Central & Eastern Europe

Property

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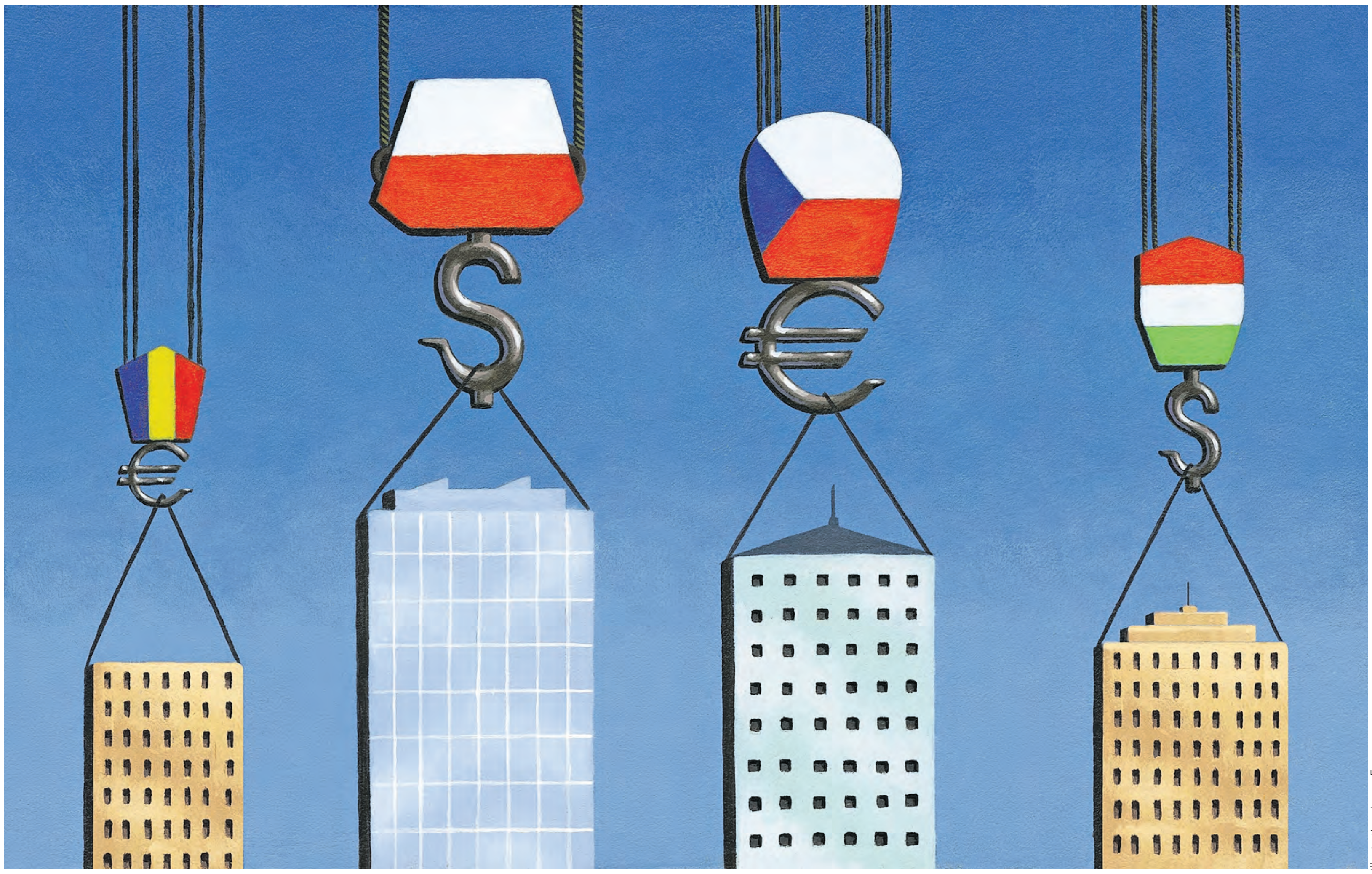

Illustration: James Fryer

Building for a brighter future

Henry Foy on how investors are starting to look beyond the regions' capital cities, *Page 2*

Inside

Second-tier cities and other countries are benefiting from global funds looking for yield, reports *Henry Foy*

Illustration: James Fryer

Flood of cash flows beyond Warsaw

Judging by the number of cranes and construction sites dotting the sides of Warsaw's main commercial street, it is easy to see how the city was the fourth most active office development market in Europe last year after London, Paris and Moscow.

