Investment | Outlook report

CEE REAL ESTATE
March 2017

The Changing of the Guard

New trends in CEE investment

The story is changing. Flows from the traditional sources of investment into the CEE commercial real estate markets, the USA, UK, Europe, Canada and Australia remained broadly static between 2011 and 2016, at around the EUR 5bln level. Much of the incremental investment seen over the past three years hails first from new origins, South Africa and more recently Singapore and China and is secondly the result of higher CEE domestic and cross-border activity. We believe that the Guard is indeed changing and that these trends are sustainable.

Whilst 2017's volumes from South Africa are not likely to match 2016's records, the numbers from Asia could well match or exceed last year's, given the large number of potential sources that capital can hail from in that vast, deep and liquid arena. Asian investors see CEE as a risky higher return diversification opportunity compared to Western Europe. The next "South Africa", in the sense of capital from riskier environments for CEE might well be Turkey, or perhaps Brazil, Russia or MENA countries if oil and commodity prices sustain at present levels. We believe the EUR 5bn of investment from the G10 arena will stay around these levels in the face of slowly rising bond yields.

The rise of the local investor

Domestic and cross-border CEE transactions rose from EUR 1.1bln in 2011 to EUR 2.6bln last year. This growth is all the more impressive as smaller-ticket deals tend to make up a greater proportion of total activity. We see the 21% CEE-sourced slice of the EUR 12.2bln 2016 investment total as rising in 2017 and beyond. Yield comparatives and expanding routes to market are the most probable principal drivers of this growth.

Whilst Hungary (especially its funds), Slovakia and the Czech Rep. are developing well, Poland and Romania have the furthest road to travel in terms of improving access of local investors to the commercial real estate marketplace. Poland might opt to push for REIT legislation or see more companies listed. REIT legislation exists in Bulgaria and Hungary but listings are only active in the former. Only in Slovakia out of the CEE-6 countries are pension funds active in the real estate sector; their participation is of course much more common in Western Europe. There is not much sign of this changing in CEE.

New origins

Emerging markets and domestics

The undisputed investment momentum present in CEE commercial real estate markets stands a good chance of defying the recent downturn in overall European volumes, as the sources of that investment are rapidly diversifying. Volume into the core CEE-6 markets topped EUR 12.2bln in 2016, the highest yet seen in this cycle, comprising we estimate 6.6% of the whole-Europe total in the second half of the year.

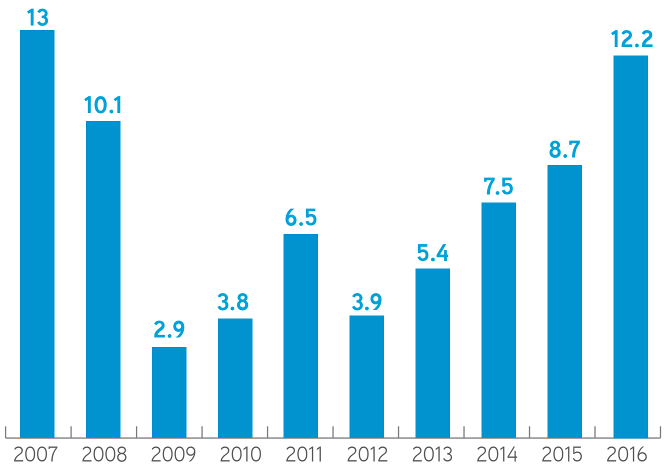
As the volume overall has risen through the last 6 years, we can see a clear incremental pattern emerging. We analysed the origin of every deal in our database since 2011 in each of the CEE-6 countries.

The totals from Europe, the UK, the USA and other G10 (Canada and Australia, not Japan) are broadly flat, fluctuating around the EUR 5.0bln level through the period under consideration. Much of the incremental volume is clearly coming from South Africa, Asia (in 2016) and within CEE, both from purely domestic sources and interestingly more cross-border.

The rise of Asia and South Africa in particular has reduced the relative importance of the UK, USA and Europe, whilst investment within CEE comprised 21% of the volumes last year.

