New Horizons in CEE Real Estate Markets - Polish case

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SUMMARY

Further yields compression in commercial real estate assures success in property investment in Polish market. Investment yields in 1st Q 2006 went down below 6% in office sector (below 8% and 7,5% in warehouse and retail sectors respectively). How will the current market expectations meet the future market development? What are the market's perspectives and what are its limitations? Authors gave thorough examination to Polish real estate market, focusing on investors' and developers' behaviors within last three years. Consequently they defined current market trends that are leading CEE real estate market into new perspectives. The Authors will introduce the participants to the mechanisms of emerging real estate markets, discussing how do defined market's conditions affect on real estate valuation.

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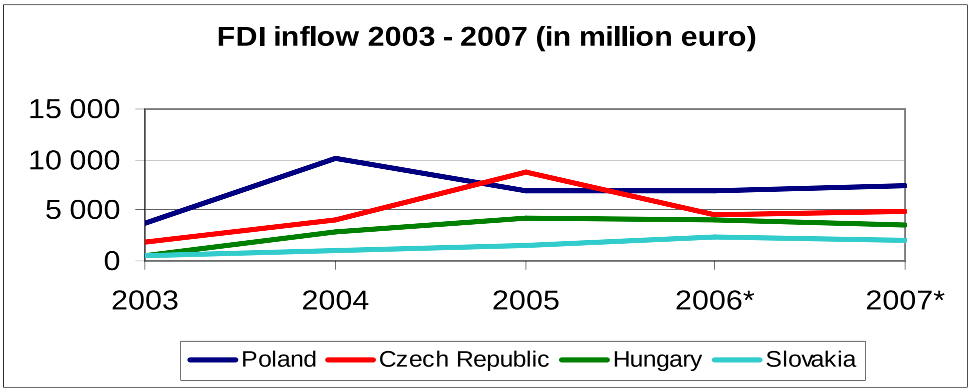
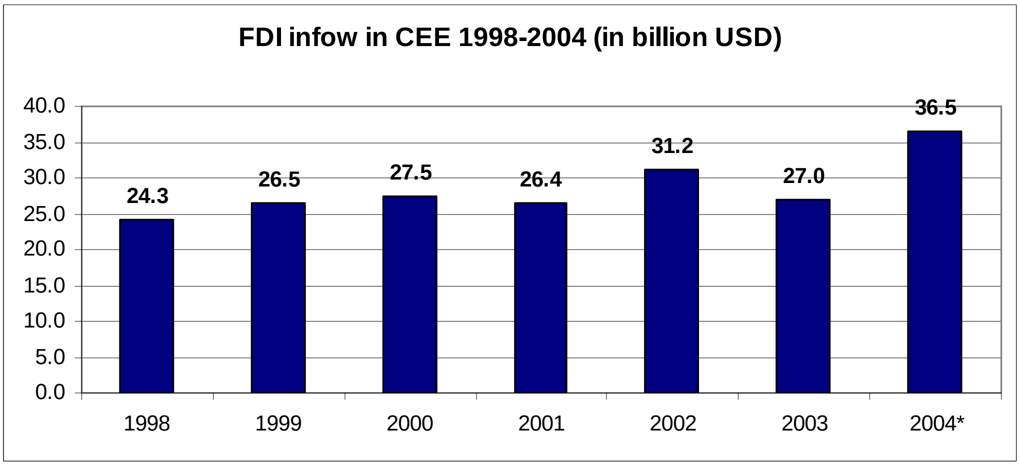
Investors continue to perceive Central and Eastern Europe as a remunerative location for investments. In respect of Foreign Direct Investment (FDI) inflow, Poland plays one of the leading roles in the region. According to international data, Poland, Czech Republic and Hungary, in that order, are receiving the largest FDI inflows.



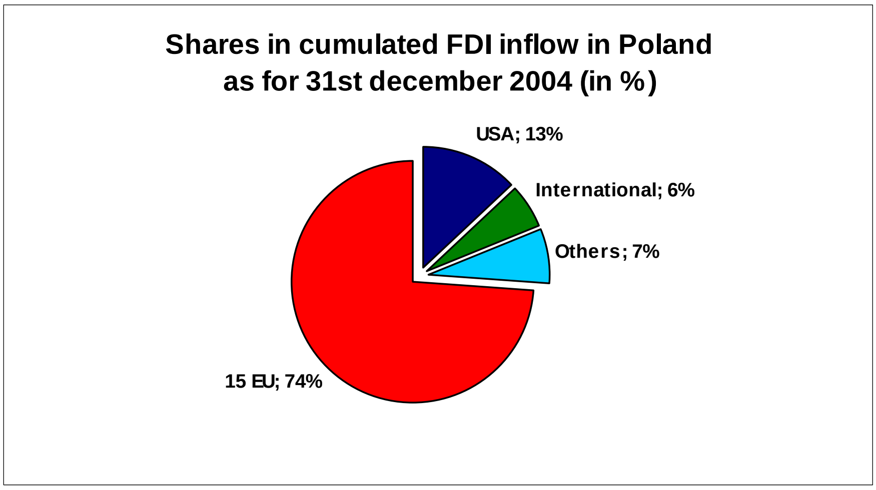
*Source: Bank Austria Creditanstalt, * forecast*

European Union's enlargement in May 2004 provided the catalyst for further investment and bolstered the confidence of foreign investors in the region. The EU - 15 countries were the major investors in the 10 new EU members. The largest investors among them during the past years were Germany and the Netherlands, followed by Austria and France.



