INVESTMENTS IN THE REAL ESTATE SECTOR. A CASE STUDY ON CENTRAL EASTERN EUROPE

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This paper presents the evolution of real estate market in European Union. Romania's real estate sector passed through significant milestones during the last years – due to economic boom, integration in the European Union and affordable financing. But after the 2007 subprime crisis and the 2010 European sovereign debt crisis new ways of approaching the market have to be designed and implemented. The M&A transactions seem to be an investment driver in Romanian real estate as proven by Immofinanz /Adama Case Study
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1.Introduction

A gradual economic recovery seems to be under way, even though limited by governments' efforts to deleverage. The compression of yields started to ease back in 2011, which would make development projects more attractive than acquisitions, also because of the fact that superior return on investments can be achieved. The option to either develop or trade rent generating assets could be the decisive factor in the performance of real estate companies in Europe.
However, even though European markets have been able to maintain a fragile balance between inflation and deflation, the growth pace is still suppressed. While Northern Europe has a healthier finances system and stronger competitive advantages, the Southern countries face higher unemployment rates and lack of consumer confidence, which makes the gap even higher – this has a direct impact on the real estate sector in these countries, making it less attractive.

2.The Real Estate Market UE

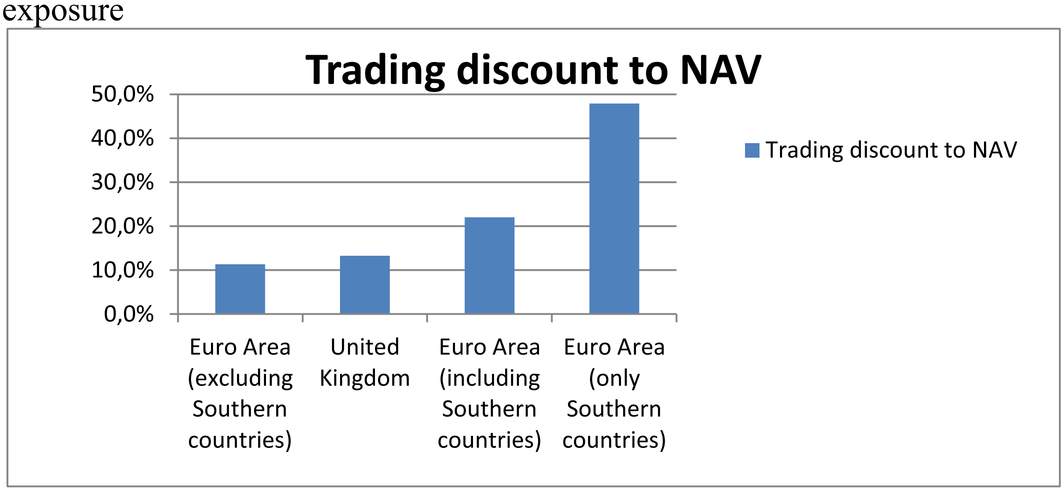
The growth rates in Southern Europe are below average, combined with the fact that the local governments are implementing medium term plans until 2014 – 2015 to cut expenditures in an attempt to rebalance the public debt, means that consumer spending is also kept to a minimum, which leads to stagnant rent levels for both retail and office properties. Moreover, the economic situation reflects directly in the decreasing occupancy level of office spaces, which traditionally also indicates economic downturn.
Also inflation and increasing energy prices have a direct impact on the real estate sector, affecting directly the occupancy costs and ability to afford higher rents, not to mention the discriminating choices of consumers for retail products.
Basically, there is no big difference between listed European real estate companies, except for the regional exposure of their portfolios – because CEE markets are perceived as uncertain and undeveloped compared to Western European markets, companies invested in this region are trading with a higher discount to the net asset value (NAV). But what has been completely neglected prior to the subprime crisis was the size of the investment market – before 2008, Western Europe has a yearly investment volume up to EUR 100 Bn., while CEE (including Russia) had a maximum volume in the boom phase of EUR 14 Bn. This crucial aspect became obvious only after the bankruptcy of Lehman Brothers in 2008, when many real estate companies

decided to exit their CEE investments, in an effort to consolidate their portfolio and concentrate on more traditional European real estate markets. Because the CEE real estate market is a relatively young one, there is little knowledge among Western European companies about this region and corroborated with the devastating effects of the recent crisis, the regional exposure has an impact on the trading discounts to NAV.