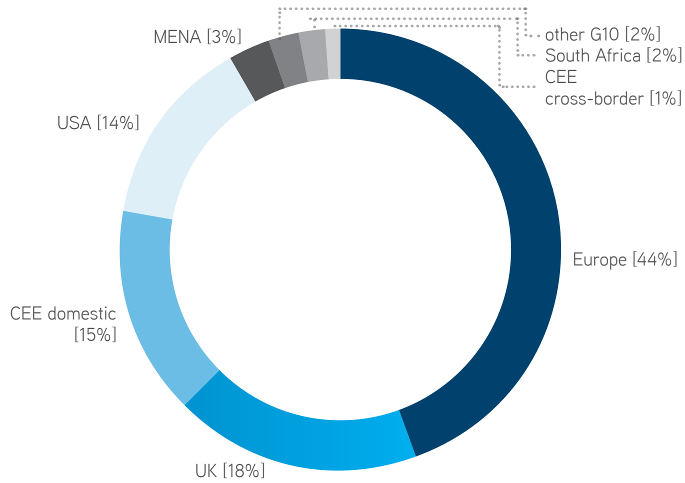
We foresee inward investment to CEE from the USA, the UK, Europe, Canada and Australia as continuing to fluctuate between the EUR 3.5bln-EUR 6.5bln range seen over the last few years. As we outlined in our 2017 CEE Outlook published in January, bond yields backing up in G10 countries and an end to QE in Japan and especially the Eurozone are likely to be headwinds to incremental investment growth this year and into 2018. The higher compensating real estate yields and solid prospects for rental growth on offer in CEE are likely to encourage the marginal investor inwards from these sources. But nevertheless, the range of investment from these sources is probably set, especially when considering additionally any political or economic instability from the election and actions of more populist leaderships (in the "Trump-Brexit World").

Fig. 1: Historic CEE investment volume (EUR bln)



Source: Real Capital Analytics (pre 2011), Colliers International

Fig. 2: 2011's regional volume split



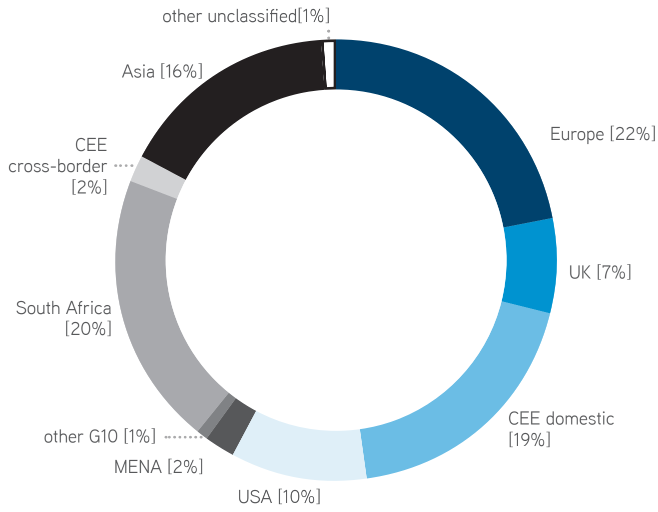
Source: Real Capital Analytics, Colliers International

Tab. 1: CEE origins- global regions (EUR mln)

INVESTMENT 2011-16	2011	2012	2013	2014	2015	2016
Europe	2,891	2,190	1,759	2,145	2,746	2,685
UK	1,183	282	489	756	765	805
USA	932	877	1,093	,016	,706	1,277
Other G10 (ex JPN)	150	18	318	3	370	84
EUR/US/UK/G10 ex JPN	**1,156**	**3,366**	**3,659**	**4,920**	**6,587**	**4,851**
Asia	-	-	210	-	29	1,983
MENA	190	115	47	271	49	208
South Africa	101	80	289	323	411	2,394
CEE domestic	993	357	835	1,314	1,105	2,305
CEE cross-border	78	5	265	592	360	290
Other/unclassified	12	56	113	116	325	168
Total	**6,529**	**3,979**	**5,418**	**7,535**	**8,865**	**12,199**

Source: RCA, Colliers International

Fig. 3: 2016's regional volume split



Source: Real Capital Analytics, Colliers International

High-risk origins: the South Africans

Investors from certain Emerging Markets are well-used to assessing perceived riskier real estate arenas such as CEE. South Africa's relevance as an origin of funds invested into CEE is ever-more relevant in the region, rising from a proportion of just 1.5% in 2011 to 19.6% in 2016.

