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OPPORTUNITY CALLS, BUT THE TIMING IS KEY

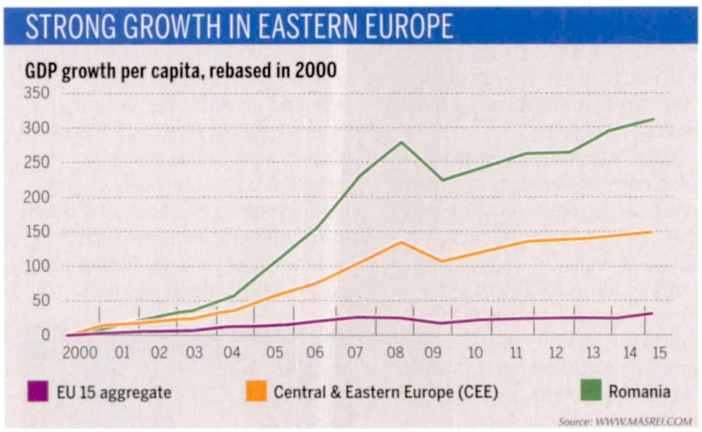
There are mixed feelings about how JSE-listed property companies' new-found infatuation with emerging countries in Central and Eastern Europe will play out, writes **Joan Muller**

When the Resilient group chose Romania as its first port of call after it had decided to expand its property portfolio beyond SA's borders in the late 2000s, many were understandably sceptical.

What did South Africans know about Romania that European and British investors didn't? And why not stick to the tried-and-tested property markets in UK, Australia and Germany, like other local real estate funds, who were also starting to build a footprint offshore?

But the group believed it had a better chance to duplicate Resilient's SA investment model of developing shopping centres in underserviced, smaller cities and towns in an emerging, underdeveloped country such as Romania than in well-supplied developed markets.

Their contrarian move into Central and Eastern Europe (CEE) via New Europe Property Investments (Nepi) paid off handsomely. Today Nepi is a dominant player in the Romanian retail market, with growing interests in Slovakia, Serbia and the Czech Republic. Since Nepi's listing on the JSE in April 2009, the share price has increased more than eightfold. The stock has also consistently been one of the sector's top performers in terms of dividend growth.



Nepi was for a long time the JSE's sole route to CEE real estate markets, but sister fund Rockcastle followed suit early last year via Poland, where it has since assembled a portfolio of six shopping centres.

In recent months, the race among SA property stocks to enter the region has hotted up considerably, with Tower Property Fund, Attacq and Hyprop Investments making acquisitions in countries such as Croatia, Serbia and Montenegro.

Last month, sector heavyweight Redefine Properties, in partnership with Pivotal Fund, acquired a 75% stake in a €1.2bn portfolio of 18 shopping centres and office blocks in Poland. The deal was the biggest offshore transaction clinched by an SA property company until then.

UK- and Germany-focused MAS Real Estate also recently announced its intention to shift its focus to the CEE region.

The key question for investors is whether local property players

Hyprop Investments' Serbian acquisition — Delta City Belgrade.

who are now pushing into that area are likely to replicate Nepi's success. Is it perhaps a case of too little, too late?

While analysts and fund managers are generally supportive of SA-focused real estate investment trusts (Reits) diversifying exposure away from the stagnating SA economy and weak rand, there is concern that some will get their fingers burnt.

A major risk is potentially overpaying for inferior assets because there is now so much new, foreign money chasing investment opportunities in the region. That's underscored by the fact that Redefine was up against 16 other bidders for the €1.2bn Polish portfolio.

"SA companies need to be careful, especially in the smaller European markets, of buying secondary assets at inflated prices," cautions Keillen Ndlovu, head of listed property funds at Stanlib. He says timing one's entry is key. "Some may be coming into the cycle a bit too late, when established investors are exiting, which is risky, particularly given the possibility of the rand [strengthening] from current weak levels."