Source: United Nations Conference on Trade and Development, **forecast*

According to PAIiIZ, Polish Information and Foreign Investment Agency, over 70% of FDI inflow to Poland has been invested by the companies from EU - 15. During the year 2004, the list of major investors included: French companies (1.57 billion USD, 20% FDI) and American companies (1.43 billion USD, 18% FDI). Moreover, in 2004 we've seen increased interest of investors with Asian roots, such as Republic of Korea (202 million USD) and Japan (108.4 million USD).



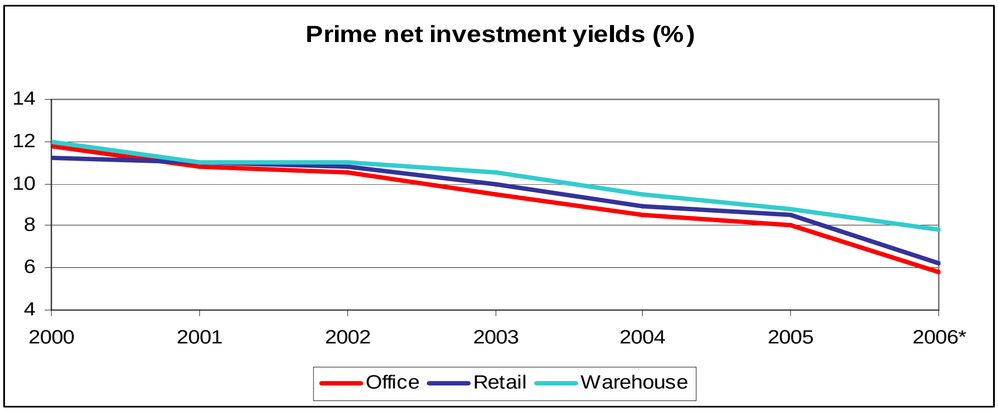
Source: Polish Information and Foreign Investment Agency

Year by year, large part of the FDI in Poland is being located in real estate sector (approximately 865.5 million USD in 2004).

In respect of the property investment market, 2005 was a record year for both, CEE and Poland itself, with over 6.5 billion euro of investment volume transacted in the region.

Until recently the commercial property market in Poland was perceived as underdeveloped - lacking regular investment trade. The situation has changed, as real estate investment volume has been increasing dynamically over the recent years. The market has been improving and becoming progressively more liquid, with higher availability of products, year by year.

In 2005 approximately 2.5 billion euro has been transacted in Poland with approximately 100 properties changing the hands. Investment activity was substantial in retail sector with the total number of 1.5 billion euro. It means that transaction volume in this sector was almost 10 times higher than a year before (which was 150 million euro). Approximately 970 million euro has been located in office sector (almost 40% more than in 2004). In the same time warehouse investment market remains very limited. The deals in this sector in 2005 totaled less than 50 million euro.



*Source: PricewaterhouseCoopers, *forecast*

Further yields' compression caused the situation, that the investment yields in 1st Q 2006 went below 6% in office sector (below 8% and 7.5% in warehouse and retail sectors respectively). This brings the yields in Poland close to the Western European levels. The situation proves that investors widely view Poland as a core European market.

The future development of the market and its dynamism depend on the advantages and disadvantages appearing on the market - opportunities and threats of doing business in Poland. The main factors encouraging property investors to act on Polish market include the following:

Polish accession into the European Union in May 2004 triggering off the increase of sense of security of investing in the region. According to the survey carried out by PAIiIZ, the most significant advantages resulting from EU enlargement include: the Polish law harmonization with European regulations, simplification of trade procedures and exemption from the duties within the EU.

Current market conditions in Western European countries. Yields on Western markets are reaching their lows. According to the latest market evidence the very best offices trade at 4.25% in Paris, 4.50% in London and 5.30% in Berlin. Such conditions push institutional investors to seek for higher returns exploring other markets. Similarly, some of the Western markets face the problem with their liquidity.

Establishment of the new funds, concentrating on property investment on CEE markets. The main players on the real estate investment market are investment funds. They are becoming more and more active, expanding their market share. Among the most active buyers on Polish property market in 2005 were: Generali Lend Lease's Accession Fund, TMW Pramerica, CA Immo and Polonia Property Fund. Several new players have recently entered the market, such as GLL Real Estate Partners, IXIS and Morley Fund. In the recent years four Polish domestic funds have been established with the purchasing capacity of approximately 700 million euro.

