Central & Eastern Europe

Property

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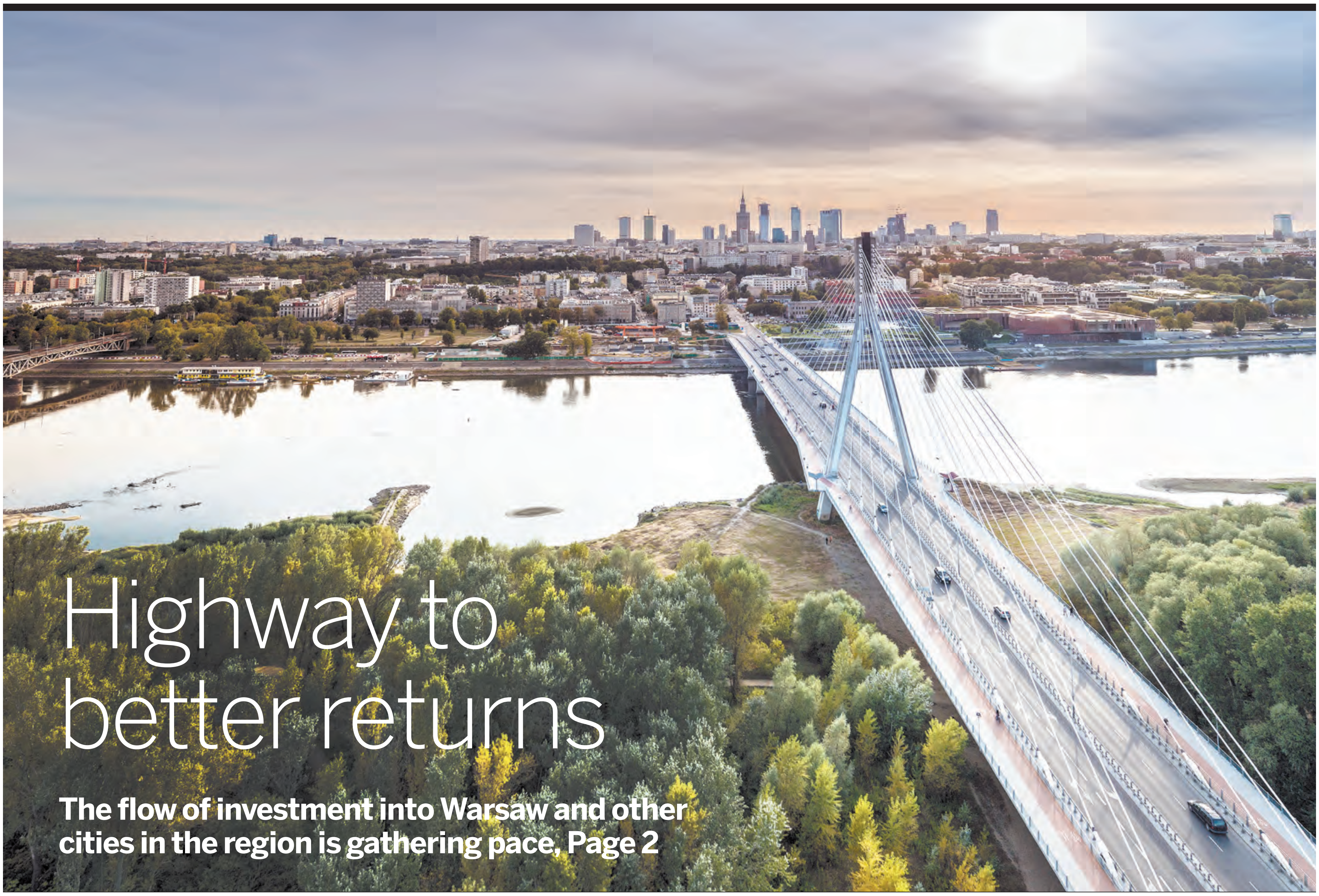

Highway to better returns

The flow of investment into Warsaw and other cities in the region is gathering pace, **Page 2**

Overview Sentiment is being driven by a strong return to growth across the region, writes *Jan Cienski*

Investment flows increase on promise of better returns

Polish investment activity: the sale of the Silesia shopping mall in Poland was one of last year's largest transactions Wojciech Pacewicz

A period of lacklustre competition is coming to a close for Globalworth, a property business with the lion's share of its €500m invested in Bucharest, the Romanian capital. The money pouring into central Europe is starting to move beyond the safe and stable Polish and Czech markets to higher-yielding frontier countries.