Ndlovu says investors need to look closely at the level of gearing as well as the debt maturity and lease expiry profiles of each individual deal.

A big allure for SA-based property funds entering CEE countries is that acquisition yields exceed debt funding costs, which provides an instant boost to dividend payouts. In most of these countries, deals can be funded at interest rates below 4% while acquisition yields are typically in the 6%-8% range.

The opposite is true for SA, where debt funding rates generally exceed acquisition yields, which means that growing portfolios can be dilutive in the short term.

But Nesi Chetty, head of listed property at Momentum SP Reid Securities, says this positive leverage effect for CEE countries may well be short-lived. "We are concerned about the outlook for dividend growth beyond year one, when these transactions have been completed and the distribution kicker realised."

He notes that SA Reits operate in an environment of high inflation and annual rental lease escalations, which has in recent years translated into dividend growth of an average 7%-9%/year. In contrast, offshore property portfolios typically generate income growth of only 1%-2%/year on the back of a much lower inflation scenario, which will inevitably have a dilutionary impact on dividend payouts.

Redefine CEO Andrew Konig

"Our view is that the acquisition of foreign assets by SA-focused Reits as a hedge against local risks will result in earnings being rebased lower by 100-200 basis points."

Chetty says any strengthening in the rand will add further pressure on dividend growth, potentially diluting overall growth for SA Reits down from the traditional 7%-9% to about 4%.

At the annual SA Reit conference held in Johannesburg last month, Australian fund manager Andrew Parsons, MD of Resolution Capital, cautioned local property stocks not to make the same mistakes as their Australian counterparts, who rushed into offshore markets a decade ago only to return home with their tails between their legs.

"Many Australian Reits went offshore at the height of the boom on the back of ill-conceived investment strategies. At the time, few seemed to ask: what is the quality of the properties being offered to us and what is our competitive advantage? When the credit crises hit in 2008 and the funding tide withdrew, it was apparent that many were swimming naked, giving credence to the old adage that locals know their property markets best."

Parsons noted that in the 10 years to the end of 2014, the Australian Reit sector's offshore exposure grew from less than 3% to 45% of total assets.

The SA listed property sector seems to be heading in the same direction. Over the past five years alone, hard currency assets owned by the SA listed property sector surged from less than 5% to 36% of total assets, Stanlib figures show. The recent Polish acquisition of Redefine and Pivotal will take the percentage even higher.

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However, the comparison is perhaps not entirely justified, seeing that the Australian Reit sector's move abroad was unfortunately timed, at the top of the cycle. In contrast, most SA Reits started diversifying offshore post the 2008-2009 crash. And the CEE region is still widely regarded as undervalued. In addition, unlike the Australians, most SA funds are reducing risk by partnering with local developers, institutions and asset managers with established track records in their markets.

SA industry players are seemingly also adopting a measured approach. Redefine CEO Andrew Konig says Poland has been on the company's map for quite a while. "But we have shown restraint in making deals, waiting for the right assets and the right time." Konig likes Poland because of its stable and booming economy, which is still benefiting from post-communism upliftment programmes. "It has a young, educated and highly skilled population that is underpinning retail spend, which supports our investment strategy into Polish malls."

Konig says Redefine's commercial property acquisitions will also gain from growing demand for office and warehouse space as more international businesses, including the likes of Amazon, Google and Hewlett-Packard, relocate their back office functions to Poland.

Attacq's timing in the second half of 2015 has already paid dividends. The company realised a R420m forex gain on its R2bn Serbian and Cyprus investments for the six months ending December due to the rand's slide. Attacq has a 17% exposure to developed European markets, mostly through its 48% stake in MAS, and co-owns a number of African malls with Hyprop through Atterbury Africa.

