CLOSING THE GAP: TIER 1 & 2 MARKETS

OCTOBER 2013

Accelerating success.

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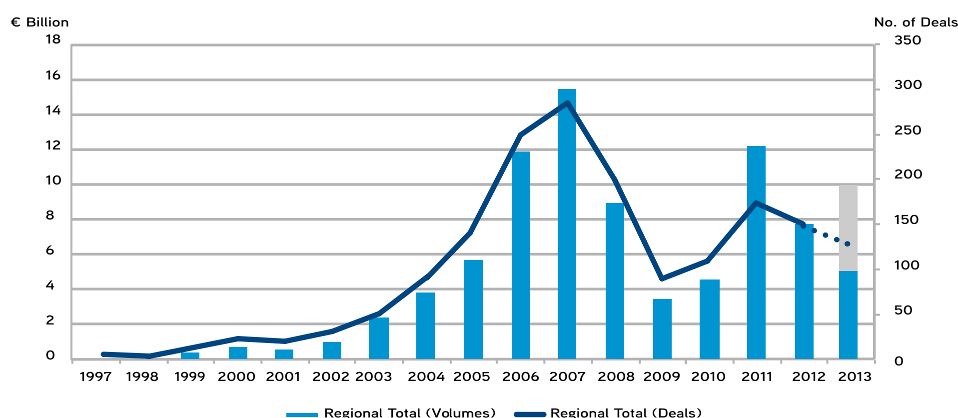
INTRODUCTION

In our 'Mind The Gap' report of June 2013 we analysed a number of key macro and finance trends and their impact on the sustainability of yield pricing in the core Central and Eastern European (CEE) office markets of Poland, the Czech Republic and Slovakia. In summary, our prognosis was for a short-term mild hardening of yields in these core CEE markets, which could be followed by a medium-term softening in line with bonds some 18-24 months down the line. With no dramatic changes in rents anticipated on the downside, we argued that prime office property continues to look a good bet warranting the shift in allocations to commercial real estate (CRE) being reported and realised by a number of institutional investors.

As our mid-year investment snapshot report pointed out, however, despite another strong year forecast for 2013 - driven largely by the 'core' investment markets of Russia, Poland and the Czech Republic - which account for 80% of the market, post-crisis - the number of deals which have been conducted over the last 18 months has actually been on the decline.

FIGURE 1: INVESTMENT VOLUMES



Source: Colliers International

This begs a couple of questions:

1. Despite the positive potential of investing in commercial real estate at present, are we likely to see this slowdown in deal volumes continue?
2. Equally, when will foreign capital be redirected or even reallocated to what are presently the more peripheral, or Tier 2 markets, of the wider CEE region?

The current slowdown in deal volumes appears to be a combination of a number of factors. Firstly, deals post-crisis take longer to close due to a need for greater attention to detail and due diligence on all aspects of a deal. Secondly, deals have been restricted to Tier 1 markets of late where the availability of suitable core/core plus product has been on the decline - investors tend to hold assets for longer periods, reducing the number of core assets available within an investment cycle.

This short report focuses primarily on question two, in order to determine whether the main Tier 2 investment markets of CEE – namely Hungary, Romania and Bulgaria - are in a position to provide a well priced competitive offer, helping to attract more capital into these markets and increase overall deal volumes and deal flow across the region.

In particular, the analysis will focus on whether the underlying macro fundamentals and property story warrant serious investment attention. Namely:

- Are these markets as risky as they are often perceived to be?
- How do they compare with Poland, the regional investment stalwart?
- Do current yields reflect fair value, considering the opportunities/risks in each market?