Dimitris Raptis, Globalworth's deputy chief executive, says: "There is less competition right now for the deals we are interested in. Everyone is looking at Poland and that's not bad for us, because we are able to target assets at attractive prices."

His company is raising an additional €200m to invest in Romania. "But if one believes in market cycles and global capital flows, yields in Warsaw and Prague will fall to such a low level that it will drive investors to our markets."

His prognosis is based on the strong increase in investment flows seen across central and eastern Europe last year.

In 2013, Russia, the region's largest market, enjoyed a 40 per cent increase in transactions to €5.2bn, according to property company CBRE. Poland, the second largest, saw a 9 per cent rise to €3bn, while the Czech Republic was up by 68 per cent at €1bn. In all, every significant market except Ukraine saw deals increase last year. Ukrainian transactions tumbled to €41m from €241m in 2012.

Austria's Immofinanz, one of Europe's largest property companies, has written off the value of all of its investments in Ukraine and has no immediate plans to be more active in the strife-torn country, says Eduard Zehetner, chief executive. However, the company is continuing to invest in Moscow. "Moscow is like a large eastern European country in itself," says Mr Zehetner.

In addition to Russia, Poland and the Czech Republic – in essence, the greater Prague area – have long been the most resilient markets in central and eastern Europe. They attract conservative German, Austrian and US funds that like the region's relatively high growth coupled with greater security. With yields in west European cities such as London and Paris at 3 per cent, investors can earn double in Warsaw for only slightly higher risk.

"Poland is still the dominant market; it's the sweetheart of central Europe," says Michael Atwell, head of CEE capital markets at CBRE.

Big pension, investment and private equity funds are entering the two top markets. Even sovereign wealth funds and investors from Asia and the Middle East are looking closely at the region.

"With rapidly falling yields in some western markets, people are starting to put their heads up and look around in the search for better returns," says Boris Olujic, a principal at Peakside Capital, a private equity property investor.

The largest transaction of last year was the €412m sale of the Silesia City Center shopping mall in southern Poland's industrial city of Katowice. It was bought by a consortium headed by Germany's Allianz Real Estate.

But, as institutional money continues to pour into Poland and the Czech Republic, investors with a higher risk tolerance are taking a greater interest in previously neglected markets such as Hungary and Romania.

Hungary had been given a wide berth because of the unpredictable leadership of premier Viktor Orbán, while Romania was hit harder by the post-crisis downturn than most of the region.

Things are now changing, however.

"Hungary is a bit like Italy, in that you have politics and the economy – and often the economy has very little to do with politics. The economy is better than you read in the newspapers," says Mr Zehetner.

Some shift of investor interest towards the southern part of CEE is unlikely to have much negative impact on Poland and the Czech Republic. Mr Atwell expects that this year will see close to €4bn in transactions in Poland, approaching its previous peak of €5bn in 2006.

Hadley Dean, managing partner for eastern Europe at Colliers, the property agency, says: "The mood is back. It feels like 2005 – everyone recognises the market is turning and wants to get on board."

This feeling is driven by a return to strong growth across most of the region. In the European Commission's latest forecast, Poland is expected to grow by 2.9 per cent this year and 3.1 per cent in 2015, while the Czech Republic has shaken off its recession and should grow by 1.8 per cent in 2014 and 2.2 per cent next year. Many private sector economists are expecting faster growth.

While growth is accelerating, inflation is still very low and interest rates are not generally expected to increase this year. Additionally, banks are keener to lend and developers are having an easier time getting financing with lower levels of pre-leased projects.

The industrial market is also seeing renewed interest, driven in part by a revival of manufacturing, especially in cars and electronics, as well as a surge of investments in retail warehouses.