One of the unfinished buildings is already celebrating having signed a blue-chip tenant: Deloitte.

The catch?

The financial services advisory firm is moving from the other side of the road.

There has been a rash of sparkling new buildings stealing tenants from slightly older versions that three years earlier were the toast of the city. But analysts agree the cannibalisation cannot last for ever.

Central and eastern Europe's property market has been hit by a wall of capital that has surged out of the US, Asia and western Europe, thanks to a heady blend of quantitative easing by central banks, a hunt for decent yields and a widespread shift to property investments by global pension funds.

Investment in central and eastern European property surged 25 per cent last year to €7.8bn, according to JLL, a property services company, flooding leading markets such as Warsaw, the prime location in the region.

"There is loads and loads of money coming in," says Hadley Dean, managing partner for eastern Europe at Colliers International, a property advisory company.

"And it is all desperate to find a home," he adds.

How that money is changing investment cycles and spending patterns in the region is the key question for the industry's developers, investors, tenants and analysts.

And it is not only the prime locations that are benefiting.

Surging inflows have disproportionately boosted smaller markets in the region, with a 52 per cent jump in Czech Republic investments last year. Romanian investment more than trebled, while Hungary's market had its best year since 2007, according to JLL.

That trend is likely to continue.

Warsaw, for a few years the market of choice for both established local players and international investors looking to dip their toes into the wider regional market, is beginning to show signs of overheating.

The vacancy rate for office space in the Polish capital was 13.5 per cent in 2014, up from 9 per cent in 2012, and is expected to touch 17 per cent by the end of this year, according to research by Erste Group Immorent, the property arm of Austria's Erste Group.

Deloitte's move across the city's Jana Pawla II Avenue is one of many big tenancy deals this year that have merely moved rental income from one building to another.

And as the money flow shows no sign of slowing, developers are betting that as appetite for Warsaw cools, capital will spread further around the region.

"There will be a halt, or a slowdown in current projects," says Tomasz Trzósło, managing director at JLL Poland.

"Investors might be more willing to do the business elsewhere. We already see that some investors are more keen to look at not only Polish regional cities, but also other capital cities in the region."

Quantitative easing policies by US, European, Japanese and British central banks spooked by the threat of stagnant growth have slashed funding costs and dumped huge amounts of capital on to investment balance sheets.

That has widened the audience for non-traditional assets such as central and eastern European property, bringing a more diverse group of buyers to the region.

And the fundamentals are strong. As the eurozone flirts with recession, leading central and eastern economies, excluding Ukraine, are expected to grow by between 2 and 3.5 per cent a year for the next two years, according to the International Monetary Fund.

Last year, Starwood Capital, a private equity group, snapped up two main properties in Warsaw; Lone Star spent €160m on a 28 per cent stake in regional player Globe Trade Centre; and Blackstone bought a Polish logistics portfolio from Standard Life for €118m.

The trend of non-traditional investors entering the region should continue. Robert Martin, principal at Europa Capital, a London-based property fund manager, notes that pension funds and Asian and Middle Eastern investors are taking far more interest in the market.

Árpád Török, chief executive of TriGranit Development, a Hungarian developer, expects "another three to five years [of significant inflows] in this region. There is more money in the global funds, the US funds, than ever before."

He adds: "They need to spend; they want to spend. What else are they going to do with the money? I am not saying this is a smart strategy, but it does provide a certain push to these markets."

> 'They need to spend; they want to spend. What else are they going to do with the money?'

Many global investors or developers have used Warsaw as a regional starting point over the past five years, and the surge in capital availability comes at the same time as a rising level of confidence among them to look further across the region.

