Equity capital continues to flow towards Europe

Evan Z. Lazar and Pawel Debowski highlight some of the key trends they are seeing in the market today

1 What differences have you seen in the European market over the last 12 months?

Pawel Debowski, Chairman, Real Estate (Europe), Dentons: Europe's economy is growing again, and political uncertainty over its future is certainly declining despite the turmoil in the East. The Eurozone debt crisis that resulted in the banking crisis seems to be over and we're now seeing a tidal wave of equity flooding into the European real estate. The number of large transactions over the last 12 months has brought back memories of the boom years. During the course of the year, we saw the return of investor confidence in some of the European real estate markets and they once again have become the place to do business. However, investors have become even more selective of late. London, Paris, Germany, Poland and Spain (sometimes Northern Italy) almost became a mantra. Well, London and Paris are pricy again and finding the right deals in Spain and Germany is not easy. This pushes money to Poland and the Czech Republic, but Poland is increasingly turning into a mature market and there is much talk over the sustainability of rents in Warsaw CBD. This results in interest shifting to Hungary and Romania, to chase yields and deals.

Evan Z. Lazar, Co-Chairman, Global Real Estate, Dentons: Pawel just mentioned the boom years. As we all remember, in 2007 transactional activity was driven by easy debt and imaginative capital structures. Well, 2014 is different. Now we have a wall of equity targeting direct commercial real estate, with a significant increase in the number of new investors and players in the sector, and an equally large increase in allocations from long-term traditional property investors.

DEBOWSKI: There is also another trend in progress. I call it the "consolidation" of the European real estate market. The divisions are fading away between Western Europe and Poland and the Czech Republic, between the mature and the hitherto emerging. Whereas Europe has gotten much more unified this year, looking from the investors' perspective liquidity is still pushing yields in Poland and the Czech Republic higher than in Western Europe.

2 What are the key trends that you are seeing for capital coming into Europe?

LAZAR: A notable feature of the markets in 2014 is the broadening of investor focus. The large European markets like the UK, Germany and France remain favorites and see very strong demand. But cross-border trading is also boosting volumes in "secondary" cities. Investors are seeking out markets further up the risk curve or those that had been amongst the hardest hit by the financial crisis and until recently considered "out of bounds" like Spain, Italy, Ireland and the Netherlands.

DEBOWSKI: On the Central and Eastern European front, we see Poland and the Czech Republic further maturing into one of the core investment locations in Europe. Hungary and Romania are coming back on track and may soon become Europe's new "sweet spots". Romania's 2014 investment volume soared nearly 300%, although coming from low levels of activity.

LAZAR: The good news is that with more capital to go around, all markets are benefiting.

DEBOWSKI: I couldn't agree more. Looking at industry sectors, prime office transactions carried out by US and UK investors and German fund managers dominated across CEE. A substantial increase in activity is expected for the retail logistics segment in the second half of 2014. The industrial sector is outperforming in the region with multi-country and cross-regional transactions completed in H1 and some more in the pipeline for H2 and beyond.

LAZAR: The demand for office space across Western Europe has also hit its highest level since the economic downturn with London retaining its dominant position and Milan and Lisbon showing strong activity.

3 Will we see several new sources of capital coming to Europe?

DEBOWSKI: The mix of international investors looking for real estate pickings in Europe is becoming more and more exotic. The Norwegians, Canadians, Chinese and Qataris hit the European press headlines almost every day. According to CBRE's recent report on capital flows in and out of the Middle East, new real estate allocations from countries like Saudi Arabia and possibly even Iran may also emerge in due course.

LAZAR: But now Chinese investors seem to be the most active new property market players. They are storming London to snap up some of its biggest properties this year. It is predicted that Chinese money flowing into international property will double before the year is out, with the number of deals originating from China expected to reach their highest levels since 2007. There is massive potential from this source of capital. While core office assets in prime locations are still the most popular asset type for Asian capital, value-added investments and opportunistic investments are likely to increase in the future. London and Paris have traditionally been the most popular destinations, but Asian investors have recently expressed a desire to invest in Central and Eastern European region as well.

DEBOWSKI: When talking about sources of capital, you can't forget about the new market players whose role seems to be constantly on the increase these days – alternative non-bank lenders, such as private real estate debt funds that originate debt to real estate assets. They boost loan volumes by offering senior and mezzanine financing, as well as other debt solutions for the acquisition and repositioning of real estate projects.

4 Where is global capital looking at the moment - what is hot in the market?

LAZAR: Global investors always compete for prime assets in prime locations. Now, many of them have started to look further to Tier 2 cities and properties, with lower prices and lot sizes being more absorbable. Southern Europe and the Nordics are definitely on the investors' radar these days. As mentioned, the change of investing mood was particularly striking in Spain, which experienced a surprisingly rapid switch from a "no-go" to a "new star" market this year. The newly passed regulations on Spanish REITs ("SOCIMIS") have proven very effective in attracting domestic and international investors due to their being tax-efficient, flexible in terms of minimum share capital (€5 million), free float and leverage limitations. Also, repossessed-asset holder Sareb boosted the market in 2013, and will continue to be a key product supplier.

EVAN Z. LAZAR (LEFT) AND PAWEL DEBOWSKI

DEBOWSKI: Mega deals seem to be proving popular to global buyers - they offer a chance to gain large exposures to key assets and markets in one transaction, saving on both time and cost. It was reported that US investors have raised an 'enormous' volume of capital targeting opportunistic European real estate, so we will probably see more of the condensed type of deals.

5 12 months is a long time in the market - how active are you compared to last year? Do you expect to be more active in 12 months' time?

LAZAR: As we said earlier, the desire for commercial real estate is currently as strong as it's ever been. The deal flow in Europe, especially this summer, was buzzing. In only the last 6 months, we have advised two major US investors on multi-jurisdictional logistics portfolio transactions.

DEBOWSKI: Too true. This year we've handled a deal flow that might just have exceeded pre-financial peaks. Domestic and cross-border transactions on the logistics, office, hotel, retail, residential sector... just name it. Investor appetite was, and remains, truly tremendous.

6 How do you see the outlook for the European market over the course of the next year?

DEBOWSKI: Europe's real estate industry has become more confident about its prospects and ability to improve profits. What is attracting investors in Europe is that the region offers opportunities for all kinds of investors – those looking for large ticket deals in core markets as well as those willing to transact in peripheral markets. However, finding large and liquid markets to spend money is starting to prove challenging due to the short supply of large asset deals in London and Paris. Frankfurt, Munich and Warsaw don't offer too many opportunities in terms of large single asset deal sizes.

LAZAR: The logistics sector continues to outperform in the Central and Eastern European region, with investors currently displaying intense demand. However, the availability of stock will likely slow this down into 2015.

DEBOWSKI: Investors are likely to rely more on alternative debt sources to finance their real estate transactions, and they will help to increase the supply of assets, through the disposal of non-performing loans and the maturity of mortgage-linked securities.