The most important event was last year's announcement that internet retailer Amazon was building enormous warehouses in Poland and the Czech Republic.

"A lot of expansion plans were put on hold during the financial crisis and are now being restarted," says Ben Bannatyne, regional head for CEE at Prologis, the industrial property developer and operator. "It is largely a matter of relocation from western Europe to central Europe."

The office market is also showing signs of strength. Much of the action outside Warsaw and Prague is being driven by continued investment in shared service and business process outsourcing centres. Many are located in secondary cities across the region, where office rents are low and there is a ready supply of cheap and well-qualified young workers.

'It feels like 2005 – everyone sees the market is turning and they want to get on board'

Cyclical market Trouble may be brewing in Warsaw

Property – as anyone who has dabbled in it knows – is a cyclical game, so although Warsaw's office market is enjoying a sharp upswing, this could be storing up problems for the future.

Last year saw a record-breaking number of office completions in the Polish capital, as developers secured easier financing and were persuaded to dust off long-delayed plans in response to a surging market.

About 300,000 square metres of offices were handed over to tenants in 2013, an increase of almost 7 per cent from 2012 and the highest level since 2000, according to JLL, the property consultancy. As a result, vacancies are edging up, approaching 12 per cent, and rents are drifting lower, falling about €1.5 to an average of €25 per sq m in central Warsaw last year.

The problem is that at least 320,000 sq m of office space is due to be delivered during 2014.

"We are going to see 500,000 sq m come on to the market in the next 18-24 months, which could create pressure on rents," says Anna Staniszewska, head of research at BNP Paribas Real Estate. "New projects are fighting for pre-lets, which increases competition among landlords forced to offer attractive rents."

About 35 per cent of this year's projects are already pre-let and tenants in existing buildings are being tempted to move to new quarters by builders desperate to show banks that completed projects are meeting their leasing targets.

In some cases, developers are knocking as much as 25 per cent off their headline rents, notes a report by Cushman & Wakefield.

That has put power into the hands of tenants, and rents are likely to decline in existing buildings, says JLL.

Jan Cienski

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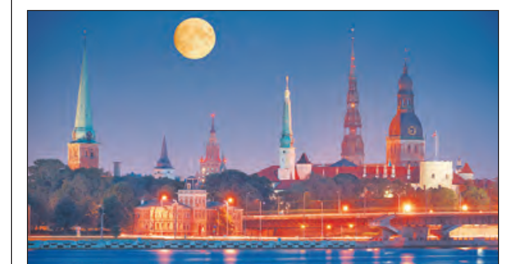

Latvian recovery
The Baltic country is bouncing back from recession but while property market activity is up to pre-crisis levels, the outlook is mixed

Paul Gheysens interview
CEEQA lifetime achievement award winner and president of property company Ghelamco, which has helped transform the skylines of eastern Europe, talks about going against the wind

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Hungary Demand is reviving but developers are cautious, says *Kester Eddy*

Glut drives down rents and deters speculative building

The Eiffel Palace redevelopment: an exception in the tough Hungarian property market

The Hungarian property sector enjoyed a rare chance to celebrate in March: the completion of the Eiffel Palace project. The 14,500 sq m redevelopment of a late 19th-century Budapest newspaper building drew universal praise from property professionals.

"It's a spectacular building, and a great step for PwC, the main tenant," says Michael Smithing, chairman of the Royal Institution of Chartered Surveyors in Hungary.

Renovated by Horizon Development, a domestic developer, Eiffel Palace employs a variety of modern features, including solar collectors, photovoltaic panels, a harvested rainwater system and programmable elevators, to meet the most stringent of environmental standards.

The internal courtyard and fittings have been restored to the original designs, which are credited to Gustav Eiffel's architectural office, no less. The building's main architects were the locals Flóris Korb and Kálmán Giergl.

Located in the central business district, with good transport connections, the effort put in appears to be paying off: Eiffel Palace is already 65 per cent let.

