunity to get 'in and out' during the remainder of the cycle could prove challenging.

It depends on which angle you look at it. Does it feel like 2006 again with prices going up and investors stretching for yield, or are the markets insulated by a restricted supply pipeline? Arguably there are always opportunities to be extracted, although some strategies work better under such conditions than others, and one that stands out right now is as a seller of core real estate. □

Wrapping up: interest rates and new entrants

Real Estate

DENTONS

European transactions 2014-2015

The European Real Estate Group at Dentons acted as legal counsel on the following selected transactions.

Deutsche Bank CRE Special Situations Group

US$398 million

Acquisition of a portfolio of commercial real estate loans from Spanish company SAREB

Spain

Deutsche Bank

Blackstone

Value Confidential

Acquisition of a portfolio of six logistics and distribution parks from Pramerica Real Estate Investors, via Logicor

Poland
Czech Republic

Blackstone

Bouygues

ca. £600 million

Phase I and II of a redevelopment project at Canning Town, part of a £3.7 billion project to transform a large part of the London Borough of Newham

United Kingdom

BOUYGUES

Aberdeen Asset Management Deutschland AG

Value Confidential

Disposal of the Metropolitan trophy office building in Warsaw to Deutsche Asset & Wealth Management

Poland

Aberdeen

AEW Europe

€150 million

Acquisition of a logistics park development in Prague from Panattoni Europe which includes space pre-let to Amazon, via Logistis

Czech Republic

AEW EUROPE

IREIT Global

€224.5 million

Acquisition of several office buildings let by long-term agreements to subsidiaries of Deutsche Telekom AG

Germany

IREITGlobal

Meininger Holding

€400 million

Formation of a commercial strategic partnership with Foncière des Régions, through its subsidiary Foncière des Murs, to source and acquire hotel properties across Europe

Europe

MEININGER

Starwood Capital Group

Value Confidential

Acquisition of the Quattro Business Park from Grupa Buma - Starwood's first investment in Kraków, Poland's second largest city

Poland

STARWOOD CAPITAL GROUP

P3

Value Confidential

Acquisition of a portfolio of three logistics parks totaling 467,000 sq. m. of lettable area and additional development land

Poland
Romania

P3 LOGISTIC PARKS

For more information about our European Real Estate Group visit us at www.dentons.com