For Austrian investors, heavily invested in CEE, a particular challenge in their expansion was opening up to markets much bigger in size compared to the local one – Romania for example is three time larger in size and by taking over the majority stake in Petrom by the Austrian OMV, suddenly a company with 10 times as many employees as in the headquarters had to be managed. Practice has proven that when implementing an investment strategy, the problems increase with the square of the distance and that each national border that has to be crossed potentially attracts new risks. This happens because of entering new cultures, new legal systems, new languages, new business practices and suddenly apparently familiar problems cannot be solved intuitive anymore. Whereas on the local market, business practices are intuitively understandable, this doesn't apply anymore in foreign markets which means a much higher level of information has to be assimilated without making the mistake of interpreting them, but processing them based on local customs.

According to Dick Boer - Executive Director Corporate Finance for European Real Estate at Kempen & Co. Merchant Bank during an EPRA news conference and captured in a Kemper & Co press release, London, September 2011, there is currently "an astonishing decoupling between the valuations of those real estate firms who are exposed to the full brunt of the sovereign debt crisis, and so also fears the Eurozone may disintegrate, and those who are largely sheltered from the storm" – thus we are speaking of a North / South axis of real estate investments within Europe, visible also in terms of investment return per share and trading discount relative to NAV. The listed companies in Southern Euro Area or with investment exposure in this region have seen dramatic decrease of their market capitalisation - the average discount to NAV for companies with portfolios in this region was 48%, for those with a limited exposure to this region 22% and for companies with no exposure in this area maximum 13%, as can be seen in the following chart.

Figure 1: Trading discount to NAV of European Real Estate Companies, based on their regional exposure



Source: own presentation based on historical market caps published by the European Public Real Estate Association www.epra.com and Kemper & Co press release, London, September 2011

There is definitely a new trend in investment decisions – as a result of the current financial and economic crisis and the need to consolidate the investment portfolios, managers became more precautious and realistic, adapting to the current phase of the business cycle. However, one

should not forget that we are currently in a cycle and that historically observed more prudent investment behaviour is typically evident at the beginning of a downturn and diminishes gradually as the economic situation improves, until the next crisis sets up.
Even the highly debated Austrian theory of business cycles could have a saying in the real estate sector as is today. Because of the time gap in the real estate between investment and production, meaning development phase, and consumption decision, meaning the completion of the development and renting out, the resources deployed in each stage of the pre-development, development and renting phase have to be carefully measured, such that when the completion of the development is brought to the market, there is still enough consumption demand for it (1). Generally, the completion of a development from investment decision and acquisition of land up to launching the project takes 3 to 5 years, which makes capital restructuring costly and corrections are only limited possible. The basic idea behind the Austrian theory is that strong expansion of credit activities fuels an unsustainable level of investments. This is actually what lies in the grounds of the subprime crisis started in 2008, when affordable and easy obtainable credits were used to finance consumption behind sustainable debt levels. The adepts of this theory believe that while recession is both inevitable and desirable, in order to clean the bad investments made in the boom phase and consolidate the portfolios, the loss of confidence in the banking system and the credit crunch can push the economy into a longer recession than initially forecasted.

Specifications of Real Estate Investments in CEE (focus Romania)