But while this is good news for the developer, it is not typical across the sector. The Budapest market – which accounts for the vast bulk of development in Hungary – was badly hit by the global economic crisis in 2008 and has been struggling since.

Total delivery last year was a mere 30,000 sq m, comprising primarily two developments, only one of which was speculative. While this was an improvement on the 23,000 sq m of 2012, both numbers are a fraction of the 2009 record, when some 300,000 sq m of new space was delivered.

David Johnston, head of the office agency for Cushman & Wakefield, the property consultancy, in Budapest, says: "To put matters in perspective, in 2009, 10 per cent of the market was new supply; in 2013 this was slashed to less than 1 per cent."

The overhang from the huge deliveries of 2008-09 saw vacancy rates for speculatively built stock surge towards 25 per cent, according to data from the Budapest Research Forum, an association of property agencies.

While sometimes ruinously tough for developers and investors alike, the glut of space has proved a boon to tenants, who have been in a strong position to negotiate rents, despite the overall vacancy rate inching down to the current level of 18.4 per cent, a five-year low.

Mr Johnston says: "Tenant incentive and inducement packages remain widespread, with huge financial 'carrots' on offer to those tenants that are interested in relocating. This has created a Dutch auction between landlords, resulting in low net effective rents for both [first class] grade A and [less modern] grade B buildings."

But exactly how low is low?

Gábor Angel, vice-president of the Hungarian association of real estate developers (IFK) says the 20 per cent plus vacancy rates "meant rents, with incentives, came down to €10 per sq m, and that's too low to justify new development".

Inevitably, it is even worse for those investors with space outside the favoured locations. "For new grade A product, out of the centre, and excluding parts of Buda [the part on the Danube's west bank], you are looking at single figures [of euros per sq m] when rent-free is taken into account," says Mr Johnston.

> 'In 2009, 10 per cent of the market was new supply: this was under 1 per cent in 2013'

The result is massive pressure on renegotiating lease contracts. So, while the take-up in 2013 was a healthy 390,000 sq m, nearly half of this was renewals, spurred to a great extent by the need to keep clients.

Mr Smithing says: "The landlord in today's market would be foolish to let you go, because then they've got a vacancy that's going to take them six months to re-lease, and they've probably got to spend something like €200 per sq m to fit it out, to put in walls, carpeting; and it maybe needs a new ceiling."

Slowly, but surely, however, demand appears to be returning, and the right property can still attract tenants.

The first phase of Váci Greens, the principal speculative office building completed in 2013, has effectively been fully let in just six months, says Cushman's Mr Johnston.

There has also been renewed interest in shared service centres. "We had four market entries last year – GE, Systemax, Avis and Computacenter – which are acquiring circa 15,000 sq m new space between them," Mr Johnston says.

"There are also existing companies upgrading their property and relocating to decent grade A options," he notes.

Meanwhile, the supply pipeline is expected to expand to about 60,000 sq m this year, although only one, at 18,000 sq m, is purely speculative.

IFK's Mr Angel says: "Things are beginning to move. The economy is picking up, and our members are starting to renew their building permits and are planning right now. And in the past three years, there was no planning.

"However, to get back to development, we need to reach €12-€13 per sq m rents. I think in the best case, that's going to be in two years," he says.

Bucharest heads for recovery quicker than its neighbours

Romania

The poverty-stricken image of the country is not mirrored in the capital, says *Kester Eddy*

Mention Bucharest, and many in western Europe will recall the downfall of former dictator Nicolae Ceausescu in 1989 and the poverty that engulfed the country as it struggled to shake off its communist past.

But those images are from another era, says Adrian Barbu, 64, who regularly visits the Romanian capital, the city of his youth, as part of running his own Switzerland-based pharmaceutical consultancy.

"In the villages maybe nothing has changed, but Bucharest is a different world. It's really quite a westernised place now, with skyscrapers, malls, offices and hotels. It has the same level of luxury [on offer] as you might have in any west European city," he says.

It is a point of view shared by many in the commercial property sector.

"The general image of Romania abroad, especially among those with no local record, is poor, but companies, and their people, that have actually worked here are generally happy," says Gijs Klomp, managing director of JLL, the property consultancy, in Romania.