TIER 1 AND 2 MARKETS

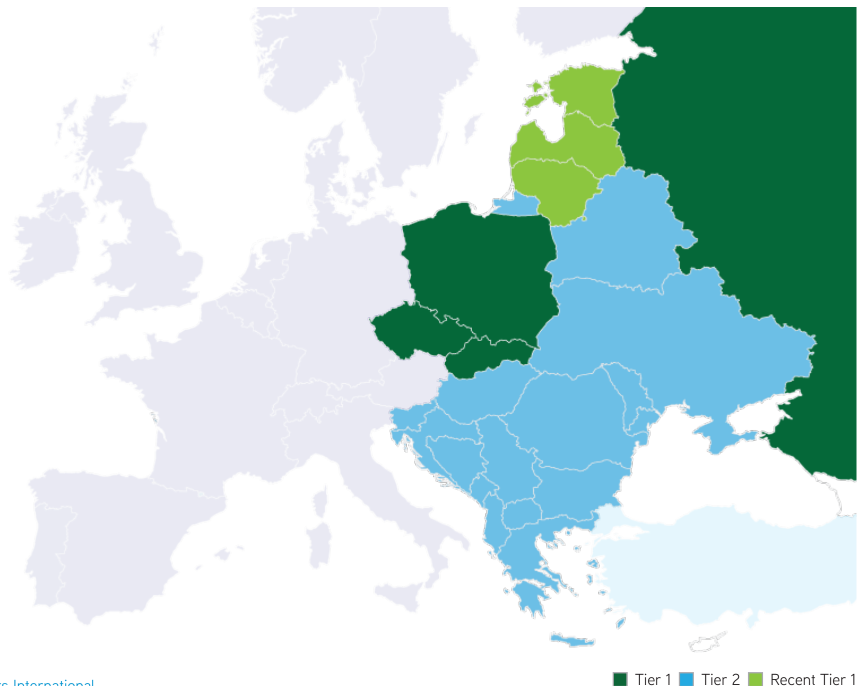
Before we delve into the market fundamentals and current investment activity in Hungary, Romania and Bulgaria, we should first define how we categorise the CEE country markets into Tier 1 and Tier 2 locations.

For the purposes of this report, Tier 1 locations are those which benefit from:

- a solvent banking system, where debt finance is widely available to the market for the acquisition and/or development of commercial real estate at cost-effective pricing.
- An active investment market, where buyers and sellers of real estate are constantly involved in the active negotiating and trading of commercial real estate.

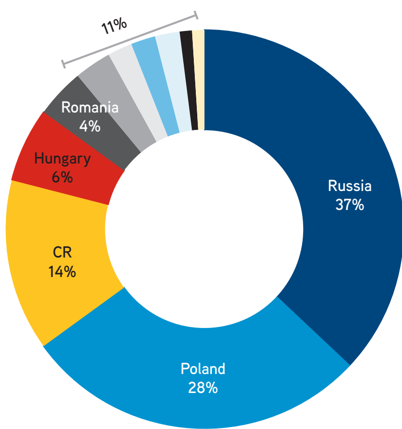
Figure 2 shows CEE's post-crisis Tier 1 markets as Russia, Poland, the Czech Republic and Slovakia, which benefit from both of the above conditions resulting in their active share of investment flows in the region.

FIGURE 2: EASTERN EUROPE TIER 1 AND 2 MARKETS



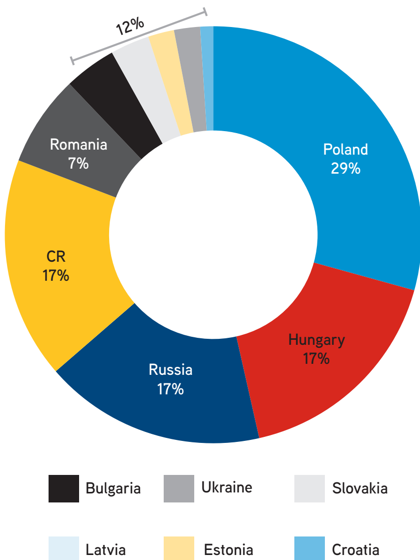
Source: Colliers International

FIGURE 3: DEAL VOLUMES BY COUNTRY [2009+]



Source: Colliers International

FIGURE 4: DEAL VOLUMES BY COUNTRY [PRE 2009]



Source: Colliers International

More recently, the Baltic markets have moved up towards Tier 1 status after a turnaround in investment levels in the first half of 2013, led by Latvia. Investment turnover in Latvia was up 70% on the same period last year - reaching €472 million for H1 2013 - assisted largely by a robust economic recovery and increasing levels of well priced debt.