"A lot of what investors in this space look for is scale. And Poland is the only place in the region that gives you that," says Collier's Mr Dean.

"People are hoping that there are another three years of the cycle [left in Warsaw], but I think the smart money is spreading out elsewhere."

An anti-corruption push in Romania bears hallmarks of one enacted in Poland a decade ago that helped spur growth in the sector, while rising transparency in countries such as Serbia and Bulgaria is bringing southeastern Europe closer to the standards expected in more mature markets.

Meanwhile a $4bn deal for an Abu Dhabi investor to regenerate Belgrade's eastern Sava riverbank is expected to spark further interest in the Serbian capital.

Further, the continuing skirmishes between Russia and Ukraine mean that, for many, those markets are on hold — or forgotten.

"The traditional funds are quite obviously looking further afield for increased returns," says Mr Dean. "The question is how far south this wave of money coming over the ocean is going to go after Poland. It is definitely not going to go east."

Many developers, investors and market analysts agree that 2015 could be the year when Romania steps up as a serious market in the region.

Like Poland, it hopes that a handful of second-tier cities outside its capital can attract significant investor interest, and it can continue to expand its business process outsourcing (BPO) industry.

The growth in Poland's BPO industry (see page five), which shows no signs of slowing, has been a huge boon for both office developers and regional city mayors. Thanks mainly to the BPO industry, Wrocław and Kraków had more office space under construction at the end of 2014 than the whole of Hungary, according to JLL data.

"The markets that have been treated unfairly, let's say, for the past two or three years, will benefit from the overflow of global capital," says TriGranit's Mr Török. "And if you look at the quality of assets in Budapest and Warsaw, frankly there is no difference.

"All the other countries will benefit because they provide more attractive yields."

Central & Eastern Europe Property

Look abroad Local groups expand beyond the region

When Marcel Sedlák arrived in London three years ago looking for potential projects for HB Reavis, the Slovakian property developer, the agents and advisers he met raised their eyebrows and looked quizzical, *writes Henry Foy*. "They were like: 'Are you serious?' 'Do you know what you are doing?'" recalls Mr Sedlák, now a director at HB Reavis.

Today, that scepticism looks misplaced. HB Reavis, which has two projects under way in the city, will officially open the doors on its first completion, on the north end of London Bridge, next year.

That opening will mark a new chapter for the company, which is part of a growing cohort of central and eastern European property developers that are leveraging domestic dominance to expand outside the region, turning the previously accepted investment story of cash flow from west to east on its head.

"There is an element of prestige about the decision [to develop in London], but it makes business sense," says Mr Sedlák. "We are becoming more and more respected in the London market. But we know that we need to prove ourselves and deliver."

The boom in central and eastern Europe's property market over the past decade has attracted finance from across the globe, resulting in a surge of business for local companies. Now, as domestic markets become more crowded, they are looking further afield.

Alongside HB Reavis, developers such as Hungary's TriGranit, CPI in the Czech Republic, Echo Investment and Capital Park in Poland and Ukraine's Dragon Capital have outgrown their home markets.

"TriGranit very quickly realised that it needed to go regional," says Árpád Török, chief executive. "We went through the learning curve a bit faster than our western European peers. So, in the past 15-20-year period, we have realised more projects and in more countries, getting accustomed to different legislations, different requirements, different markets. We have been forced to work in 10, 15 countries in parallel.

"So we are more flexible and quicker learners, but deliver what has been delivered in western Europe for the past 50-60 years."

Marcel Sedlák: 'There is an element of prestige about the decision to develop in London'

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Central & Eastern Europe Property

Budapest appeals at home and abroad

Hungary City centre office and residential real estate is behind the recovery and rising prices, says *Andrew Byrne*

Last year may have marked a turning point for Hungary's property market, as strong macroeconomic performance, combined with loose monetary policies across Europe and investors' greater tolerance for risk helped lift commercial real estate from its crisis-era doldrums.

But the country's higher risk premiums, compared with neighbours Poland and the Czech Republic, may in part reflect investor wariness of Hungary's unpredictable regulatory environment.