Private equity consortiums seeking for investment products of the value up to 10 million euro. These investors have two objectives: to invest safely and to invest with higher return than on their maternal markets. The most active among them are investors from Ireland, United Kingdom and Spain.

Increased presence of international portfolio transactions. Particularly retail sector attracts large size deals, commonly of the cross – border nature. As the retail development in recent and forthcoming years is booming, and few retail chains are considering entering the Polish market, we can expect new large portfolio deals in the future. So far, few large portfolio deals has changed the hands. In 2005, the Klepierre's investment, the acquisition of 338 million euro Plaza Center's portfolio was the most significant transaction in terms of volume. In the same year Meinl European Investments has purchased a portfolio of 7 Echo Investment's shopping centers (size of deal of 60 million euro). 2004 and 2005 have seen three large size portfolio deals: Ahold portfolio – Hypernova supermarkets (65 million euro), Carrefour portfolio, including shopping malls and hypermarkets (376 million euro) and also Metro AG portfolio (700 million euro).

Investment yields compression. Downward trend in yields secure the future increase in the property value. Yields continue to fall among all sectors, which is related to the weight of money targeting the CEE region. The buyers act very aggressively, intensifying competition for institutional quality product, forcing increase in prices and further fall in yields.

Low labor costs. According to the investors' opinion, the young, educated workforce is easily available in Poland. High unemployment levels (approximately 17%) and low average salary (of approximately 625 euro) result in the high supply of cheap labor. On the other hand high rate of unemployment is one of the main restraints to the development of the Polish economy.

The following disadvantages may discourage investors operating on Polish property market:

Sharp fall in yields in 2005, which was related mainly to the mismatch between the huge amounts of capital entering the Polish market versus the limited availability of the investment products. After the investors have bid the yields down to the new lows, a disharmony occurred between running yield available in the market and investors' return requirements. This has driven investors to decrease return expectations for Poland. According to the experts, the rate of yield compression is expected to slow, or, at some point, it can stop.

Artificial fall of yield in case of certain properties, which could be related to the drop in office lettings and renegotiations of existing lease contracts. It should be noted that since the 1990's the office rents have been dropping in Poland, which was partially related to the fact that in the past the rents were calculated in US dollars and now, the majority of them is being calculated in euro. Investing on Polish property market requires more precise project analysis during due diligence process in favor to minimize the investment risk.

The limitations of availability of the good quality products. Good example is the low supply of warehouse space for sale. The majority of the warehouse stock is held by two developers - ProLogis and Parkridge Development - who are not interested in selling the properties yet. Simultaneously, large proportion of the modern warehouse space is being developed with approval of the investment funds willing to buy the property for a long-term ownership. As a result, there is very low availability of the modern warehouses space for sale.

Underdevelopment of road infrastructure. Polish road infrastructure is unsatisfactory. Development of the planned highways is moving forward very slowly. Neighboring markets, such as Czech Republic, Slovakia and Hungary, with well-developed modern road networks, constitute potential competition for developing Polish logistic centers.

CONCLUSION

As presented above, the Polish property market has experienced booming development in recent years. Large investors' interest pushed huge amount of the capital into the market, causing increased competition among investors, provoking many structural changes of the market. We can expect, that in the nearest future investors will change their behaviors, refocusing their objectives. The possible future investors' behaviors are presented below:

Refocusing on other markets. Poland will have to face the competition of other CEE markets, such as Russia or Ukraine. These are the markets of great perspective and the current lack of investment products. They may develop very fast and some of the international investors will be interested in spreading out their risk and diversifying their portfolios geographically. In the long term it may cause the fall of the foreign investment volume in Poland and the decrease of the competition on the market.

Refocusing on second and third tier cities. Lack of the availability of premium products in Warsaw caused, that some investors refocus on smaller scale properties in secondary towns. So far, retail transactions have been much more disbursed throughout Poland comparing to those taking place in other sectors. However, it is expected that office and warehouse sector will also draw more attention from investors in the nearest future. The number of transactions has already been taking place (for example the recent sales of: Lubicz Office Centre in Cracow, Alfa Plaza office scheme in Gdynia and Quattro Forum office scheme in Wrocław).

Refocusing on underdeveloped properties. Some of the market players consider investing in underdeveloped properties, such us properties with high vacancy, legal or technical problems. They take the leasing or development risk but, in return, they are paying lower price, at higher yield.

Some funds are considering moving outside from the three core markets (retail, office and warehouse), investing in more risky areas, such as for instance – hotels.

Refocusing of investment funds on middle size deals. Opposite to the previous years, when the institutional investors were mostly focusing on large-scale properties, they might be moving towards medium sized investments (of approximately 10 million euro).

SOURCES:

- Bank Austria Creditanstalt,
- Polish Information and Foreign Investment Agency,
- United Nations Conference on Trade and Development,
- National Bank of Poland,
- PricewaterhouseCoopers,
- Ernst & Young, Colliers International,
- Jones Lang LaSalle,
- Knight Frank,
- King Sturge.

BIOGRAPHICAL NOTES

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