PEAKSIDE CAPITAL

Opportunistic Investing in Europe:
The Case for Germany, Poland and the Czech Republic

Introduction and Overview

Over the last 12 to 18 months, there has been a noticeable increase in interest from US investors for opportunistic real estate investment in Europe. At Peakside Capital, we attribute this change to both “pull” and “push” factors. The “pull” is the realization in the US that the worst of the Eurozone crisis is behind us and parts of Europe are actually doing quite well. The “push” is the realization that the opportunities arising from the financial crisis in the US are now largely exhausted and so investors are looking further afield, with Europe being the next target. In other words, US-based investors now view Europe more as an “opportunity” than a “risk”.

For the most part, we at Peakside agree with this shift, but we also think that it is very important to differentiate between countries in Europe. Europe has never been “one size fits all” and the differences between countries are now probably more pronounced than at any other time since the “big bang” expansion of the European Union in 2004. It is also very clear to us that the Eurozone crisis has left behind problems, notably the debt overhang, which will make Europe a low-growth area for the foreseeable future.

In this environment, we strongly believe that to generate attractive returns, an investor must both *buy well* and *add value*. Without both of these factors, in a slow-growth Europe where there are few obvious asset mis-pricings or arbitrage opportunities, it is exceedingly difficult to generate opportunistic returns from real estate. This environment also implies that a “bottom’s up” approach is required: investing building-by-building, in a “buy, fix, sell” strategy, rather than trying to generate returns through following perceived macro trends.

We think that the European markets need to be looked at from three different perspectives:

- The performance of the economy and the health of the real estate market, since these are major factors in the ability to execute lease-up and repositioning strategies, and the ability to sell the resulting “fixed” buildings;
- The level of distress and the existence of “motivated” sellers, since this is a necessary, but not sufficient, condition of “buying well”; and
- The absence of strong competition for transactions, since this is a second necessary and, when combined with the factor above, a sufficient condition for “buying well”.

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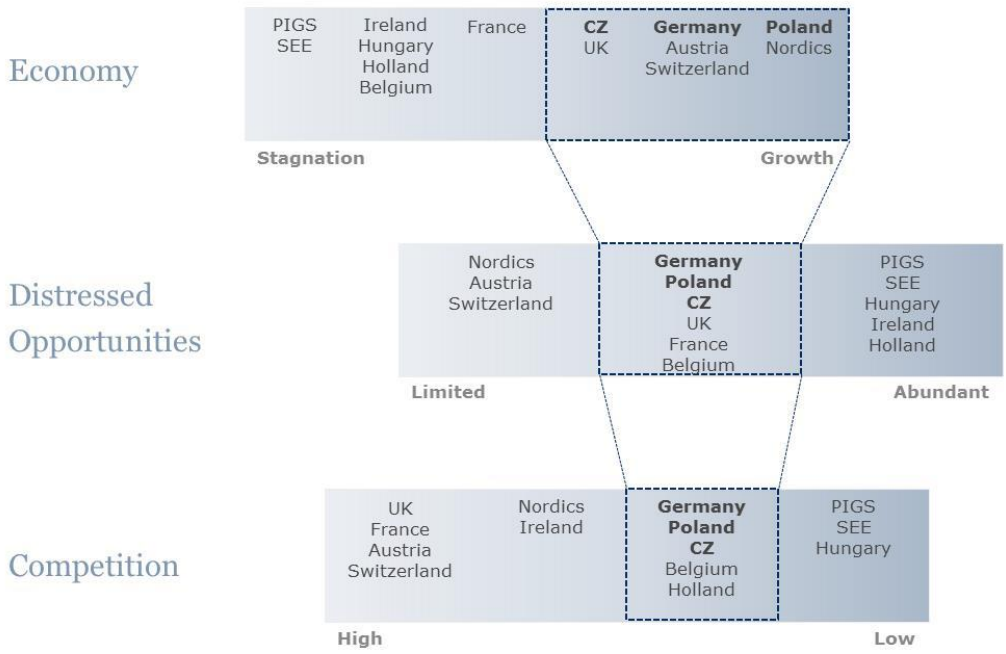
This perspective on Europe is graphically depicted below:



The **UK** is experiencing reasonable economic performance and it certainly has a large stock of distressed transactions, but London is home to virtually every opportunistic investor in Europe and the level of competition for transactions is fierce. It is very difficult to "buy well" in this market.

Ireland is an interesting market, with high levels of distress and strongly improving international competitiveness, but its proximity to the UK has brought a high level of competition to the market (including investors from the US West Coast!) and its domestic sector is still very challenged.

Investors are gradually realizing that **France** has some of the biggest economic problems in Europe, including ongoing fiscal issues, despite an already oversized tax burden, and an unreformed labor market. In addition, France is extremely well covered by opportunity funds, many of which have headquarters or second offices there.

The **Nordics** have performed strongly over the last few years, as have their real estate markets. With the exception of some overbuilt pockets in the Danish residential market, however, there is substantially no distress in these markets and therefore few compelling buying opportunities. This statement also applies to **Switzerland** and **Austria**, where safe-haven cash in-flows have lifted the real estate markets to very high levels.

In **Benelux**, the Dutch economy and market are deeply distressed – probably the worst performer in Northern Europe. Belgium suffers from many of the same problems as France, including one of the biggest government debt burdens in Europe.