A hastily introduced law this year to restrict Sunday and late-night trading has prompted complaints from foreign retailers, and development activity in retail has stagnated.

Instead, yield-seeking domestic, European and Middle Eastern investors have focused their attention on premium office and residential properties in central Budapest.

Behind the headline figures of €460m of income-producing investment last year — an increase of 70 per cent on 2013 — analysts note a two-speed recovery, with a small number of big-ticket investments in high-grade property in the capital amplifying overall investment volumes.

"Much of the recovery is concentrated in the Budapest central business district," says Áron Horváth, head of the Eltinga Centre for Real Estate Research. "City authorities are upgrading infrastructure in central areas along the Váci út corridor and a mix of Hungarian and foreign investors are active in high-end property transactions here."

Case study Futureal, Budapest

Gábor Futó, co-founder and chief executive of Futureal, a Budapest-based developer, is talking big. "Vision Towers is one of the most significant buildings delivered since the crisis," he says, referring to his company's office development on Budapest's Váci út corridor. "It [encapsulates] all the ups and downs of the real estate market here."

The project was launched by KPMG, the professional services firm, which invited bids for a headquarters in 2011 when the eurozone was in turmoil, and vacancy rates in the Hungarian capital remained obstinately above 20 per cent.

"We were the only developer bidding that didn't have land, but they trusted us," says Mr Futó. "We purchased an old [communist era] hotel at a major crossroads with a metro station; one of the best plots in the city."

Futureal agreed on a first phase, an 11,000 sq m tower for KPMG, to be followed by a second, comprising two towers offering 9,000 sq m space in total.

The developer handed over the first phase last August, and the second — already largely let to two big tenants — in February. Both buildings have been sold to Erste Bank's real estate fund.

"We're not releasing the precise numbers, but I can say we sold it for an attractive yield, in the region of 7 per cent," says Mr Futó.

Kester Eddy

Headline deals, such as the sale of the Eiffel Palace office building to Hungary's central bank for €46m, have drawn significant attention. The bank has invested about €80m in property in 2014, according to Mr Horváth, placing it in the unusual position of being a leading investor in the market.

Separately, commercial lenders are working through a glut of non-performing loans and officials hope the central bank can spur financial institutions to increase lending by removing distressed assets from their balance sheets.

Mr Horváth says: "The central bank will invest about €1bn over 10 years in the commercial real estate market through a 'bad bank' taking on non-performing loans from banks. But solving the problem of distressed assets will take years."

Early sales of some distressed assets by lenders such as Banca Intesa SanPaolo's CIB suggest lenders are accepting losses of about 50 per cent on boom-time developments in various stages of completion.

In the residential market, the government's mass conversion of foreign currency mortgages and low inflation has meant greater disposable income among Hungarians who are now seeking to buy homes in greater numbers.

The median price for homes was up 4 per cent in the capital last year, according to FHB's residential price survey. Prices remain well below their pre-crisis peak, but the increase in 2014 was the first significant rise since 2008 and is already feeding into a recovery in home construction, according to the bank.

Towering figure: the Eiffel Palace was sold recently for €46m

Outsourcing Boom boosts Poland's office construction

Marek Grodziński, vice-president of business process outsourcing at Capgemini in Poland bristles when you absent-mindedly refer to his company's towering offices in Krakow's business district as a "call-centre".

As well he might. With lawyers, software designers and creative directors clocking in for work each morning, it is a far cry from the rows of telephone cubicles that have come to symbolise the global outsourcing industry.

Poland's business services industry, which has exploded in recent years as global financial companies shifted back-office functions to the central European country, is rapidly expanding into new and more lucrative areas in order to maintain a breakneck growth trajectory that has been a boon for the country's property industry.

From 43,000 jobs in 2006, outsourcing is expected to employ almost 200,000 people in 2017, according to a forecast by McKinsey, a consultancy.

That growth rate means that in many cities, as much as 60 per cent of new office construction is being built in order to serve the sector.

Some estimates put the potential total closer to 500,000 employees in the coming decade, requiring a long and lucrative pipeline of property projects.