Hungary, Romania and Bulgaria do not presently benefit from the two conditions outlined above, which deteriorated following the onset of banking reform at the end of 2011. For these reasons, along with Serbia, Croatia and Ukraine, they form the current Tier 2 markets of the region.

With any league system, teams get promoted and relegated based on their performance. Whilst Hungary has lost its lustre in recent years, there are indications that it may rebound back towards its position as one of the stronger Tier 1 markets. Romania and Bulgaria never really got the chance to get properly going before the financial crisis and subsequent banking reform cut their momentum. So to what extent are these Tier 2 markets closing the gap on their Tier 1 peers, and when are they likely to see a rebound, or growth in the level of investment volumes?

TIER 2 MARKETS: TURNING THE CORNER?

Despite a rather slow summer, evidence on the ground points to a rebound in activity in these Tier 2 markets over the last couple of months. Whilst there has been no significant change in terms of the number of deals being closed there has been a marked shift in the number of investors on the ground actively seeking out opportunities.

In Hungary, there has also been a shift in the attitude of some banks towards the financing of commercial real estate (CRE) transactions, with financing conditions improving both in terms of availability and less prohibitive pricing, terms and conditions. This in part is being driven by the National Bank of Hungary (MNB), which has made 14 consecutive 25-bps cuts to its base rate since August 2012, to an all time low of 3.6% in September 2013. Most analysts expect the cuts to continue towards 3.0% by year-end. Alongside the improving capital adequacy ratios (CARs) of certain key banks, the Hungarian investment debt situation appears to be turning the corner.

Whilst there is limited recent evidence of a similar development in the availability and pricing of real estate debt in Romania and Bulgaria, it may not be too long before they follow suit. One positive change has been the reported increase in investment appetite for Greek banks. As the Greek economy finally turns around it's own hairpin bend, hedge funds and investors including Paulson & Co, Baupost, Eaglevale, Dromeus Capital, York Capital, Wellington Capital Group and Fidelity have been reported by the Financial Times (FT) (6th October 2013) to be considering investing 'aggressively' into Greek banks. The major Greek banks had very strong positions in the bulk of the South Eastern European (SEE) countries, including Bulgaria and Romania. Now that they are very well capitalised and poised to recover, this could have a very positive impact on local banking conditions in these two countries.

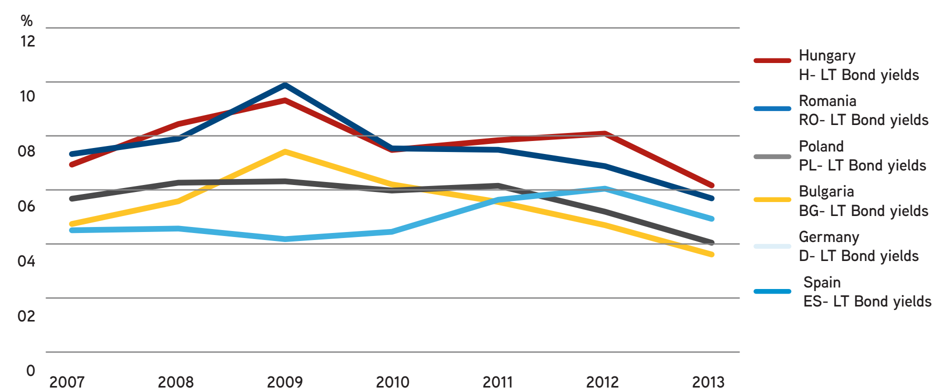
It is worth noting that when fortunes do change, they can turn around quickly. There has been evidence of a quite rapid change in investment sentiment and activity in some of Europe's other more beleaguered markets in Q2 of this year. The FT reported in September (1st Sept. 2013), that foreign commercial real estate investment had re-entered 'Europe's most beleaguered markets' creating a 60% surge in property investment in Portugal, Italy, Ireland, Greece and Spain in Q2 2013. Large institutional funds as well as private investors have been playing their part in the hunt for well priced fixed assets, particularly in Spain. Spain is a large, deep market and the risk profile of the country has noticeably dropped from its peak in 2012 when government bonds were topping well over 700 basis points (bps), to only 450 bps today. If this economic/political turnaround has assisted in the fortunes of the Spanish market, how do Hungary, Romania and Bulgaria compare?