WHO OWNS WHAT

Company	Properties	Location	Value
Attacq	7 retail centres (8.25%) 2 retail centres (48.5%)	Serbia Cyprus	€300m €198.7m
Hyprop	1 retail centre (60%) 1 retail centre (60%)	Serbia Montenegro	€202.75m
Nepi	18 retail centres; 5 office parks & 2 industrial parks 2 retail centres & 1 office park 1 retail centre 1 retail centre	Romania Slovakia Serbia Czech Republic	€1.9bn
Pivotal	10 retail centres + 8 office blocks (6%)	Poland	€1.2bn
Redefine	10 retail centres + 8 office blocks (69%)	Poland	€1.2bn
Rockcastle	6 Retail centres	Poland	€350m
Tower	4 Retail centres & 1 office tower	Croatia	€90m
Fortress*	51.8m shares in Nepi 339.45m shares in Rockcastle	Romania/Slovakia/Serbia Poland	€543.9m $762.8m
Resilient*	27.9m shares in Nepi 187.5m shares in Rockcastle	Romania/Slovakia/Serbia Poland	€292.9m $421.5m

*Indirect exposure through listed investments

Source: COMPANY FINANCIAL STATEMENTS; INVESTORS MONTHLY

Says Attacq CEO Morne Wilken: "Our strategy is the same in Eastern Europe as in SA, with a focus on quality shopping centres that dominate their catchment areas.

"We focus on capital cities, and tie up with a local partner where it makes sense."

Similarly, Marc Edwards, CEO of Tower, which has over the past eight months acquired four shopping centres and one office tower in Croatia in partnership with a local developer, believes the company has entered the region at the right time.

"Property prices and rentals have only recently bottomed out. This shift presents a significant buying opportunity given expected rental uplifts as the Croatian economy moves out of recession into positive growth."

Edwards says there will also be huge benefits for the Croatian economy when it joins the Euro currency union, which could possibly be as early as 2020.

MAS, which so far has focused only on the UK and developed

Attacq CEO Morne Wilken

European markets, including Germany and Switzerland, is now looking for development opportunities in Romania, Poland and the Czech Republic.

MAS is entering the region via a strategic alliance with Prime Kapital, led by Martin Slabbert and Victor Semionov, former Nepi directors who have built a formidable track record during their previous tenure at the Romanian-focused fund.

MAS MD Lukas Nakos says the fact that property prices in Western Europe have escalated to above 2007 peaks prompted the company to broaden its investment strategy. "Total internal rate of returns available in Western Europe is now in the 10%-12% range while [the CEE area] still offers 15%-20%. "So the latter is now a far more lucrative place for developers to be."

Nakos notes that CEE countries have undergone a major economic transformation over the past 15 years, underpinned by admission to the EU and Nato. "In relative terms, GDP per capita, wages and private consumption [in CEE countries] far outperformed the rest of Europe in recent years and is expected to continue to do so. That's creating plenty of opportunities for developers to replace old property assets with modern retail, office and industrial schemes."

Hyprop CEO Pieter Prinsloo says the company likes the region, as these countries are emerging markets that offer a similar investment model to that of SA. Earlier this year, Hyprop invested R2bn for a 60% stake in two malls, one in Montenegro and one in Belgrade, Serbia.

Prinsloo hopes to acquire at least three or four more Eastern European malls, typically at yields of about 8%. That could take Hyprop's foreign exposure close to 30%, up from the current 18% of total assets. He says new malls that were built in Eastern Europe at the height of the boom and taken back by the banks during the credit crises are only now being released back onto the market, creating buying opportunities for cash-flush foreign investors who can operate on a fairly small scale.

"The big Western European funds need scale and size and are therefore not interested in the smaller deals." Prinsloo believes SA players have the experience to unlock value through upgrades and redevelopments in the CEE retail market, which is not yet as sophisticated as that of SA.

"We have also in recent years built relationships with a number of large foreign retailers who have come to SA and are keen to expand into Eastern Europe."

Ultimately, SA property players' move into the CEE region is being driven by the deteriorating economic and political outlook in their own back yards. As Prinsloo points out: "The bottom line is that SA funds don't have a choice other than to look for new growth opportunities offshore." IM

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