Outsourcing is of particular importance to developers, thanks to its spread across six second-tier cities in Poland outside Warsaw giving the country an edge over other central and eastern European markets where investment activity is highly dependent on the country's capital city.

According to JLL, a property services company, the country's outsourcing industry accounted for 65 per cent of all leased offices rented outside Warsaw in 2014 — equivalent to about 268,000 square metres of space.

"But I believe that there are still a lot of global companies that are only midway through the process [of outsourcing], and there are still a lot of processes that could be optimised and located . . . here in Poland," says Tomasz Trzoslo, Poland managing director at JLL.

Henry Foy

The only way is up: Capgemini's Krakow office

Oil price fall and sanctions affect the market

Russia

Both commercial and residential sectors are struggling, writes *Roman Osharov*

The dusty windows of Moscow's soon-to-open OKO Tower provide a panorama of the Russian capital.

The most striking sights are not the spires of the Kremlin or the towering church of Christ the Saviour, but the unfinished buildings of OKO's neighbours: Federation Tower, which has been under construction since 2003; IQ-Quarter, which sits on top of a metro station; and the double helix-shaped Evolution tower.

Here in Moscow-City, the business district conceived a decade ago as Russia's answer to London's Canary Wharf, the impact of the country's economic crisis is evident.

"We can't say the state of the market is positive," says Maria Sergienko, commercial property director at Capital Group, developers of the OKO Tower.

According to Blackwood, a Russian property consultancy, the vacancy rate of the Moscow-City developments will be 45 per cent this year — meaning the city's flagship business hub will be almost half empty.

The situation has been exacerbated by the fact that OKO is just one of several big projects — some of them delayed by the 2008 financial crisis — that are now coming on to the market.

Last year, the Moscow property sector saw a record 1.4m square metres of office space completed, and analysts estimate a similar quantity could be delivered in 2015.

For developers, however, low occupancy rates are only half the problem. With the rouble halving against the dollar in 2014, and the Russian economy lurching into a sharp contraction, rents are also under pressure.

"Moscow-City is experiencing a big hit because of a correction in rental rates of about 40-50 per cent from pre-crisis levels," says Vladimir Pinaev, chief executive for Russia at CBRE, the property consultants.

Moscow-City is a high-rise microcosm of the troubles sweeping the Russian property market. A year after the annexation of Crimea, the country is suffering under the weight of sanctions, a fall in oil prices and structural problems in the former centrally planned economy.

The World Bank recently predicted that the Russian economy would contract 3.8 per cent this year and 0.3 per cent in 2016.

In addition, the slide in the rouble has put pressure on both developers and their clients.

City living: the towers of the Moscow International Business Center (Moscow-City)
Bloomberg/Andrey Rudakov

"Many developers have fallen on hard times financially, as office projects were traditionally financed in dollars," says Capital Group's Ms Sergienko. What is more, she adds, some office owners have begun to dump their properties, leading to a "market slump of 15-20 per cent".

A similar scenario is unfolding in the retail part of the market. After a brief rush to the shops in December in anticipation of higher prices as the rouble tumbled, Russian consumers have tightened their belts and retailers have fallen on tough times.

Knight Frank, the property consultancy, predicts 30 per cent of the shopping centre projects under way in Moscow will be frozen.

Some believe the figure could be higher.

Julia Sokolova, shopping mall leasing director at Knight Frank in Moscow, says: "Developers' funds could be exhausted by now and new loans or western funding are hard to come by. Also some developers could postpone completing projects until rents rise."

Residential property has also not escaped the economic woes. St Petersburg-based Etalon Group, a residential developer, has announced that this year it will build 200,000 square metres less than its original target of 700,000 sq m.

According to Russia's Ministry for Construction, Housing and Utilities, residential construction completions will fall 6 per cent this year from last year's 80m sq m, which was a post-Soviet era record.

> The vacancy rate at Moscow-City will be 45 per cent this year

Not all is bleak, however, in the Russian property sector. Some investors — and tenants — are sensing an opportunity given the fall in prices and rents.