COUNTRY RISK & BOND ANALYSIS

Country and political risk now have a big sway over the attitude of investors towards markets, especially given that the bulk of investors actively seeking opportunities in Europe are of those of a core and core plus persuasion and thus generally more averse to risk.

So when we get to Hungary, Romania and Bulgaria, it is notable that all three countries have been getting conflicting press attention over the last year or so. On the one hand they are all seemingly subject to political turmoil yet at the same time receiving IMF and/or EU praise for their economic diligence - albeit to different degrees. This raises the question: is all political and economic risk the same, and what is being priced into long term government bonds?

FIGURE 5: CEE LONG-TERM GOVERNMENT BOND YIELDS



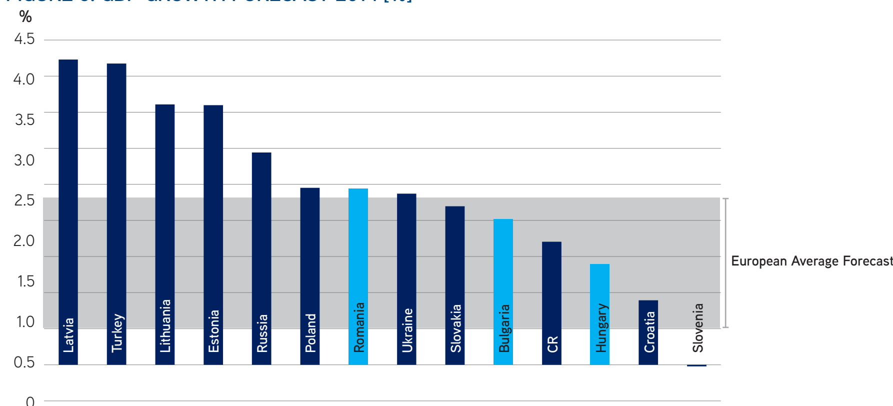
Source: Eurostat convergence yields

A review of government bond yields in each of these Tier 2 markets shows that, like Spain, rates have moved in quite rapidly since 2012, reflecting a turnaround in economic performance and macro management. As of September 2013, both Hungarian and Romanian long-term government bonds were below 6% on average for the year, at 5.97% and 5.49% respectively. Bulgaria was faring much better at only 3.41%, below Poland's rate of 4.3% and only 200 bps higher than Germany at 1.47%. With the overall trend in German and other haven country bond rates moving up (German bond rates reached 1.74% in August 2013, from lows of 1.2% in April 2013), whilst those in Tier 2 countries are moving down, does this warrant a shift in investment into these Tier 2 markets as a result?

ECONOMIC FORECASTS: POSITIVE

If economic forecasts are anything to go by, that answer would be yes. Given that the current EU-average GDP forecast for 2014 is between 1-2.2%, then forecasts for Hungary, Bulgaria and Romania are higher than, or at least match, the EU average range.

FIGURE 6: GDP GROWTH FORECAST 2014 [%]



Source: Focus Economics

Economic forecasts are not the only consideration, but on the whole each country is doing reasonably well in managing the macro position as the following country summaries explain:

HUNGARY

The economy seems to be quite well placed for growth, with low (sub 2%) inflation, record low interest rates, a well managed budget deficit of 2.1% in 2012, and 2.8% budget deficit forecast for 2013. Consumption has started increasing, government spending is also up, exports are performing and the hard-hit take home pay of Hungarian workers seems to be rising at last. Whether these economic results can be sustained beyond the short-term remains to be seen.

One significant problem, however, is the negative perception of the government which is hitting total FDI. Whilst the National Bank has introduced a second stimulus program aimed at boosting investment, the Hungarian government's nationalistic stance has resulted in a weak investor environment, which is a risk to economic growth. Given that there are national elections in April/May 2014, this may result in reduced foreign and fixed investment until mid 2014 and as a consequence GDP growth may suffer.