The **Southern Periphery** (Portugal, Italy, Greece and Spain – the "PIGS") continue to have falling economies and real estate markets, coupled with highly volatile domestic politics. The level of distress, however, is enormous (especially in Spain) and there will probably be some great opportunities in these markets, but the risk of "catching a falling knife" is high. Investing here is really more of a macroeconomic, around the world "bet" than it is a real estate one and the question has to be asked if there aren't more efficient ways of doing this than buying buildings.

The **Balkans** (Romania, Bulgaria, former Yugoslavia, and, spiritually if not geographically, Hungary) have deep economic problems and, in some cases, massively oversupplied real estate markets. The political environment here is also much more Emerging Market than European. These markets are not for the faint hearted and exit liquidity is currently non-existent and likely to remain patchy.

The remaining markets (the **Baltics** and **Slovakia**) are small and illiquid (at least at the moment).

This whirlwind tour leaves us with **Germany, Poland and the Czech Republic**. We believe that these markets occupy a "sweet spot" for opportunistic investing that combines an attractive economic background and real estate market with both enough leftover financial distress to create interesting buying opportunities and limited competition. Not coincidentally, these three countries also function as virtually a single economic unit, with geographical proximity and very strong trade and investment flows.

The Economies and Real Estate Markets

Germany

Peakside has always been a strong believer in the German economy. With the exception of a "lost decade" running from the mid-1990s to the early 2000s, when it was recovering from disastrous policy decisions taken in connection with reunification, Germany has been the economic powerhouse of Europe for over 100 years. With the largest population in Europe, world-leading companies[1] across a broad spectrum of industries, a strong focus on exports and an aversion to debt-driven booms and busts[2], Germany can be counted on to produce a steadily growing macroeconomic background for a "buy, fix, sell" strategy.

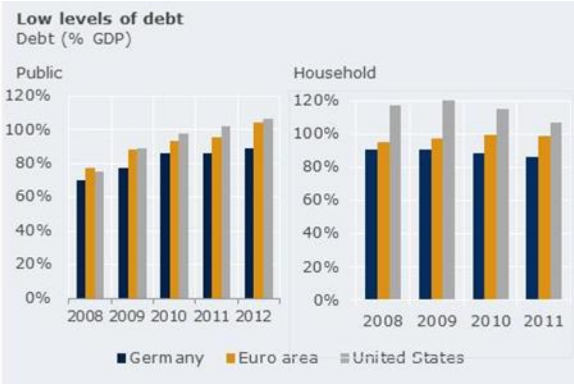
Germany continues to have **strong economic fundamentals**. Its economy has recovered from recession and it has steadily decreasing unemployment.

Source: Eurostat, 2013; OECD Economic Outlook, 2013

[1] Such as Daimler Benz, BMW, The Volkswagen Group, Allianz, Deutsche Bank, SAP, Munich RE, Siemens, Deutsche Telekom, BASF, Bayer, Aldi, Lidl, Continental, etc., as well as a large number of world-leading *mittelstand* companies.

[2] It should always be remembered that the German word for "debt" (*Schuld*) is the same as "guilt" or "sin".

After reaching a peak deficit of 4.1% in 2010, still far below most of the countries in the OECD, Germany has once again produced a government surplus of 0.2% in 2012. As a result of its relatively **low levels of public and private debt**, Germany is not subject to the significant deleveraging "headwinds" and fiscal constraints that are affecting many other developed economies.

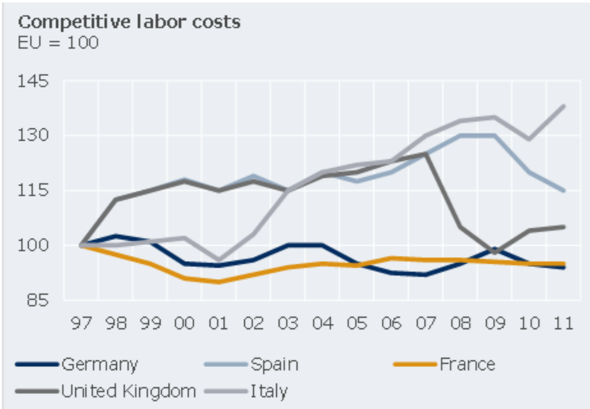


Source: Eurostat, 2013; OECD Economic Outlook, 2012

Another factor that makes Germany a strong investment region is its **highly competitive economy**. In 2012, Germany was the sixth most competitive economy in the world according to the World Economic Forum's *Global Competitiveness Report*. With the "Hartz" reforms of the labor market, which came into effect between 2003 and 2005, Germany has significantly restructured its labor laws and introduced more flexibility and competitiveness.

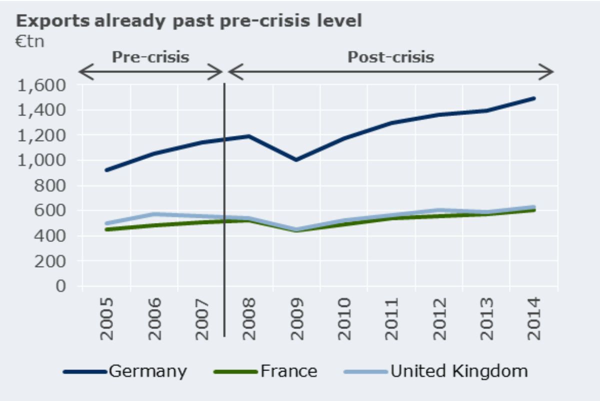
Global competitiveness index rating

Country/Economy	Score	Rank	
		2011-2012	2010-2011
Switzerland	5.74	1	1
Singapore	5.63	2	3
Sweden	5.60	3	2
Finland	5.47	4	7
United States	5.43	5	4
Germany	**5.40**	**6**	**5**
Netherlands	5.40	7	8
Denmark	5.40	8	9
Japan	5.40	9	6
United Kingdom	5.39	10	12
Hong Kong SAR	5.36	11	11