Led by listed specialists NEPI and Rockcastle (presently merging) and Echo Investments/Redefine (forming Echo Properties Polska), flows jumped in 2016. Only Hungary and Bulgaria are, as yet, untouched by the wave. These look like new destinations in 2017.

We see the inflows continuing from South Africa, as the causation conditions remain in place. South Africa has a large listed REIT and investment company sector that has significant experience investing in its domestic environment and in Africa. That domestic South African environment has endemic inflation of 5%-6% and thus a tendency for the South African Rand ("ZAR") to depreciate over time. This situation means funding yields of 8%-9% and therefore high hurdle rates for investment and a natural tendency to look to invest in non-ZAR assets. South African investors coming to CEE are therefore inured to and cognisant of risk, can assess real estate yields in the 5%-11% range as "normal" and in fact pleasantly surprised to be able to form vehicles with the ability to raise capital at more like European interest rates.

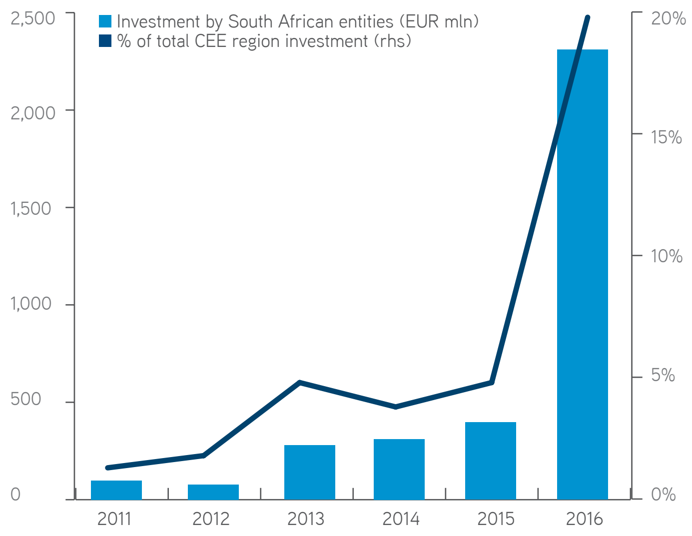
Whilst this investment trend is established and the listed REITs are themselves in a competitive environment, the spike in flow in 2016 will probably not be repeated. We estimate that around 10%-12% of South African REIT net asset values ('NAVs') are now committed to the CEE region (with a similar proportion in Western Europe). Some of the more committed players have over 20% of their NAV in the CEE region. Considering this as a target and the natural incremental growth of NAVs overall, we believe fresh investment from this source could top EUR 1.0bln in 2017, a picture that has to take into account also the merger of NEPI and Rockcastle.

Are there more "South Africas" out there, meaning potential new "higher-risk" origins of capital flows? Brazil and Turkey are both sizeable Emerging Markets, with endemic inflation, longer-run currency depreciation records, high funding rates and a domestic investor base. Turkey even has listed REITs and Brazil too, with institutional investor funds. Istanbul's REITs tend to be arms of the local conglomerates and do not have the local market muscle of their South African counterparts. With the recent political progression in Turkey under President Erdogan, there is arguably a "push" factor in place for those conglomerates to seek diversification out of the country.

The most significant Turkish activity through 2011-16 was over the border in Bulgaria, with some EUR 55mln of flows over the past 4 years, mainly in land transactions. This Turkish flow amounted to 7% of Bulgaria's investments in that period.