Hungarian FDI	2008	2009	2010	2011	2012
Equity capital, net	2,301,2	2,821,6	2,740.1	-1,789.7	584.1
Reinvested earnings, net	895.1	-191.8	-185.5	1,260.4	924.2
Other capital, net liabilties	-86.4	-1,341.9	-1,317.4	1,655.3	1,683.4
Total FDI (€million)	**3,109.9**	**1,288.0**	**1,237.1**	**1,126.0**	**3,191.6**

Source: Hungarian Central Bank

So overall, not the greatest of climates from an external perspective, but fundamentally not as bad under the surface as it may first appear. The large discount in government bond yields relative to the likes of Germany and Poland is certainly warranted, but the trend is one of convergence improving the relative attractiveness of investing into Hungary, provided this can be sustained.

BULGARIA

Despite recent events in 2013, Bulgaria GDP has adapted well since EU accession in 2007. Most 2004 EU accession members saw a drop in GDP in the first year post accession, but then the financial crisis threw a spanner in the works in 2009 before a recovery in 2010. Bulgaria has continued to manage fiscal stability and debt very well, although the bottom line for Bulgaria is that GDP recovery is dependent on international trade, but we could say that about most European countries .

Bulgarian FDI	2007	2008	2009	2010	2011	2012
Equity capital, net	4,765.2	4,109.8	1,884.0	1,604.7	1,103.6	1,051.0
Reinvested earnings, net	1,547.2	-183.5	-269.0	-445.7	-173.7	76.6
Other capital, net liabilties	2,739.5	2,801.5	822.0	-7.8	384.7	350.7
Total FDI (€ million)	**9,051.9**	**6,727.8**	**2,437.0**	**1,151.2**	**1,314.6**	**1,478.3**

Source: Bulgarian Central Bank

The IMF's July 2013 report praised efforts made in maintaining fiscal stability with public debt at less than 20% and a deficit consistently below 3% - amongst the best in Europe. Despite concerns being raised about growth, an increase in industrial production relative to fixed investment points to a recovery in capacity utilisation, which could also explain the recovery in FDI reinvested earnings. Overall, a good investment climate supporting low government bond yields, despite the well publicised protests about corruption and cronyism.

ROMANIA

The bold decisions taken in mid-2012 which threatened to isolate Romania within the European Union, have led to a stable regime which is producing good economic results. The main headlines for 2013 were from the IMF and EU, both of whom praised Romania's commitment to fiscal tightening pushing public debt to less than 38% and the fiscal deficit down to 2.6% by end 2013. However, there is a chance that this continued tightening could put Romania's growth plans at risk when considered against the context of muted growth elsewhere in the EU.

Romanian FDI	2008	2009	2010	2011	2012
Equity capital, net (inc. retained losses)	5,265	3,118	4,067	4.,009	798
Reinvested earnings, net	-392	-1,389	-2,243	-2,497	-31
Other capital, net liabilties	4,623	1,759	396	303	948
Total FDI (€million)	**9,496**	**3,488**	**2,200**	**1,815**	**1,715**

Source: Romanian Central Bank

One sticking point for Romania appears to be developing policy which steers the economy away from a rural and agricultural base, with urbanisation very low at around 53% since EU accession. This does, however, underpin the continued long term commercialisation opportunity the country provides. However, despite the equity element of FDI in Romania holding up at around €4 billion a year, FDI growth has been creeping downwards recently with total FDI growth for 2012 a negative 5.5%. That said, non-equity investments are stable so it looks like the international investment community is maintaining a holding strategy in Romania while the wider EU investment market reorganises itself.