Investment activity is controlled by international investors, in the form of corporations, private property vehicles and stock listed property companies. Decreasing asset prices in combination with a deteriorating economic outlook have made buyers more selective in their search for real estate property profits, choosing smaller deals in terms of scale and risk, but with higher margins.
Romania's real estate sector passed through significant milestones during the last years – due to economic boom, integration in the European Union and affordable financing, the land prices started to rise back in 2005 and reached a peak in 2008. The financial and economic crisis hit badly the real estate owners in the country, faced with the need to write-down drastically the value of their investments, prime properties loosing up to 30% and remote locations up to 80% in valuation. By analysing the loss in values, it can be concluded that the real estate sector has registered the most significant impact of the economic downturn.
Immofinanz Group (through Immoeast AG at that time), was hit just as bad as smaller investors, having to decrease the fair value its real estate projects in the financial year 2008/2009 with EUR 823 M13, out of which EUR 533 M directly attributable to CEE markets, and additional EUR 145.8 M14 were written off from the market value of financial investments in real estate companies with operations in Romania.
These changes led to an almost frozen year 2009 what regards real estate transactions, dropping in volume and value to the levels of 2005. The downsize of economic activity was obvious, demand being subdued in all sectors due to weaker purchasing power and tight monetary policy Most investors concentrated on redefining their investment strategies and stopping the losses. Nevertheless, at the end of 2009, construction and real estate sector was the third largest invested in in Romania with a volume of EUR 6.5 Bn. representing 12.9% of total economy .
The new strategic orientation continued throughout 2010, when major players have shown a clear need of consolidating their portfolios, by disposing of non-core assets and / or terminating joint venture agreements. In addition to these, Immofinanz Group also concentrated on financial restructuring and cash flow optimization, by merging retroactively per 30.04.2009 Immoeast AG with Immofinanz AG, which simplified the capital structure and created new financing opportunities on the capital markets.

The year 2011 was an active year, in which major European real estate companies still pursued their efforts to consolidate portfolios and approached also mergers and acquisitions: TAG Immobilien AG completed in January 2011 the takeover of 50, 02% of Colonia Real Estate AG for the price of EUR 90.35 M , the merger of NSI and VastNed O/I was completed in October 2011 , Deutsche Wohnen and its competitor GSW are negotiation over the acquisition of the latter. Last but not least, Immofinanz Group, one of the biggest real estate investor in Romania and a major European stock listed player, completed on November 9th, 2011 the acquisition of the remaining 69.3% of the 100% share capital in the CEE residential developer Adama Holding Public Ltd. ("Adama") for a price of EUR 42.4 M .

A careful analysis of statistical data gathered among active Austrian real estate investors gives a moderate, yet slights promising forecast for the year 2012 - 75% of them estimate a decrease in real estate activities due to the Euro-crisis and 32% of them expect financing difficulties due to implementation of Basel III regulatory standards, on the other hand 57% believe that increasing inflation will redirect investment preferences towards real estate, 56% see new opportunities in IPOs and capital increases and 32% believe business opportunities and increased real estate offer generated by the portfolio restructurings .

Investors in the real estate in Romania are now more prudent and discriminating than before, looking for better locations, better access and only quality constructions, that could return a sure profit over the medium and long term. The banks are also approaching a very conservative financing strategy after being forced to acknowledge on their balance sheet huge amounts of bad loans , which were subsequently written-off. In the case of Erste Bank, this meant an accounting loss of EUR 1.5 Bn., out of which EUR 692 M loss of BCR company value and EUR 762 M write down of Erste Bank Hungary goodwill. The positive reaction however to be expected on the market after such an accounting cleaning is the untightening of the financial sector and a boost of the real estate development pipeline thereof.

Development projects were the clear value drivers in the period 2004 – 2006 and seem now again to be even more attractive than mergers and acquisitions, the main reason being the solution to improve the portfolio quality and retain developer's profit thus increasing the cash flow. In a market of customers, prime properties are the key to exit the crisis and secure a strong position on the market. According to estimates of investment banks, EUR 7 Bn. will be invested in 2012 in completing European developing projects - real estate companies with high exposure on development activities, i.e. at least 15% of their rent generating assets portfolio, mark the highest growth of cash flow per share and IRR on NAV.

Even though in CEE and SEE markets sustainable developments or green buildings are not yet a standard, the trend is also here increasingly present. Besides the reduced impact on the environmental, the investors benefit also from the longer life cycle and reduced operational costs of the buildings and can achieve a higher premium in case of trading activities. For a property to be certified as green building, it must withstand an integrated sustainability assessment, including high energy efficiency, resource-conserving materials or usage of existing transport infrastructure.