Source: World Economic Forum, Global Competitiveness Report 2011-2012; Eurostat, 2013

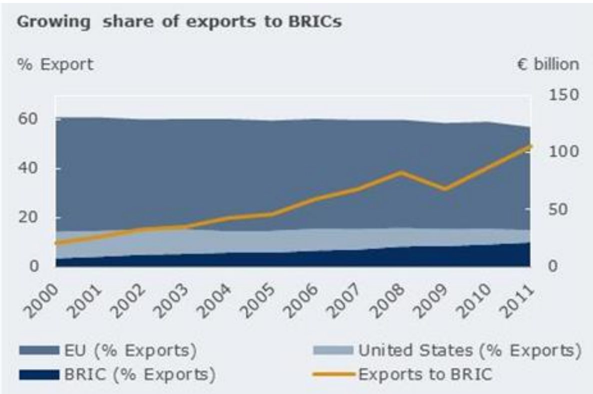
This strong competiveness has made **Germany a very strong exporter**. Although Germany has recently lost its title as the world's leading export nation to China, a country with almost 17 times its population, Germany's exports are now substantially above pre-crisis levels. Exports have prospered in many different economic environments largely because of Germany's diversified customer base.

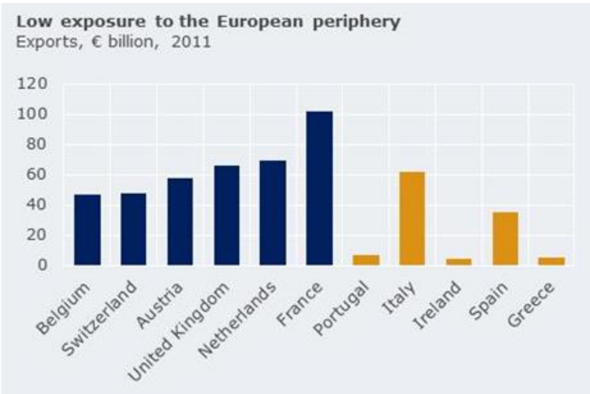


Source: Eurostat, July 2013

Source: Statistisches Bundesamt, Wiesbaden, 2013

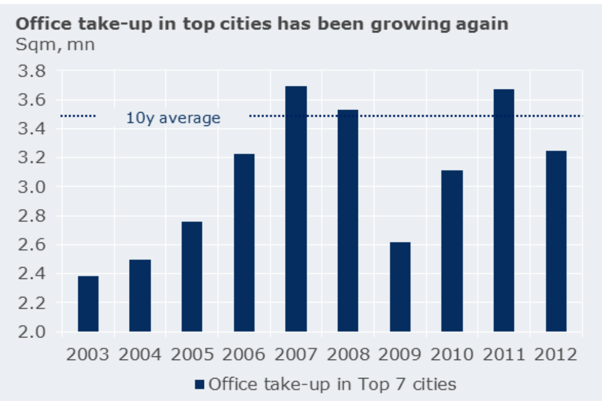
Germany also has a **rising share of exports to growth markets**, such as the BRICs, which totalled approximately €128 billion in 2012, up almost 200% since 2000. Exports to the BRICs represented 11.7% of exports, compared to 3.9% in 2000, reflecting Germany's strength in production goods and high-end consumer products, such as cars. Germany has also benefitted from a low exposure to the weak European peripheral countries.



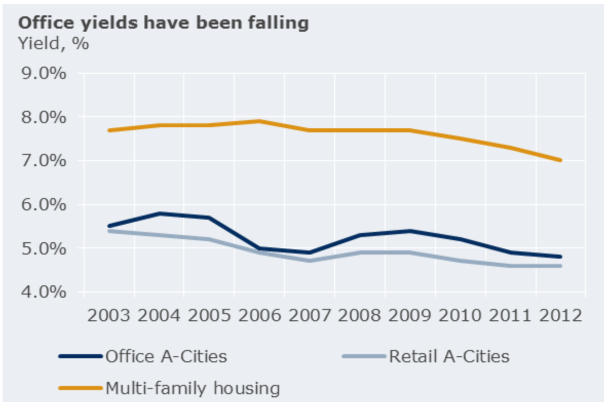


Source: Statistisches Bundesamt, Wiesbaden, August 2012

This solid economic performance has translated into a robust real estate market. **Leasing take-up** in the top cities is back at its 10-year average and **office yields** have fallen steadily.