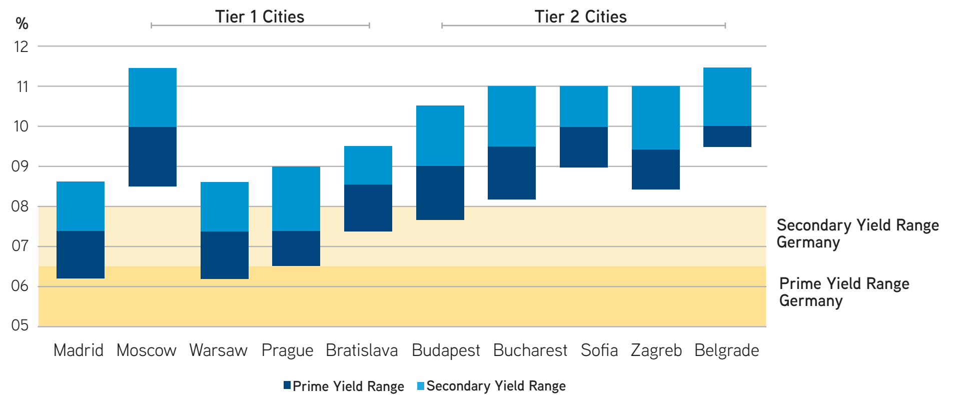
MACRO RISK SUMMARY

To conclude, local politics and the availability of banking debt appear to be the biggest obstacles to renewed investment activity in each of these markets, some moreso than others. Given the largely positive economic reforms in all countries to date and recent evidence of an upturn in banking conditions generally, these markets may be close to turning the corner in 2014, if not the end of 2013. Hungary may take a little longer, with the IMF/EU expressing caution over the sustainability of current economic reforms. Politics may continue to get in the way of Hungary's recovery as investment decisions are held-off until the national election results in April/May 2014.

THE PROPERTY FUNDAMENTALS: DISCOUNTED YIELD PRICING

From a yield perspective, the current discounts on offer relative to country risk are attractive. This message is reinforced when comparing these markets to the Tier 1 cities in the region and wider European area. There are discounts of at least 200 bps available relative to the likes of Warsaw and Prague, or even Madrid which is now re-emerging from its post-crisis nadir.

FIGURE 7: YIELD PRICING- TIER 1 VS. TIER 2 MARKETS



Source: Colliers International

When compared to Germany, this pricing discount is even stronger at around 300 bps. Whether this is enough to entice investors out of their comfort zones remains to be seen, and yields may need to soften a little to get more investors actively back into the markets.

THE PROPERTY FUNDAMENTALS: LOW CAPITAL VALUES

From a capital value perspective, it is noticeable that values for both prime office and retail (shopping centres) remain at both below par, and well below their previous 2007/08 peak. This in itself is a strong growth message, particularly given the potential for longer-term yield compression.

FIGURE 8: PRIME OFFICE CAP. VALUE INDEX

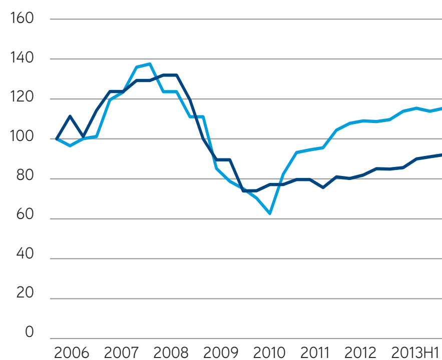
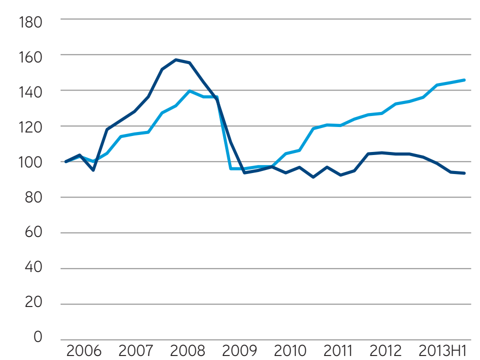