He points to companies that, having made an initial investment, soon expanded further, on the basis of a favourable first experience. "We have Renault [the French carmaker], which bought the Dacia automotive plant, and subsequently invested heavily in Romania, including research and development facilities," he says.

Others include Hewlett-Packard and Oracle, technology companies that started in the country with small operations, but have grown to create "massive" shared service operations and R&D operations, he says. "As a rough estimate, based on their rented office space, Oracle and HP together must now have some 5,500 staff in Romania today," says Mr Klomp.

However, the improved environment in Bucharest did not help when the global crisis first took hold. Despite seeing fast growth in the run-up to Romania's accession to the EU in 2007, the country went into a deep recession in 2009.

The good news is that the capital city appears to be moving into a recovery relatively early, certainly compared with Budapest in neighbouring Hungary.

JLL puts new delivery last year at 119,000 square metres. While barely a third that of 2009's total, it is still 2.5 times the 2012 figure, and pushed the total office space through the 2m sq m level. With gross take up of 293,000 sq m last year, about a more than in 2012, overall vacancy rates decreased slightly to an estimated 14.4 per cent.

With another 120,000-140,000 sq m due for delivery this year, the vacancy rate may creep upwards, Mr Klomp says, although take up is also expected to continue rising.

However, several involved in the industry note that the global figures mask wide variations in the market.

"Bucharest, maybe even more than other markets [in the region], shows a huge gap between prime, central locations, where vacancy rates are under 10 per cent, and the less favoured sub-markets, where a third of space can be vacant," says Ingrid Gratzer, market researcher with Erste Group Immorent, the real estate financing and development arm of Austria's Erste Bank.

She points to the Pipera and Baneasa sub-markets, which had frenzied building activity earlier, but where today leasing is limited due to a lack of infrastructure. "The vacancy rates in these areas are the highest in Bucharest, at 35 per cent," Ms Gratzer says.

The sector is also complicated by the difference in the quality of the office space available. The Bucharest office of CBRE, the property consultancy, completely reassessed its classification system of the office market last year using a strict, 10-criteria evaluation method, which downgraded some 200,000 sq m of former class A – effectively modern – office space into lower categories. Accordingly, CBRE rates only 800,000 sq m as class A from the total 2.13m sq m of stock, with the remainder 1.33m sq m ranked as class B, and as the market recovers, it is the superior space that has seen the greatest demand.

> 'The image abroad is poor, but companies that have actually worked [in Bucharest] are generally happy'

"There is substantial difference between the performance of class A [properties], which have an overall vacancy rate of 10.7 per cent, while for class B the rate exceeds 18 per cent," says Razvan Iorgu, managing director CBRE Romania.

Market upturn: the mood is changing in the Romanian capital

The wide range of properties on offer means headline rents for class A stock vary from €18-€15 per sq m in the central business district to single-digit rents for class B space in less favoured sub-markets.

However, despite the upturn, it is still a tenant's market, says Mr Iorgu.

"We estimate that, on average, net effective rents are 92-94 per cent of the headline figure, and with special attention given to anchor tenants or properties with a high amount of vacant space, the net effective can be down to 85 per cent," he says.

The investment market is also slowly picking up. JLL estimates investment last year at €330m – 20 per cent up on 2012 – with retail as the main focus of activity, accounting for 64 per cent of volume.

"Office was only about 19 per cent of the total, with one building transacted with an initial yield of 8.7 per cent. Office is driven by a lack of suitable supply," says JLL's Mr Klomp.

But, with economic growth hitting 3.5 per cent last year (boosted by a 5.2 per cent jump in the final quarter), the mood is becoming more positive.

Banks, which had been acting very cautiously with regard to credit since 2009, have also become more open in the past year, says Mr Iorgu, with finance now available for the right projects, if well prepared.

However, Romania still lacks adequate road and rail infrastructure if it is to fulfil its economic potential, says Mr Klomp. The government should do more, he adds: "They should provide a more stable political environment, including better, co-ordinated support for companies considering investments in Romania."