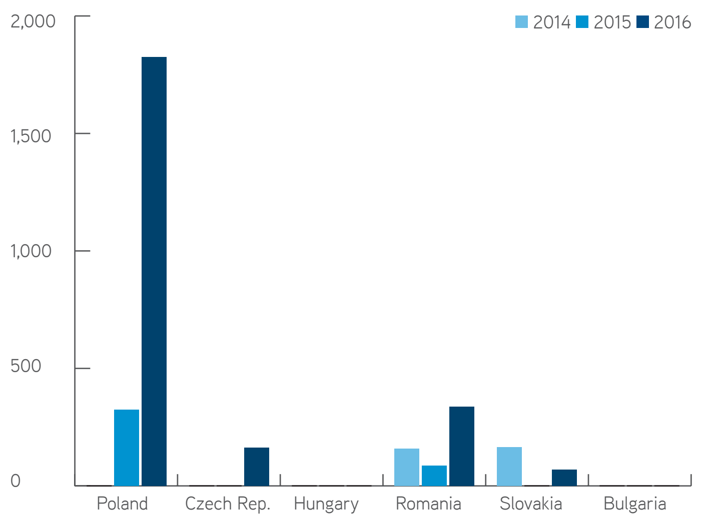
Brazil is more remote from CEE presently and has only generated a single EUR 4.5mln purchase in Slovakia in 2014. The "push" factor is arguably lower out of Brazil at present, as the aftermath of the "car-wash" corruption scandal reverberates around the capital market there, keeping attention focused inwards for now.

Fig. 4: South African investment in CEE markets



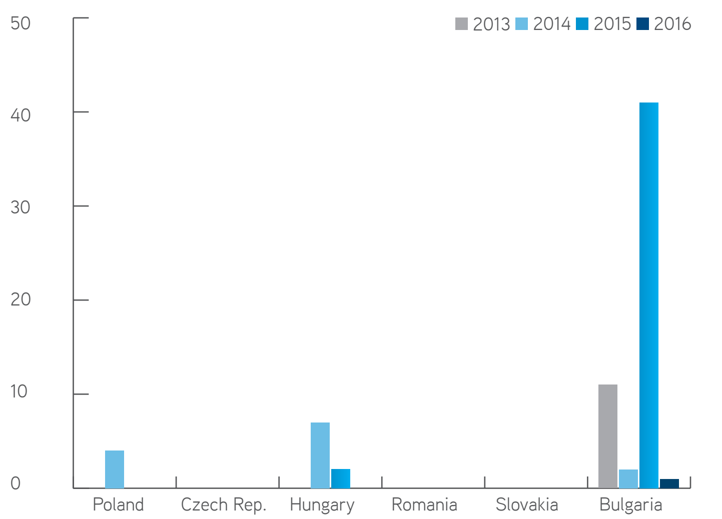
Source: Real Capital Analytics, Colliers International

Fig. 5: Country split of South African inflows (EUR mln)



Source: Real Capital Analytics, Colliers International

Fig. 6: Country split of Turkish inflows (EUR mln)



Source: Real Capital Analytics, Colliers International

Russia may also be an origin of larger flows into CEE in the future. Anyone who has tracked the history of capital markets in Russia knows about "capital flight" and the presence of mega-rich, merely rich individuals, corporates and real estate vehicles. Whilst the post-Crimea sanctions situation may have held back investment into Western economies, some of the market environments in CEE are perhaps more tolerant of Russian capital investment. Investment flows out of Russia are generally a function of the crude oil price, which at its present levels in the USD 50-55/bbl range is mildly supportive. Any weakness in oil markets ahead could deteriorate the potential for external flows.

Lower-risk origins: Asian sunrise

Asia's ever-rising position in the global economy leads many to speculate over flows to other arenas in all asset classes. Asian investors are well-tuned to assessing and participating in real estate investment markets, with activity in the sector prevalent for over 25 years in many countries in that region. That and low funding and real estate yields places most Asian investors as viewing CEE as a higher risk and return diversification opportunity. CEE only appeared on the Asian radar screen in 2013, with Chinese investments in Poland (EUR 206mln) and Hungary (EUR 3.5mln). 2014 was a barren year with 2015 seeing a sporadic EUR 28mln spread around the region. 2016 saw a transformation, due to the landmark Industrial sector TPG-Ivanhoe sale of P3 to Singapore's Sovereign Wealth Fund GIC. This Q4 2016 transaction generated EUR 1.64bln spread over CEE-6 (out of the total 9-country consideration of EUR 2.4bln). The deal was also a signal to the market that large Asian investors are at ease in handling whole portfolios, a relatively new phenomenon for CEE markets.