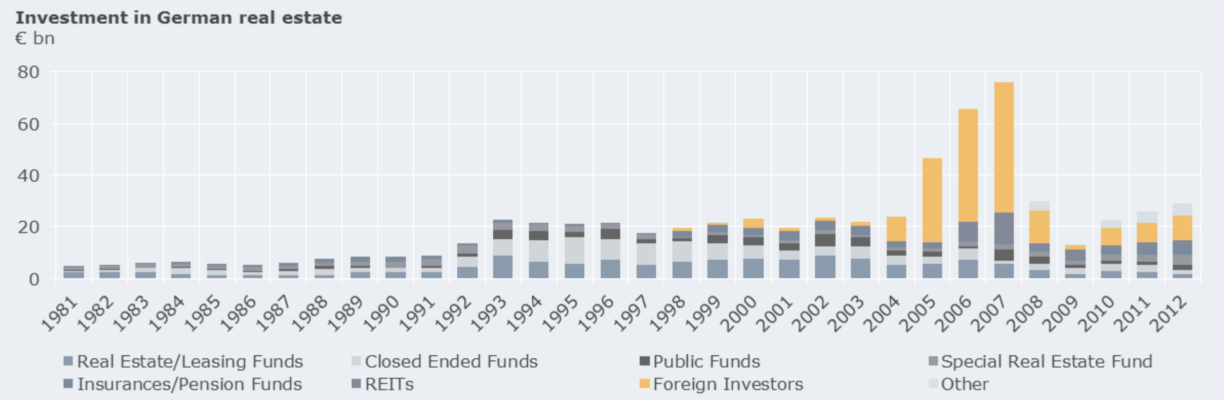


Source: BNP Paribas 2013



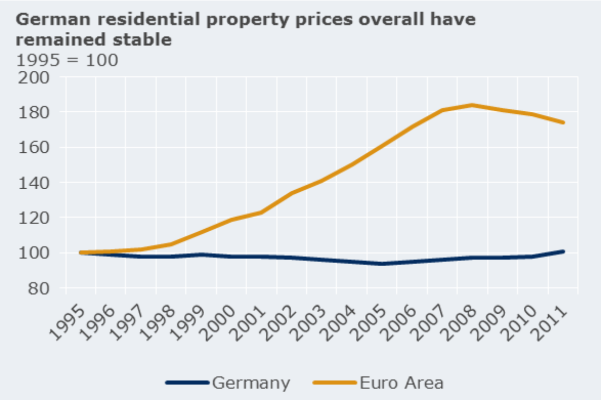
Source: Deutsche Hypo 2013

With the exception of the “bubble years” (2005, 2006 and 2007), **transaction volumes are at record levels,** with a diverse roster of investors.

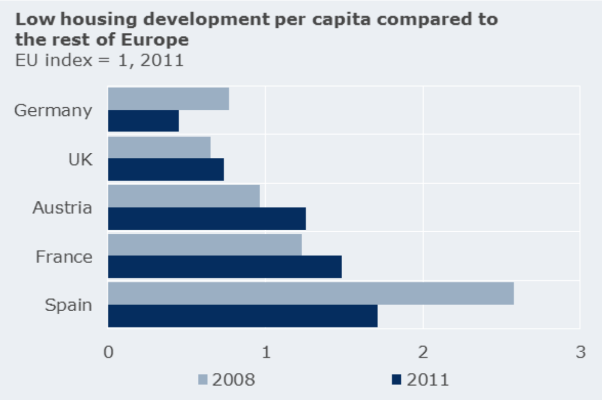


Source: Deutsche Hypo 2013

The German residential market also has a rarity in the European context: **a growth opportunity**. German residential prices flat-lined over the 15-year period from 1995 to 2010, when the rest of Europe experienced a rollercoaster. This price stagnation has, in turn, produced a very low level of development.



Source: Deutsche Bundesbank 2012

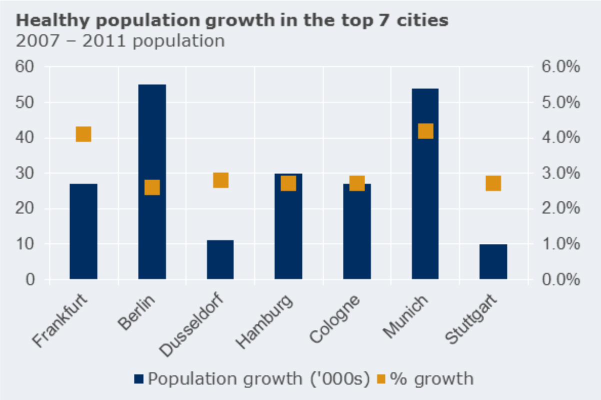


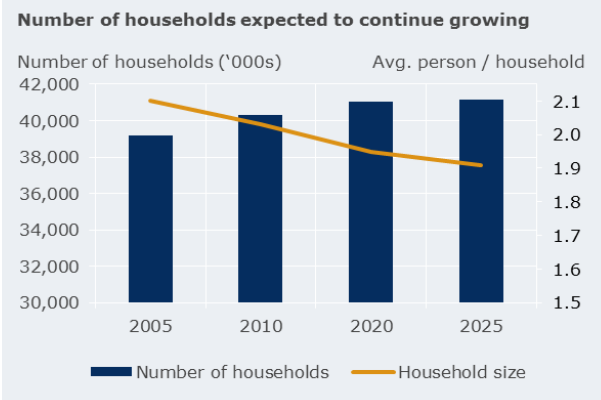
Source: Deloitte, “Property Index: Overview of European Residential Markets”, 2012

With limited house price appreciation and a strong economy, Germany has the **best housing affordability** in Europe.

Source: Deloitte, “Property Index: Overview of European Residential Markets”, 2012

Although Germany has weak overall population growth, the **big cities continue to increase** at the expense of secondary locations and **household formation is forecast to remain positive** as family sizes shrink. These trends, combined with changing consumer preferences, have produced localized shortages. Although the recent price and rental increases are starting to spur more production, there is still a large cumulative backlog to be met.