Russia The annexation of Crimea has left foreign investors wary of new deals, reports *Jack Farchy*

Political situation puts real estate boom on ice

Moscow's Avia Park: at 240,000 sq m, it will be the largest shopping centre in Europe

Until recently, the Russian commercial property market was booming. Investment into the sector hit a record $8.2bn last year, according to Colliers International, the property advisers, with large investments from the likes of Morgan Stanley and Calpers, the California state pension fund.

But as Russian growth slowed and the rouble began to slide, the market cooled. Russia's annexation of Crimea in March, triggering sanctions from the west, has put the property boom on ice.

"It's not even a slowdown – it has been put on hold. Everyone is wondering what will happen with Ukraine," says Vladimir Sergunin, business development director at Colliers.

The commercial real estate (CRE) market is not alone in being brought to a standstill by political developments in Ukraine.

As foreign investors fled the Russian markets in the wake of the rapidly deteriorating geopolitical situation, and the US and EU began to explore sanctions, Russia's stock markets tumbled. The Micex benchmark of equities has fallen some 10 per cent since the start of the year, while the rouble has weakened against the dollar by more than 8 per cent.

Andrei Klepach, Russia's deputy economy minister, said that capital outflows from the country in the first quarter of the year would be close to $70bn, exceeding the $63bn that left the country in the whole of last year.

Many banks and brokers are predicting that the Russian economy will dip into recession this year.

In the commercial property market, brokers and analysts say deals have ground to a halt, with foreign investors particularly wary of making new investments.

"We see postponements – but deals are not broken, just postponed," says Mr Sergunin at Colliers. "Generally, the position is on hold – investors are taking a break. They're not going to sell; they're not going to buy immediately."

Tom Devonshire-Griffin, head of capital markets in the Moscow office of JLL, the property consultancy, says the Crimea crisis is likely to make foreign investors even more cautious about investing in the Russian CRE sector.

"Most of the international buyers who buy here buy grudgingly. They do it because the returns are so good. They don't need a lot of excuse to be put off," says Mr Devonshire-Griffin.

"Anyone not involved in a deal is not going to look at Russia for a while," adds Tom Mundy, head of research at JLL for Russia and the Commonwealth of Independent States, a grouping of former soviet republics.

The market had been slowing down even before Crimea became front page news. With Russia's economic growth slowing sharply from 3.4 per cent in 2012 to 1.3 per cent last year, and the rouble steadily losing ground against the dollar and the euro, the prospects for Russia's important retail sector were already in doubt at the start of the year.

Moreover, the investments of the past few years are beginning to bear fruit, with Moscow set to see a record amount of additional retail space added in 2014, according to JLL. Among those planned developments is Avia Park, a shopping centre being built in northwest Moscow that at 240,000 sq m will be the largest in Europe.

Others are more pessimistic. "I see the prospects for the coming year as quite negative," says Alexander Kopylov, executive director in the CIS region for EY, the professional services firm.

Retailers have already begun attempting to renegotiate their rents with landlords, according to Mr Mundy of JLL: "Given the amount of stock coming on line, tenants are feeling more empowered to have the conversation with their landlords."

For all that, few would disagree that the fundamental story of the Russian commercial property market is compelling.

As the country's middle class grows, Russian consumers are discovering the joys of shopping. Among international brands, Mirko Botticelli, Jack Wolfskin, Saxon + Parole, Shake Shack and Wetzel's Pretzels all recently entered the Russian market.

But developers are struggling to build enough shopping centres, office buildings and warehouses to keep up. On a per-capita basis, Moscow still has less than a 10th of the prime office space of San Diego, half the shopping centre space of Warsaw and half the warehouse space of Munich, according to Mr Mundy.

The situation in some cities outside the commercial hubs of Moscow and St Petersburg (known colloquially as SPB) is even more extreme – a factor that could make them even more attractive for investment, some believe.

> 'Lots of Russian investors are rubbing their hands, thinking this will be a great opportunity'

"Fifteen to 20 years ago, 90 per cent of our projects were in Moscow and SPB and 10 per cent were in the regions," says David Whitehouse, managing director for the CIS at Aecom, an architecture and design group. "Now it's probably vice versa."