FIGURE 9: PRIME RETAIL CAP. VALUE INDEX



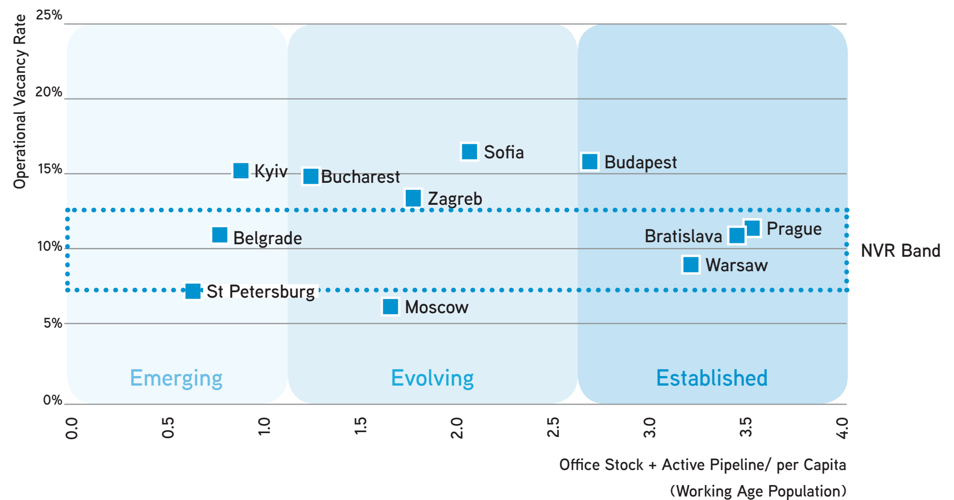
Tier 1 Office Value Index   Tier 2 Office Value Index

Source: Colliers International

THE PROPERTY FUNDAMENTALS: OFFICE RENTS ON THE UP?

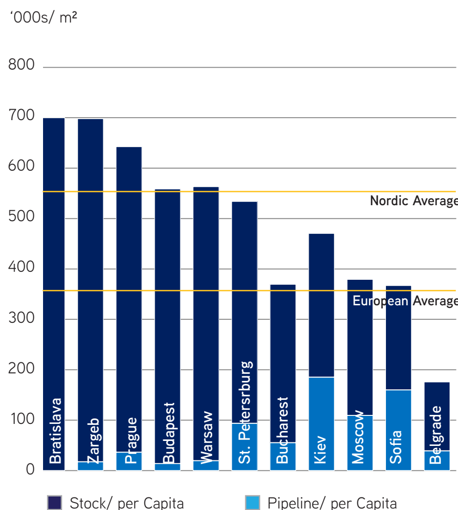
From an office rental perspective, the major city markets in the region are in a much healthier position than headline vacancy and rental rates would suggest. Operational vacancy rates in Budapest, Bucharest and Sofia are around 15% respectively, rather than closer to the 20% suggested by headline vacancy rates, as pointed out in our 2013 Mid-year Office Market Metrics report. With economic recoveries now underway, we should start to see an increase in take-up and net absorption in each of these markets, and there is growing evidence of this happening as we close on Q3 2013. This shift in demand and absorption should eventually lift rents from their current nadir, meaning office rents and returns should be sustainable in the short and mid-long term. Additionally, the current volume of space per capita in each of these markets suggest there is strong capacity for longer-term supply-side growth.

FIGURE 10: OPERATIONAL OFFICE VACANCY



Source: Colliers International

FIGURE 11: TRADITIONAL SHOPPING CENTRE STOCK & PIPELINE H1 2013



Source: Colliers International

THE PROPERTY FUNDAMENTALS: NEW RETAIL OPPORTUNITIES

From a retail perspective, the number of investment opportunities may be lower given that dominant retail schemes in the major catchment areas of these markets have already been successful in attracting capital. The highly defensive characteristics of the large successful, shopping centres often create substantial barriers to entry for potential competing schemes. Such schemes are typically kept for long holding periods, often succeeding seven years, thus the opportunity for investment sales will be quite limited. Equally, with most markets in the region appearing quite full from a traditional shopping centre/per capita perspective, the potential for development-led investment also appears limited – even though there appears to be more future long-term potential in Sofia and Bucharest than in Budapest.

At least for existing investors, retail stock growth has been largely in line with GDP per capita growth, judging by the low vacancy levels reported in the main traditional shopping centres. If vacancy remains below 10% then returns on existing stock should be satisfactory, although some centres will certainly do better than others. Looking forward, however, retail real estate owners will need to fully understand the growing challenges and opportunities for retail emanating from on-line retailing, or multi-channel retailing as it is often termed.

The growth in e-commerce will, of course, help to drive demand for warehousing and logistics premises, which act as a derivative of retail demand. Equally, strong forecast growth in manufacturing across the CEE region will help to boost demand for modern warehousing as will improving levels of infrastructure. Collectively, this will help expand the demand for new warehousing and distribution facilities, driving its appeal to investors.