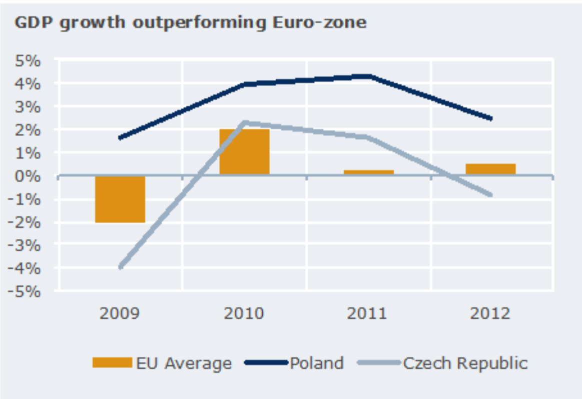


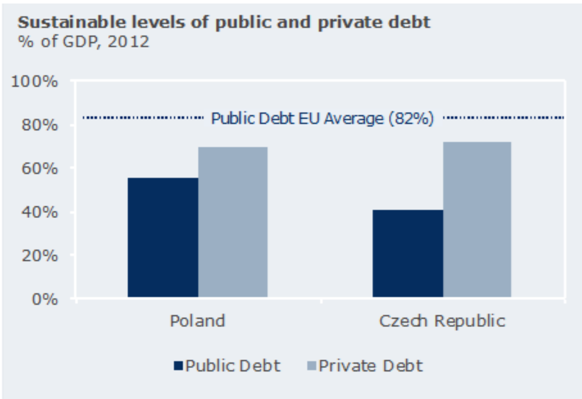
Source: DZ Bank 2013, citypopulation.de

Source: NAI Apollo 2012, Statistisches Bundesamt, 2012

Poland and the Czech Republic

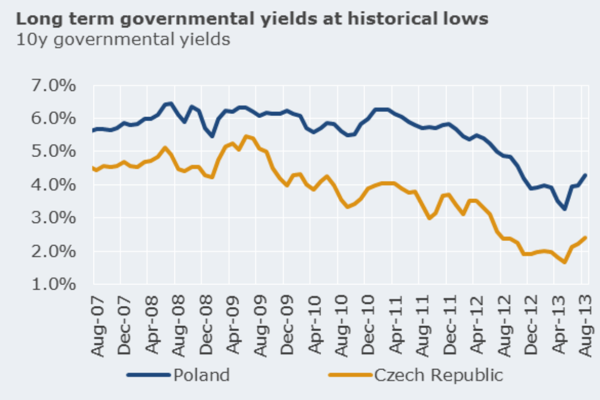
Poland was the only country in Europe that **did not experience negative GDP growth** during the financial crisis. The **Czech Republic** has experienced GDP contraction as a result of the crisis but it is an export-oriented economy with close links to Germany and its capital city, **Prague, is a sizable and wealthy market** with considerable international interest. In addition, like Germany, these countries generally have **sustainable levels of public and private debt** which means that they do not face significant deleveraging needs and fiscal constraints.



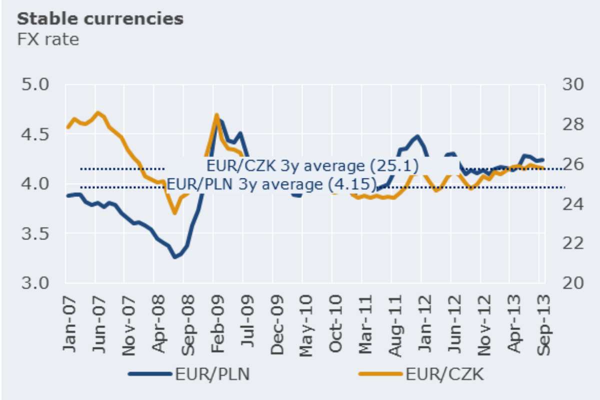


Source: Eurostat, 2013

Both countries have **record low interest rates** and **their currencies have been reasonably stable** versus the Euro. Their **sovereign debt ratings have actually improved** since the beginning of the financial crisis, with the Czech Republic recently being upgraded to an "AA-" rating by Standard & Poor's and Poland being rated "A-" (or better), with stable to positive outlooks. The **banking sector in both countries is strong**, notably because domestic deposits are more than sufficient to fund domestic lending, meaning that they are not exposed to international or capital markets' funding risks.