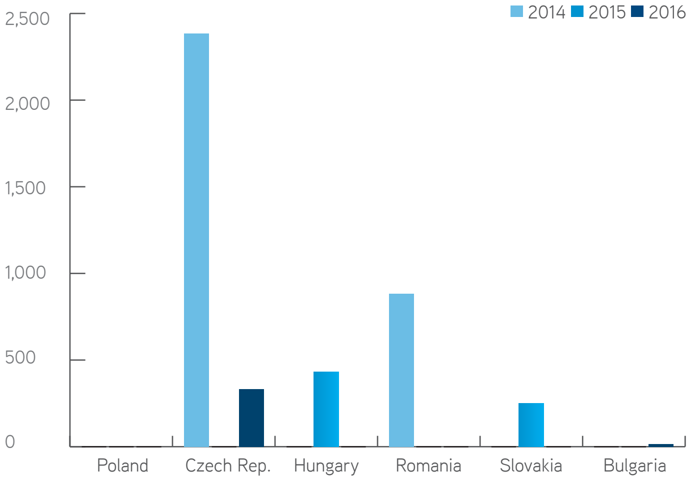
If P3 was not enough to convince, another signal that Asians deal in size is that the biggest single office transaction in the region last year was China's CEFC purchase of the Florentinum office asset in Prague from Penta for EUR 283mln in Q4 2016.

As the CEE markets deepen in liquidity and number of assets, so Asian buyers should come more into play. Are any countries more likely players at the table? China is the giant in the room: flow from state-affiliated companies is likely unless the authorities in China tighten up on FX outflows further. Macro indicators we follow do suggest this is a major risk in 2017, as China deals with its ballooning debt pile. South Korea, ignoring the obvious North Korea risk, Hong Kong, Thailand and Singapore are all particular potential sources with outward-looking funds, conglomerates, entrepreneurs and wealthy individuals who have already looked at mainstream UK, European and US markets and could easily diversify into the CEE-6 region. After P3, Singapore's Sovereign Wealth Funds will likely have to decide to look at the Office, Retail and perhaps Hotel & Leisure sectors if they are to commit further money to CEE.

Of real note is the virtual absence of activity in CEE from the world's 3rd-largest economy. Japan registered only a lone EUR 4m transaction in Bulgaria in 2015. Japanese conglomerates and entrepreneurs have long been investors in US and European real estate. Japanese investors are often relatively slow and require a cycle to be relatively well-established before committing. CEE fits this frame currently.

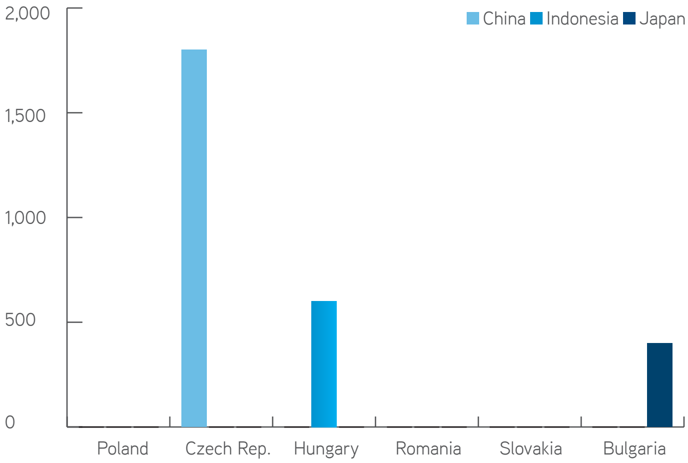
In addition, the probability of Japan's giant pension funds, including GPIF, being permitted to invest directly in foreign real estate is rising. Whilst the US and the UK might be the first port of call for an estimated USD 300-400bn allocation, even a marginal allocation to CEE in the next 2 years would be market-moving. Japanese funds are already looking at foreign REITs.

Fig. 7: Country split of Russian inflows (EUR mln)



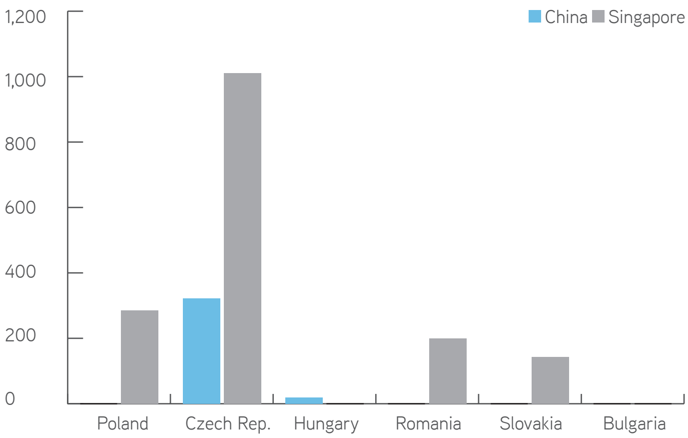
Source: Real Capital Analytics, Colliers International