Indeed, as foreign investors appear likely to reduce their involvement in the market, some believe Russians will be ready to step in.

Roman Abramovich's Millhouse Capital has become one of the most active investors in commercial property; last year, it put $1.1bn into the sector.

"Lots of Russian investors are sitting here rubbing their hands and thinking this will be a great opportunity," says Mr Devonshire-Griffin.

Soviet structures need reclaiming from a grim past

Architecture
EDWIN HEATHCOTE

Moscow may be keen to "defend" Russian-speaking minorities beyond its borders, but it has proved surprisingly less devoted to preserving its own architectural legacy.

The architectural world is aghast at plans to demolish an engineering masterpiece, Moscow's Shukhov Tower. Built in 1922, in the middle of a civil war but also a period of artistic ferment and revolution, the 160m high hyperboloid communications tower is one of the great monuments of the brief flowering of Constructivism.

Ironically, just as the Shukhov Tower and dozens of other masterpieces from arguably the most fertile and inventive period in the history of modernism crumble, contemporary architects are paying homage to the radical ideas of the 1920s.

David Adjaye's designs for the Skolkovo Business School, on the outskirts of Moscow, self-consciously refer to Suprematist paintings and Constructivist fantasies of the revolutionary period. The slender rectangular blocks, placed atop a slim glazed disc, are clearly derived from the paintings of Malevich and his contemporaries.

Mr Adjaye's striking school has been the trailer for the main attraction to come: the Skolkovo Innovation City. This tech hub was conceived very much in the manner of those early Soviet utopian cities, intended to revolve around a single industry.

The site was to include a school, hospital, offices and incubators, and house a population of 30,000. But, amid allegations of corruption and political manoeuvring, little has happened on the 1,000 acre site. Only two buildings are emerging: the Hypercube, an LED-clad block, and an oddly-shaped truncated pyramid named the Matryoshka Building, the interior of which has a glowing Russian doll-shaped atrium.

Things are moving far faster in Moscow centre, where the coppery glass Mercury City last year became Europe's tallest tower. Designed by Russian architect Mikhail Posokhin and American Frank Williams, it is ugly and ill-conceived. It is being overtaken by the nearby Federation Tower, which is part of a cluster of towers that have become the visual symbol of the Moscow International Business Centre.

This cluster could be anywhere in the world and it stands in the starkest possible contrast to the inventive genius of the rotting and rusting Constructivist monuments.

One architect approaching the ambition, if not always the elegance, of the Soviet builders, is German designer Jürgen Mayer H. This experimental architect has found great success in the former Soviet republics, most notably in Georgia, where his hyper-modern style seems to suit the prevailing neophilia.

His best buildings blend the sculptural invention of late Soviet, state-sponsored public architecture with the kinds of buildings that have been enabled by contemporary computer-aided design and manufacture techniques.

His series of 20 service stations with shops and restaurants for Georgia's motorways constitutes a brilliant example of roadside architecture.

In central Europe, each country seems to be emerging with its own architectural speciality. In Serbia, Belgrade is rebuilding its waterfront with two extraordinarily ambitious designs from

Sunset: the Shukhov Tower

Japanese architect Sou Fujimoto and a huge commercial and residential design from Zaha Hadid.

In Hungary, the focus is on wineries, exquisite buildings integrated with the landscape and local architecture. Dezsö Ekler's intriguingly sculptural building at Somló and the curving concrete sheds of Plant's Bazaltbor winery are fine examples.