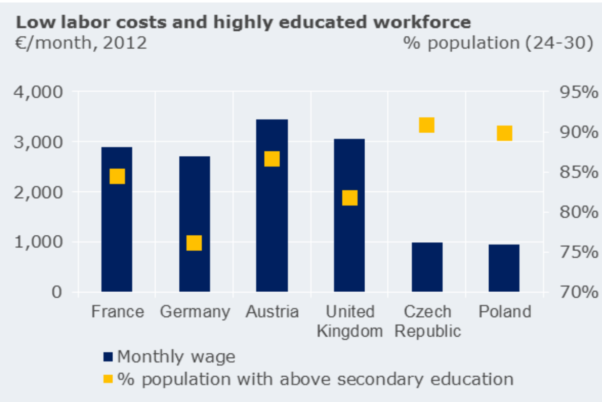


Source: National Bank of Poland and Eurostat

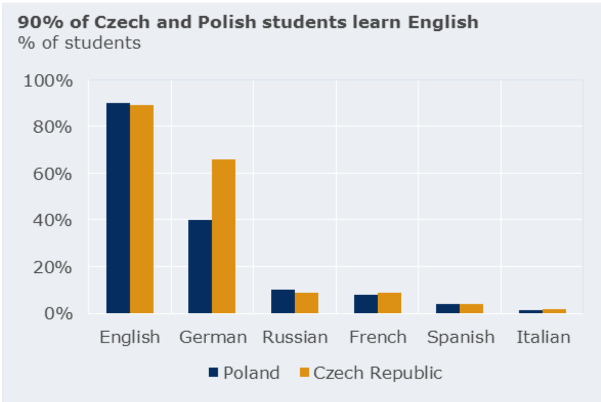


Source: National Bank of Poland (data for 2001 – 2011), Polish Information and Foreign Investment Agency (estimation for 2012) and Eurostat

Both countries have **low labor costs** and a **well-educated and multi-lingual workforce**, which, when combined with their close proximity, make them **attractive manufacturing and outsourcing hubs for Europe**.

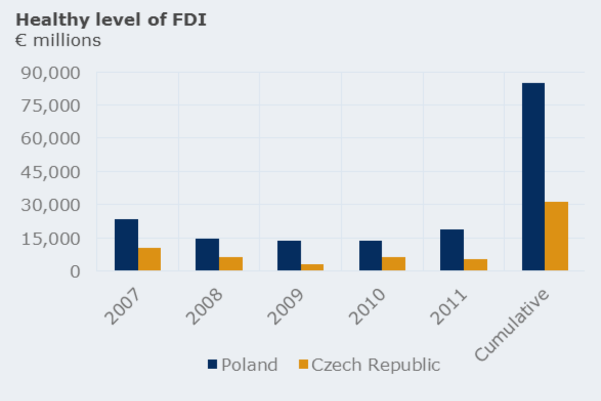


Source: Eurostat, 2013

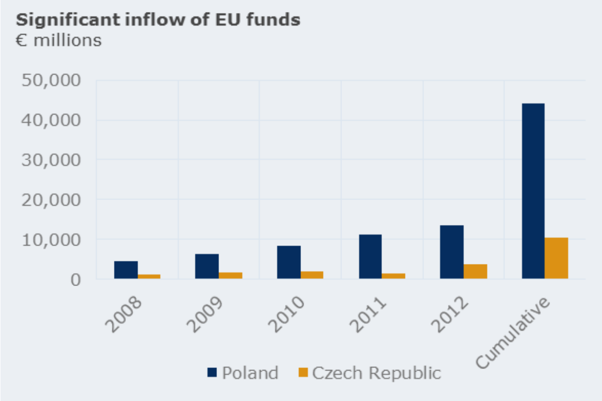


Source: Central Statistical Office, June 2013. Czechinvest, May 2012

These factors have contributed to a **signficant amount of foreign direct investment** in both Poland and the Czech Republic, with Germany being the largest single source of this investment for both countries. These FDI flows have been augmented by **significant net European Union transfers**, which equalled €17.3 billion in 2012. EU funds have been heavily used to improve infrastructure, notably the highway system in Poland.



Source: Eurostat, 2013



Source: Central Statistical Office, June 2013

Poland has become **a world leader in outsourcing**, ranked only behind the vastly larger populations of India and China. This has been augmented by the recent trend among European companies to "nearshore" many of their activities, preferring the shorter supply lines and closer control that comes from Poland and the Czech Republic.

Poland is major outsourcing hub
3.4% of all global outsourcing/ offshoring jobs, ranking **1st in Central Eastern Europe ("CEE"), 2nd in Europe and 6th globally**
3rd in ranking of destinations for global services by the Hackett Group (together with China and India)
13th best host economy for FDI globally in the UNCTAD's World Investment Survey 2010-2012

Source: Jones Lang La Salle, Onshore, Nearshore, Offshore: Unsure?, June 2013

Number of outsourcing projects

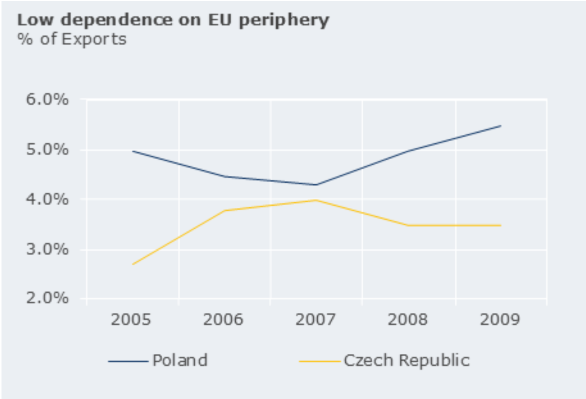
No.	Country	Number of projects
1	United Kingdom	812
2	Germany	410
4	Russia	265
6	Poland	237
8	Netherlands	145
10	Turkey	133
	TOTAL	3,891

Source: The fDI Report, fDI Markets, 2013

(The trend to outsource can sometimes take unexpected and comical forms. For example, there was recently an article on Bloomberg's website entitled "*Germans Export Grandma to Poland as Costs, Care Converge*" (September 16, 2013), discussing the trend for German families to put their grandparents in Polish nursing homes, where the costs are lower and the quality of care is higher.)