For Marat Khusnullin, Moscow's deputy mayor for urban development and construction, the capital's property sector represents an investment opportunity.

"For foreigners, it's really a sweet deal," he says. "It is almost half price."

Russian buyers have deserted the market

Latvia The weakening rouble has cut demand sharply, writes *David Crouch*

Down by the beach: properties in the Latvian seaside resort of Jūrmala
Nathaniel Noir/Alamy

When the vodka flows this summer in the glamorous Latvian seaside resort of Jūrmala, a playground for Russia's well-connected wealthy, it will leave a bitter taste.

East-west tensions over the conflict in Ukraine have combined with the slowdown in Russia's economy to place a cloud over this town — and raise doubts about its high-end property market.

Until recently, Latvia has been a popular destination for Russians seeking property.

A quarter of the country's 2m people are ethnic Russians, and some 37 per cent of Latvians speak Russian as their first language.

In the eastern border region of Latgale, Russians have been snapping up cheap *dachas* as summer houses. But it is the capital Riga, and its coastal satellite of Jūrmala, where demand for property has been strongest.

Until last summer, Russians could gain residency rights for an investment of €150,000, the cheapest deal in the EU.

Latvia was regarded as a handy "emergency airport" should the situation in Russia deteriorate. More than 10,000 Russians have obtained Latvian residency under the programme.

The big money sought high-end property in Jūrmala, with the town attracting a who's who of Vladimir Putin's Russia: oligarchs, politicians, entertainers and mafia figures.

It was joked that the combined wealth of Russians enjoying a €34,000-a-head VIP table at the town's concert hall exceeded Latvia's entire budget.

No wonder Jūrmalawas nicknamed "the Latvian Rublyovka", after the street in Moscow's southwestern suburbs that is home to some of Russia's wealthiest people.

Now questions are being asked about whether Russian demand for high-end property will hold up — or whether some bargains might be on the horizon.

"The top end of the market in Latvia is already down 20-30 per cent," says Elena Marinicheva of estate agents Evans in Moscow, which says demand for property is down 90 per cent.

"There are far fewer Russian clients. Property viewings are taking place, but deals are rare."

Russians on the EU's blacklist are not getting rid of their property yet, but are holding on — they can rent out, even if they cannot visit, says Irina Alazova, head of real estate at Mercury Group in Riga.

"Jūrmala already feels the worsening situation, but everyone is waiting for the summer," she says. "It is a period of uncertainly, no one knows what will happen."

Property prices have been growing at double-digit rates for several years, but are now down about 10 per cent, says Mārtiņš Kazāks, chief economist in Latvia for Swedbank of Sweden.

But the market is not homogeneous, so it is hard to tell whether the lower prices are simply because people are buying cheaper properties in worse locations.

Apart from the EU blacklist, two more factors are weighing on prices, estate agents say.

> Prices, having risen at double-digit rates, are down 10 per cent

Deniss Kairans, managing director of Colliers International in Latvia, says: "If we are talking about the high end in Jūrmala, then of course demand from Russian buyers is much, much lower."

Geopolitics is playing a role in spooking Russian investors, he says, but most of all the falling rouble has made it much more expensive for them to buy. The rouble slumped by almost half against the euro last year, and although it has strengthened since January, it is still a third weaker than it was in the middle of last year.

The other factor is Latvia's decision last year to raise the minimum investment required for residency rights to €250,000, which combined with the weakening rouble to make property unaffordable for many middle-class Russians with an eye on Latvia.

As the deadline for the change in the law approached there was a rush to buy, but then the market collapsed.

In August 2014, Newsec, a property consultancy, registered 350 transactions in the Riga residential market with buyers from Russia and the CIS; the following month there were three.

"This is purely related to the residency permit, not the Ukraine-Russia war," says Neringa Rastenyte, a Baltic specialist for Newsec.

Russians still dream of buying a safe haven in the EU via Latvian property, but most of them simply cannot afford it any more, according to Filipp Berezin, editor of Russian property website Prian.ru.

With Russia teetering on the edge of a deep recession and the situation in Ukraine unresolved, it looks like Russians may be shut out of Baltic residential property for a while.