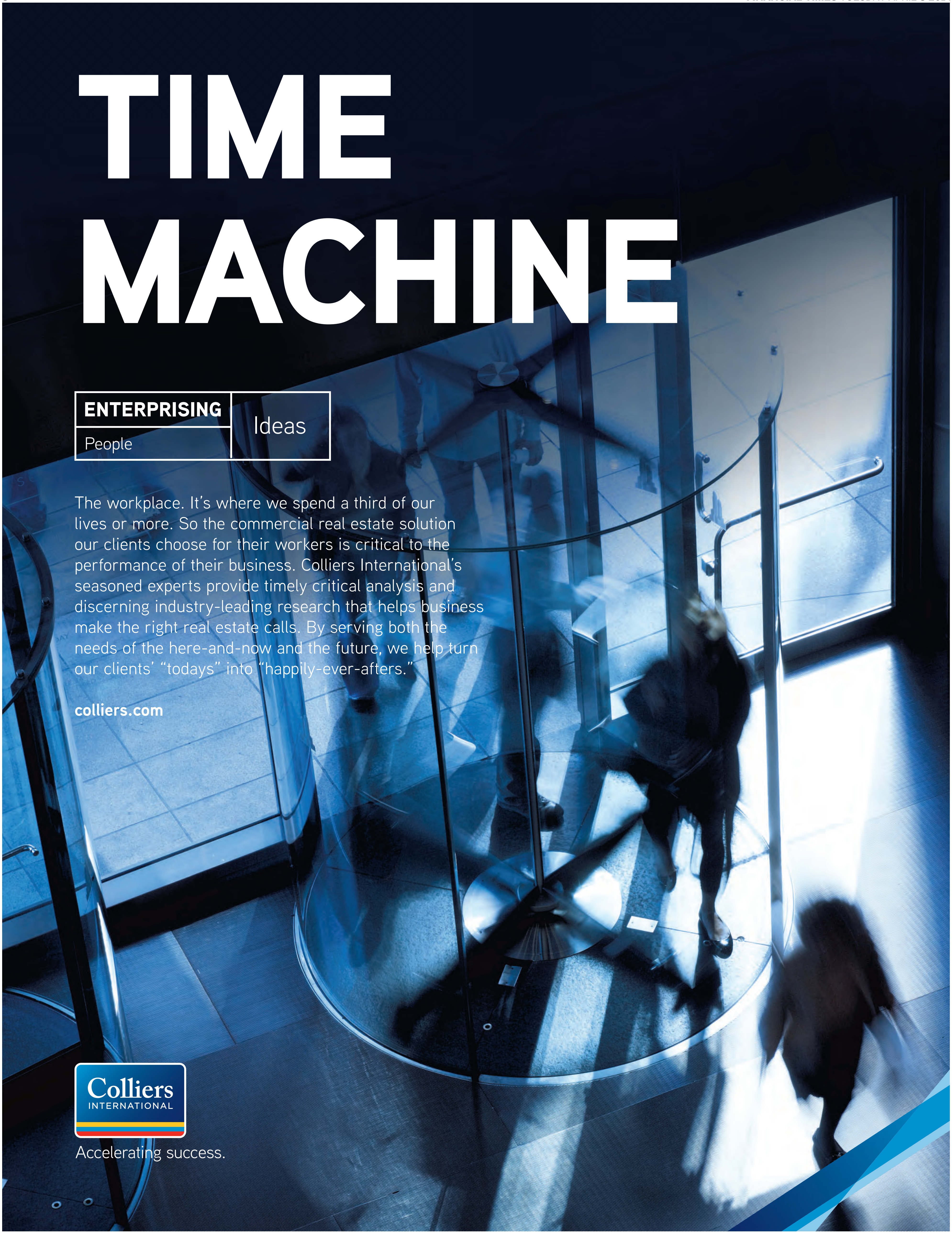
If Poland has developed a specialism, it is towers. Dutch practice MVRDV's design for the Baltyk Tower in Poznan is an inventive and surprising design, a crystalline building cantilevering out over the street as it also steps back.

However, the legacy of communism remains the most interesting aspect of eastern and central Europe. The Shukhov tower is hardly alone; the cities of the former Soviet bloc are crammed with extraordinary buildings from the Soviet era.

The system-built housing, that rings every city in the east, remains a problematic legacy, but other parts present wonderful opportunities for adaptive reuse.

For the moment, these buildings bring with them charged memories and often painful associations, but as these fade for younger generations, the buildings will take on new meanings.

Perhaps they will be seen for what they are: remarkable experiments in architecture and social planning.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