Investment Drivers in Romanian Real Estate - Case Study Immofinanz /Adama

The most recent and one of the most notable transactions was the acquisition of the CEE real estate developer Adama Holding Public Limited through the Austrian stock-listed real estate company Immofinanz Group. The acquisition of the remaining 69.22% of the 100% share capital of Adama was completed on November 9th, 2011 for a price of EUR 42.4 M . Immofinanz Group held a minority stake in Adama since 2007 and decided for the buy-out of renowned investors like the US hedge fund Tiger Global, investment bank Morgan Stanley and Lehman Brothers UK in order to fulfil its defined group strategy of expanding construction and development activities in the residential market. Moreover, the acquisition of Adama complies with Immofinanz' portfolio consolidation strategy, which requires exit from all financial and

non-core investments and 100% takeover of such participations where synergies and strategic control can be achieved .
Immofinanz Group is one of the five largest listed property companies in Europe and is included in the leading ATX index of the Vienna Stock Exchange. The company has a high-quality portfolio of more than 1,600 investment properties with a carrying amount of approx. EUR 8.5 Bn. The core business of the IMMOFINANZ Group covers the acquisition and management of investment properties, the realisation of development projects and the sale of objects. The IMMOFINANZ Group concentrates its activities in the retail, office, logistics and residential segments of eight regional core markets: Austria, Germany, Czech Republic, Slovakia, Hungary, Romania, Poland and Russia.
This acquisition by Immofinanz Group was especially interesting for the Romanian and other South- Eastern European markets, Adama being a leading property developer, that focuses on real estate projects mainly for residential, but also office and commercial use, foremost in Romania, besides Ukraine, Turkey, Croatia and Moldavia. Adama covers the entire property development chain - from the acquisition of land to planning and approval processes as well as the realisation and marketing of projects The company has ownership or use rights for more than 40 land plots in various stages of development or construction, with a total volume of 1.44 M sqm designated for approximately 22.000 residential units for the middle-class population and approximately 400.000 sqm of office and commercial space. At the moment of acquisition, Adama had 8% of the residential market share in Bucharest.
Adama is a well-known brand on the Romanian market, not only due to its high market share but mostly due to its image on the market. The social responsibility, the innovative orientation or the premium quality of the products are associations which way be utilized for designing of the brand activity . In this case, we talk about an allusive brand name which makes a cultural reference, allowing positive associations and giving leads about its principal benefits .
“Adama” is the Hebrew word for earth, traditionally standing for stability, quality and sustainability. For the product strategy, the company opted for the brand EVO, deriving from the key word Evolution. The message is that Adama is a stable, strong developer, evolving as a leading brand, in the here and now, capable of delivering tailored living solutions to its clients, by adapting according to the ever-changing demands and re-shaping regional urban landscapes. The product brand has been extended to Evocasa (residential), Evocenter (office) and Evomall (commercial).

Conclusions

We are still in the process of economic recovery after the 2007 subprime crisis and the 2010 European sovereign debt crisis and we are experiencing business decisions being taken with more precaution and decision-makers turning more realistic and risk averse.
The real estate sector being severely affected by the subprime crisis, we have seen an investment bubble in the mid 2000’ years followed by an abrupt stop thereof and intense portfolio restructuring efforts up to the current period: strategic reorientation in 2010, disposals, mergers and acquisitions in 2011, fears of double-dipping but also new opportunities expected for 2012. There is definitely an on-going rethinking of real estate investment strategies, but they are not expected to be new ones, but just be reinvented – investors act within the cycle and are now, just like after every other crisis marked on the chart above, more aware of the fact that the business is being replayed, therefore are more conservative and discriminatory, but as time passes they are searching for new opportunities and accepting certain levels of risk in order to generate business.
According to statistical analysis of the crises timeline, a definite trend is evident that at some point we will be facing a replicated collapse and since the average interval decreased from 25 years in the 18th century to less than 10 in the 19th and 20th centuries and we are experiencing already the 3rd crisis in the new millennium, one should only hope that the frequency of the

cycles will be much slower than the recovery and that every business lesson learned will count towards a quicker and a better start in a booming phase.

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