Fig. 8: Asian investment in CEE 2015 (EUR mln)



Source: Real Capital Analytics, Colliers International

Fig. 9: Asian investment in CEE 2016 (EUR mln)



Source: Real Capital Analytics, Colliers International

The domestic story

The rise of the local investor

Also bound into the changing of the guard is the rise of the local and CEE regional investor in CEE-6 in this cycle. As can be naturally expected, the further the distance in time from 1989, the more developed the domestic capital markets become. Combining domestic and cross-border investments, the proportion of the pie deriving from the region is higher than 6 years ago, at 21% (19% domestic and 2% cross-border).

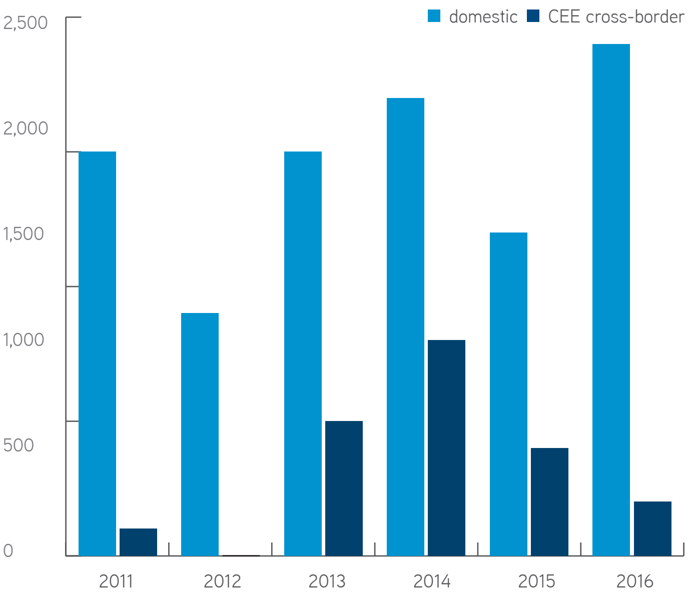
That pie itself is obviously now substantially larger than in 2011. Cross-border transactions have nearly quadrupled in size across the region, while domestic-sourced deals have more than doubled in size. The growth of the latter is very evident in every country except Poland and Bulgaria.

Assessing the same data in relative terms, as proportions of all investment into each country reveals that despite the substantial growth rate in Romania, the domestic participation was only 4% in 2016. Poland's ratio languishes at 2% whilst Bulgaria's, domestic flow despite not growing overall in absolute terms since 2011 was in 2016 the dominant driver of activity in the country at 57%. Hungary, Czech Rep. and Slovakia are the stars of the show, growing both in absolute terms and taking healthy 37%, 30% and 28% slices of their pies.

Slovakia and the Czech Republic are also the most active when looking at the sources of cross-border investment in the region in the past few years. The Czech Republic led with EUR 828mln over the 2011-16 period.

What one gives one gets as Slovakia and the Czech Republic are also the most popular cross-border destinations for CEE-origin flows, followed by, interestingly, Romania. Hungary, a relative laggard, may see increased flows from the region in 2017-18.

Fig. 10: Progression of CEE domestic/ cross border investment



Source: Real Capital Analytics, Colliers International

Tab. 2: Domestically-sourced volume (EUR mln)

DOMESTIC TO DOMESTIC	2011	2012	2013	2014	2015	2016	% GROWTH 2011-16
Poland	121	80	354	316	228	98	-19%
Czech Rep.	567	259	325	424	423	1,155	104%
Hungary	18	-	36	229	275	627	3,408%
Romania	7	-	-	22	8	34	386%
Slovakia	94	2	67	126	63	243	158%
Bulgaria	186	16	53	198	109	148	-20%
Total	**993**	**357**	**835**	**1,314**	**1,105**	**2,305**	**132%**