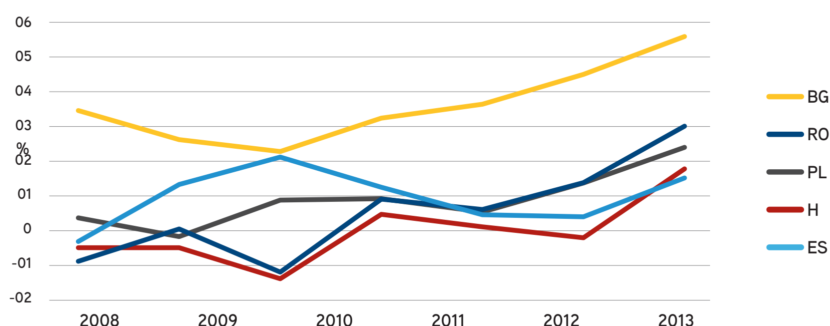
CONCLUSION: ARE HUNGARY, ROMANIA AND BULGARIA CLOSING THE GAP?

By dissecting the economic, investment and property dynamics of our three target countries, as well as considering a little of local political risk and the impact on government bonds, we have formed a better opinion of whether these countries are closing the gap on their Tier 1 peers.

On the one hand these countries are starting to close the gap: the wider macro-conditions have improved, reflected in lower government bond yields, and active investor interest is on the increase.

On the other hand, the external perception of political regimes remains challenged and although banking conditions may be turning the corner, debt conditions remain difficult. Loan-to-Value Ratios (LTVs) are currently believed to be a conservative 60% in Romania and Bulgaria, rising to 65% in Hungary. Romania and Hungary also have some non-performing loan (NPL) legacy issues to address before the lending environment can improve. The current lack of available, affordable debt financing will continue to put a restraint on investment liquidity, putting upward pressure on yields for debt driven investors.

FIGURE 12: AVERAGE CRE RISK PREMIA OVER GOVERNMENT LONG TERM BONDS



Source: Focus Economics/ Colliers International

Perhaps the key question is: 'Does current pricing warrant serious investor interest'?

If we relate government bond rates to property yields, we can see that both Bulgaria and Romania offer a very comfortable spread in pricing, above the 'acceptable' 300 bps property risk premium yields should be offering relative to bonds. Although current prime office yields of 7.75% in Budapest do not conform to the acceptable CRE 300 bps risk premium, they do offer an attractive 200 bps discount which is above historic national pre-and-post crisis rates, and the current spread available in Spain.

Equally, with prime yield discounts of 200-300 bps relative to other Tier 1 Eastern European markets (and other European markets), combined with capital values which are below par, let alone peak values we would say an affirmative yes.

In addition, office vacancy and rents have topped and bottomed out respectively, and with increasing GDP and take-up growth forecast for 2014, office rents look like they could see a recovery in the near future (off a relatively long bottom). Whilst retail offers limited opportunity in the traditional shopping centre sector, there are opportunities to be explored in more niche retail sectors, particularly given the potential impact of on-line retailing in markets in due course.

Whether the wider investment community agrees with this opinion remains to be seen. We may yet need to see a slight softening of current yields in order to entice both debt-driven and the more risk-averse buyers into the Tier 2 markets. The immediate problem, however, appears to be a lack of investment grade product. Whilst the underlying fundamentals and growth opportunities are positive, existing owners of real estate clearly feel the same way as the majority of owners are showing they are under no pressure or desire to sell 'at the bottom'. At least this confidence in the markets reinforces the message that the Tier 2 markets of CEE are worth considering as investment destinations, as and when investment product becomes available for purchase.

482 offices in 62 countries on 6 continents

United States: 140
Canada: 42
Latin America: 20
Asia Pacific: 195
EMEA: 85

- €1.5 billion in annual revenue
- 104 million square meters under management
- 13,500 professionals

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> The future role of Banking and the impact on the real estate industry.

> The impact of Latent Capital Gains Tax on commercial yield pricing.

> Generational change and the impact on office space demand and supply.

> The market positioning of the Business Process Outsourcing industry in Eastern Europe.

> Infrastructure change and the impact on the European logistics industry.

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