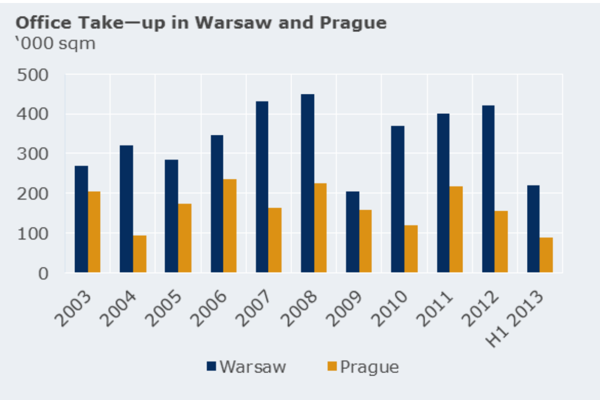
Both Poland and the Czech Republic **have strongly grown their exports since 2001** and both countries now export more than prior to the financial crisis. **Germany was the major export destination** for these economies, accounting for 20% to 30% of total exports, and these countries have **very low exports** to the weak European periphery.

Source: Czech Statistic Office, Poland Statistic Office

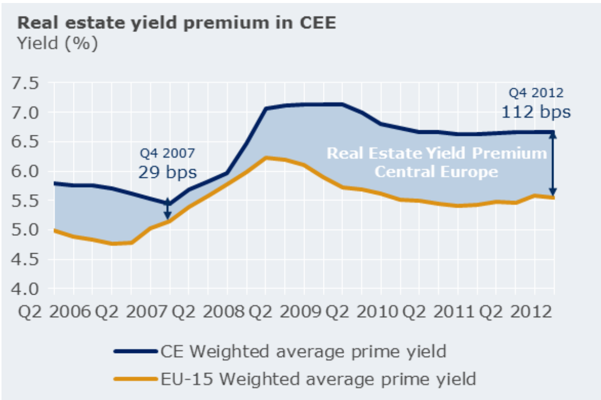


Source: Eurostat, 2012; Deutsche Bundesbank, April 2011

This solid economic background has once again translated into robust real estate demand. **Leasing take-up** has returned to pre-crisis levels and is, in the case of Warsaw, now comfortably above these levels. This strong leasing performance has not translated into material rental improvements due to an overhang in supply, particularly in certain areas of Warsaw, but at least they ensure that there is scope for lease-up strategies. **Yields have also come down** but, unlike during the "bubble" years when the yield gap between these markets and the major markets of Western Europe compressed to unsustainable levels, the yield spread is now, at least in Peakside Capital's opinion, a reasonable reflection of the different risk, maturity and liquidity of the markets.



Source: Prague Office Market H1 2013, CBRE, Warsaw Office Market H1 2013, JLL



Source: CBRE, April 2013. Central Europe ("CE") weighted average prime yield is the average of Poland, Czech Republic, Slovakia and Hungary

After coming to a halt in 2009, real estate investment levels have once again recovered, with Poland in particular exhibiting high levels of investment activity. This liquidity reflects, in part, the increasing transparency of these markets, which now approach those in the more mature markets. According to Jones Lang LaSalle's *2012 Transparency Index*, "the gap in transparency between Western Europe and some of the main Central European markets has been virtually eliminated as core CEE markets approach the mainstream. Ranked 19th globally, Poland, for example, has transparency levels comparable to Western Europe and is now considered by some investors a 'core' market."[3]

[3] Jones Lang LaSalle, "On Point: CEE Investment Market Overview - H2 2012".

Source: CBRE, Q1 2013

Poland is the most transparent CEE real estate market

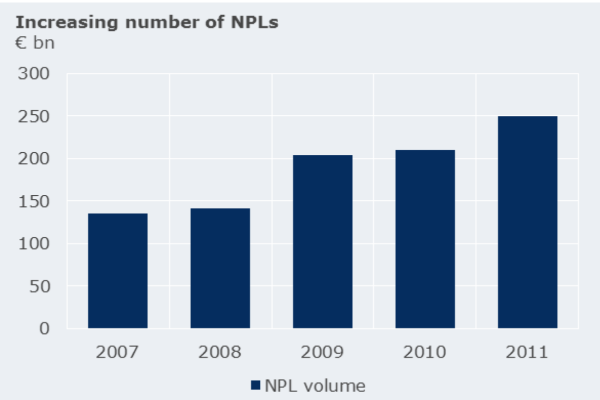
No.	Country	Score
2	United Kingdom	1.33
12	Germany	1.80
19	Poland	2.11
22	Austria	2.22
24	Czech Republic	2.34
26	Hungary	2.53
36	Slovakia	2.90

Source: Source: CBRE, European Capital Markets, Q4 2012

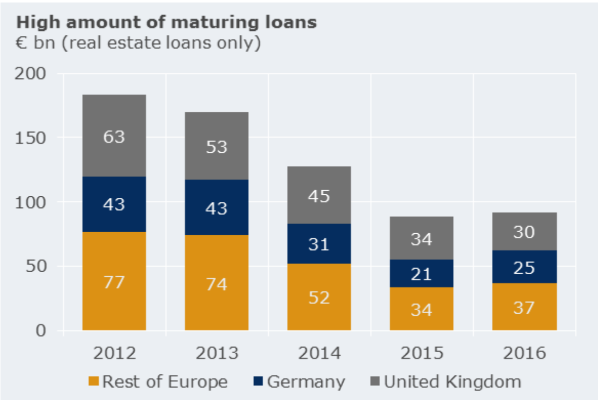
Financial Distress and Motivated Sellers

Germany

Although Germany's economy and real estate markets have largely recovered from the financial crisis and are performing well, there are **still a large number of Non-Performing Loans ("NPLs")** in the system as a result of the excess lending that took place during the period leading up to the crisis. **There is also a large stock of loans with upcoming maturity dates**, many of which cannot be entirely refinanced in the current lending markets and may produce further NPLs.