Tab. 3: Domestically-sourced volume (% of whole investment in each country)

	2011	2012	2013	2014	2015	2016
Poland	5%	3%	11%	10%	6%	2%
Czech Rep.	25%	42%	29%	29%	16%	30%
Hungary	3%	0%	14%	38%	44%	37%
Romania	4%	0%	0%	2%	1%	4%
Slovakia	19%	7%	20%	22%	14%	28%
Bulgaria	46%	6%	64%	85%	52%	57%

Tab. 4: Cross-border source of CEE flows

ORIGIN	2011	2012	2013	2014	2015	2016	TOTAL
Czech Rep.	73	-	219	259	229	48	828
Hungary	5	-	15	37	-	-	57
Poland	-	-	-	-	-	92	92
Slovakia	-	5	31	59	91	84	271
Estonia	-	-	-	-	-	11	11
Russia	-	-	-	196	40	21	257
Ukraine	-	-	-	42	-	14	56
Georgia	-	-	-	-	-	20	20

Tab. 5: Recipients of cross-border flows 2011-16 (EUR mln)

ORIGIN TO DESTINATION	INTO BULGARIA	INTO CZECH REP.	INTO HUNGARY	INTO POLAND	INTO ROMANIA	INTO SLOVAKIA
Bulgaria	710	-	-	-	-	-
Czech Rep.	-	3,153	-	140	196	492
Hungary	3	-	1,184	39	15	-
Poland	-	-	-	1,196	92	-
Romania	-	-	-	-	71	-
Slovakia	-	208	62	-	-	595
Estonia	1	10	-	-	-	-
Russia	1	163	26	-	53	15
Ukraine	-	50	-	6	-	-
Georgia	20	-	-	-	-	-
Total excl. domestic	**25**	**432**	**88**	**184**	**355**	**507**

Source Tab. 2-5: Real Capital Analytics, Colliers International

Comparing vs. GDP and other assets

Will domestic investors choose to increase their investments in real estate assets? Looking at their situation overall vs. GDP, there may well be room to grow as the market capitalization ('MCAP') of the investment opportunity is at reasonable levels (in a band between 55%-65%) except in Slovakia, whose investors really do not have an equity stock market alternative.

How attractive are real estate yields for domestic investors versus other assets? Versus bonds, premiums remain high but narrowest in Poland, widest in Slovakia and Bulgaria. Equity dividend yields are additionally not a competing force in these countries and Hungary. Only in Romania and the Czech Republic might domestic income-focused investors pause for thought when considering real estate versus equities.

Types of domestic vehicles

A major factor in the future development of the domestic sphere is the supply of vehicles to allow retail, professional and institutional investors access to the sector.

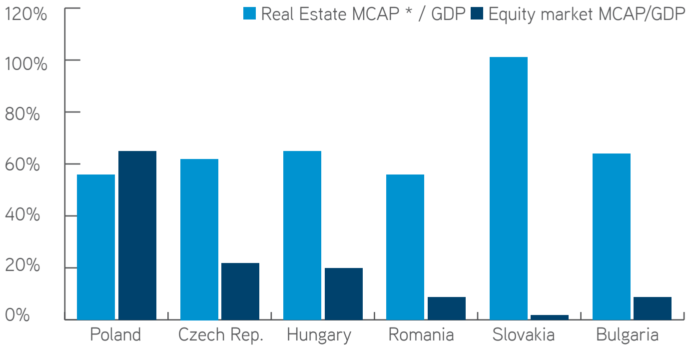
Of the avenues available in the rest of the world, retail funds are most established in Slovakia, in Hungary and to a more limited extent in the Czech Republic. The lack of these types of funds in Poland and Romania goes some way to explaining the low proportion of activity from domestic investors in their own countries and low participation rates in cross-border activity.

Summing the fund sizes on figure 13 suggests that in Slovakia public funds hold 1.2% of the Colliers International estimated MCAP. Hungary's figure is 1.1%, Czech's 0.4%. Hungary's funds are behind the recent domestic growth explosion.

In CEE it is possible to list REITs in Hungary and Bulgaria. But only in the latter is the market at all developed, with several in existence since the mid-2000s. We may see REIT legislation in Poland, sorely needed to provide enhanced access to market for investors.