Paradoxically, however, the deeper the Russian economy falls into recession, and if political stability does not improve, there will be wealthy Russians looking for an escape route for their capital, fuelling demand for property abroad.

Central & Eastern Europe Property

David Mitzner, a visionary 100 years surrounded by miracles

PROFILE
Henry Foy

Twenty-five floors up, the windows of David Mitzner's Warsaw office have a panoramic view over the streets that formed the largest Jewish ghetto in Europe during the Nazi occupation.

More than seventy years ago, Mr Mitzner's family was taken from those streets and killed. Today, the neighbourhood is dotted with gleaming new skyscrapers, the fruits of a property boom that many trace back to the time of his return to the country.

Mr Mitzner, who turned 100 last week, is for many the father of the central and eastern European property industry. His $1bn purchase in 2004 of the entire Polish real estate portfolio of Metro, the retailer, remains the region's largest deal.

"When you see what one man has built, it inspires you," says Steven Mitzner, his grandson and a director of the family business. "He is a legend."

If his business career beats the odds, his personal life defies belief.

Incarcerated by the invading Soviet army in 1939 and sent to a gulag in Siberia, Mr Mitzner was one of only two members of his family to survive the Holocaust.

After being deported to Kazakhstan, he smuggled himself into communist Poland and then out again to safety in the US.

His biography is titled *Nesim all around me*. *Nesim* is Hebrew for "miracles". It is no understatement.

"I managed to survive first the Germans, then the Russians," he says in the book. "And you know what? I knew I just had to keep on surviving."

Son of a small-time businessman, Mr Mitzner, who was born in 1915 as the first world war raged, was brought up in an orthodox Jewish family in Warsaw during the 1920s and 1930s as anti-Semitism was rising to a peak across central Europe.

When Poland was carved up between Nazi Germany and the Soviet Union, Mr Mitzner was in Soviet territory in what is now Lviv in modern-day western Ukraine. His mother and two sisters were three of 400,000 Jews in Nazi-controlled Warsaw forced into the city's ghetto.

Mr Mitzner began taking daring and dangerous trips across the German-Soviet lines to visit and provide money for his family. It was on a return trip that he was arrested by a Russian border guard who, in mistakenly registering him as a German citizen illegally entering enemy territory, and not a Polish Jew, probably saved his life.

David Mitzner: 'I managed to survive first the Germans, then the Russians'

As the occupying units began to deport Warsaw's Jewish residents to their deaths in concentration camps, including his mother and one of his sisters, Mr Mitzner was sent to a gulag in Serov, in the vast emptiness of western Siberia, where he would chop down trees for lumber for almost eight years.

During this incarceration, his brother and father were killed at the hands of the Soviets.

In 1947, Mr Mitzner was summoned by the camp commanders and told he was to be freed, and deported to work on a farm collective in what today is Almaty in Kazakhstan. From there, he managed to stow away on a five-day train to Moscow, and finally arrived back in Warsaw to an unrecognisable city where 85 per cent of its prewar buildings had been destroyed.

Fearing the impending crushing of Polish democracy by Stalin, Mr Mitzner decided he had no choice but once more to leave his homeland.

He stowed away for three days in the hold of a ship across the Baltic to Sweden where he was granted asylum and attended his first Shabbat service for almost a decade.

Months later, on April 11 1949, his 34th birthday, Mr Mitzner stepped on to the docks in New York with nothing but the clothes on his back and $17 in his pocket.

It would be four decades before he returned to Poland. By that stage a successful businessman, he made an emotional visit to the Majdanek death camp where his mother had been executed 43 years earlier.

After the Berlin Wall fell in 1989, Mr Mitzner made a series of fruitless business trips to Poland.

It was on what he said would be his final attempt to invest in the nascent democracy that he gambled on a disused factory, buying it for $6m and spending another $12m on building office buildings on the plot.

"He is a visionary. He had the foresight to see the potential of CEE," says Steven, his grandson.

It was to prove a shrewd investment. Within three years, he had made his money back in rental income. And he has not stopped since.

Cities in CEE