Source: Ernst & Young, European Non-Performing Loan Report 2011

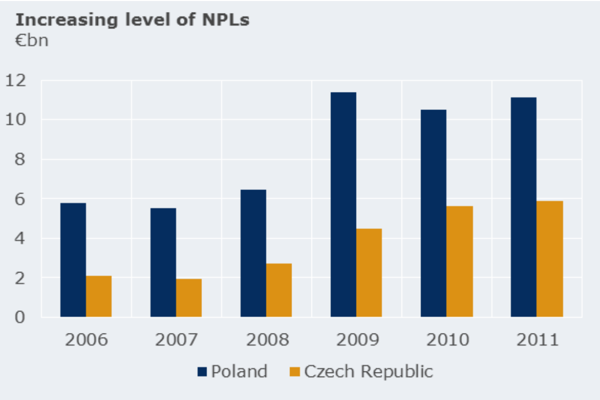


Deutsche Bank, CBRE, DTZ research

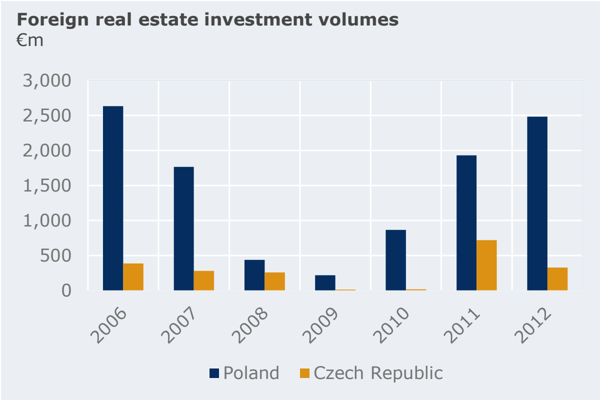
In particular, as shown in the earlier chart at the top of page 6, a **large number of foreign investors** entered the German market just before the crisis. Many of these investors did not understand the German market and had limited on-the-ground ability to manage their investments; they were also typically over-leveraged, often with debt from offshore banks for which Germany is no longer "core". As they withdraw from Germany, these offshore investors are a rich source of motivated sellers.

Poland and Czech Republic

Polish and Czech banks have experienced **rising NPLs**, creating financial pressure and potentially motivated sellers. In addition, a number of offshore banks, notably German and Austrian, were active in these markets and are now withdrawing, frequently after generating a large number of NPLs that do not appear in these statistics. Foreign investors were also extremely active in these markets during the "bubble years" and many of them are now looking to exit the markets. They have been replaced by a new generation of foreign investors, particularly in Poland, who are attracted by "core" assets with a more interesting yield than they can achieve in Western Europe.



Source: Czech Statistic Office, Poland Statistic Office



Source: CBRE, JLL, DTZ, Savills

Competition

It is hard to be very scientific about the level of competition in these markets compared to the rest of Europe. However, some general statements are probably safe to make.

There is no argument that the number of opportunistic investors who look at Poland and the Czech Republic is much lower than, say, the UK and France. For a number of investors, these countries are – wrongly, in our view – still considered "emerging" markets. Perhaps more importantly, with few exceptions, opportunistic investors are unable to source the type of deal sizes in these markets necessary to "move the needle" on a large fund. Also, if you look at the composition of their deal teams, as well as the location and composition of their offices, you quickly realize that for most opportunistic investors, these are "passport" markets. Without "boots on the ground" and experienced nationals in senior positions, it cannot be said that these investors provide effective competition. Nothing replaces the knowledge and contact networks coming from a true local presence.

Germany is a tougher argument to make, since a large number of opportunistic investors will do transactions in Germany and many have recently made the country a highlight of their investment strategy. Digging a little deeper, however, shows that much of this effort is of the "passport" type: few natives on the team, particularly in senior positions, and a limited physical presence. This contrasts sharply with a market such as the UK where, for example, 47% of the firms listed by Preqin[4] as pursuing an opportunistic or value added strategy have their headquarters in the UK; the corresponding figure for Germany is 6%. This lack of effective competition becomes even greater when large transactions are eliminated from consideration, since these are the ones that attract most opportunity funds; for routine transaction sizes, most large funds can't be bothered. Finally, it is important to remember that, unlike

[4] Preqin research website.

the UK (where London is by far the dominant market) and France (where Paris plays the same role), Germany has six major markets (Berlin, Frankfurt, Hamburg, Munich, Stuttgart, and Dusseldorf). Competition in Germany is much more dispersed.

Conclusion

In a slow-growth Europe, we believe that the mantra for opportunistic investing has to be *buy well* and *add value*. At Peakside Capital, we are therefore always on the lookout for a combination of motivated sellers and limited competition, so that the first part of this equation can be met. It is also important to find markets where a successful value adding strategy will be rewarded: where there is sufficient economic activity and tenant demand to execute lease-up strategies and where a successfully stabilized building will find a ready exit market. Looked at from this perspective, Europe offers no better opportunity than the markets of Germany, Poland and the Czech Republic.

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