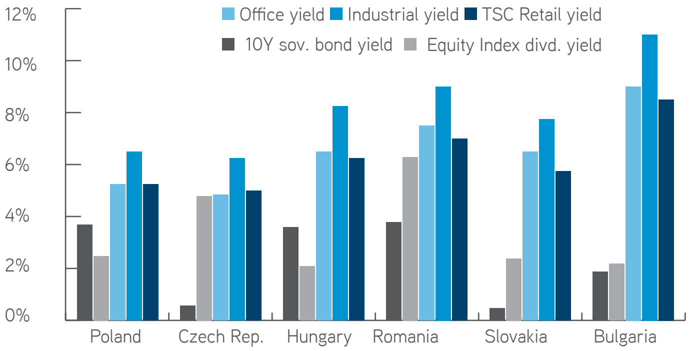
Stock market listings, REITs and single-asset SICAVs could well be a way forward to enhancing demand from domestic sources even in 2017. Demand from pension funds remains muted, except those in Slovakia, which have a regional focus.

Fig. 11: Size of asset classes vs 2016 GDP



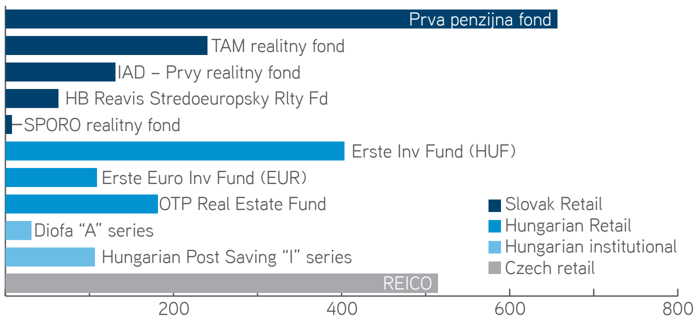
* Calculation of commercial R.E. MCAP is Colliers International data for Office, Industrial, Retail (TSC/SSC) sectors for all cities as of end Q4 2016.
Source: Real Capital Analytics, Colliers International

Fig. 12: Competitive yields across asset classes*



* Slovak sovereign bond yield is 8Y. Capital city real estate yields as of Q4 2016.
Source: Bloomberg, investing.com, Colliers International

Fig. 13: Size of example local funds (EUR mln)*



* Hungarian funds show value of real estate assets, not total NAVs.
Source: Real Capital Analytics, Colliers International

Tab. 6: REIT status and listed plays on real estate

MARKETS	REITS	LISTED PLAYS
Poland	No legislation. May be prepared for 2018	GTC, EPP, Polnord, Dom Dev't
Czech Rep.	No legislation	None
Hungary	SZIT legislation in place. No REITs exist	Graphisoft Park, BIF, Appenin
Romania	No legislation	Impact, NEPI, SIFs
Slovakia	No legislation	None
Bulgaria	SPIC legislation in place. 58 REITs exist.	13 REITs on BSE main board. Fairplay and BREF most active.

Source: Colliers International, investincomehome.com

Tab. 7: Examples of funds in the core CEE region

FUND TYPE	RETAIL-TYPE FUND EXAMPLES	PROFESSIONAL/ INSTITUTIONAL INVESTORS EXAMPLES
Czech Rep.	REICO	Accolade, WOOD & Co SICAVs
Hungary	Erste, OTP	Diófa
Romania	none	none
Slovakia	Prva penz., TAM, IAD, HB Reavis, SPORO	Proxenta, Arca Capital
Bulgaria	none	none

Source: Colliers International, investincomehome.com

554 offices in **66** countries on **6** continents

United States: **153**
Canada: **34**
Latin America: **24**
Asia Pacific: **231**
EMEA: **112**

$2.3
billion in annual revenue

185
million square metres under management

16,000
professionals and staff

AUTHORS:

Mark Robinson
CEE Research Specialist | Research
+420 226 537 646
mark.robinson@colliers.com

CONTRIBUTOR:

Lucie Schwabova | Marketing Manager EMEA & CZ

Colliers International | Prague
Slovansky Dum, Building B/C
Na Prikope 859/22
110 00 Prague 1 | Czech Republic
+420 226 537 618

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