



# POLISH REAL ESTATE

## LOOKING ABROAD FOR PROPERTY OPPORTUNITIES

Yields for commercial property in prime Western markets have narrowed back to levels last seen in the boom years up to 2007. In the UK, prime commercial properties such as offices in London's West End and supermarkets let to strong covenants, are trading once again at yields below 5%. The same is true of prime properties in other mature economies such as France, Germany, Netherlands and Switzerland (CBRE report, Q3 2010).

Significant rental growth is a necessary pre-requisite to justify such asset pricing because there is little room for further yield compression and interest rates can only go up from current levels.

A prime property acquired at a yield of 4%, the price of prime offices in London's West End according to CBRE (Q3, 2010), represents a negative spread over 30 year Gilts of some 0.2%, which suggests prime property is a better credit than the UK Government. If interest rates rise by 1% the rent on a property acquired at a yield of 4% would have to increase by 25% just to maintain the (negative) yield gap. And even if rents were to rise by such a significant amount in the near future, the yield would still only be 5%.

In support of the case for rental growth, economic and market data suggests a global economic recovery is underway but it and tenant demand remains patchy in most mature markets, even in London's West End. The search for yield, in such a low interest rate environment as we are currently in, has resulted in significant increases in the value of what is regarded as secure property – principally prime property in Western markets. But it is these countries which created the credit crunch in the first place which are the highest leveraged and have the furthest to go to recover. The prospect of rental growth here is at best mixed.

### NOT ANOTHER BUBBLE

Notwithstanding the examples cited above, there are undoubtedly special situations where value can be derived in these mature markets but they are the exception, not the rule.

Yields for commercial property in many emerging economies can offer a significantly higher yield at purchase and a much more certain prospect of rental growth as a result of significantly higher rates of economic growth. Of course, the execution risk in these less regulated jurisdictions can often

be greater. In addition to a potential lack of liquidity, other risks include legal, fiscal and political changes but these can be mitigated.

Forecasts concerning the sustainability of rental income are based on quantitative and circumstantial analysis and are, therefore, more certain than forecasts about the future direction of capitalisation rates. We seek to invest in well-let but higher-yielding commercial properties where there is a significant gap between the yield at which a property can be bought and the risk free rate of return – irrespective of whether debt finance is to be used. Such an approach has the added benefit of generating high cash income returns during ownership and the lack of liquidity inherent in property investment can, therefore, be mitigated.

This investment philosophy drove us offshore from the UK in 2005 when the yield gap had all but disappeared and it is the absence of this gap again that makes us nervous of the mature Western prime markets.

Back in 2005 we settled on Poland as our chosen jurisdiction in which to invest. Not only could properties there be acquired with a significant positive yield gap (often at yields well in excess of 8%) but its macro-economic outlook was very good: low inflation, high growth, capacity within the economy, low Government and consumer debt, a low current account deficit and a balanced economy. It had also just joined the EU and foreign direct investment was growing fast. In addition, it had a relatively large and well educated young population with a tremendous work ethic. All of this, coupled with the benefit of the political and legislative protective blanket of the EU made Poland a compelling investment proposition – as it still does today.

With hindsight, Fprop's strategic decision in 2005 to sell its UK property assets and reinvest in Poland has proved prescient. Of the 27 member states of the EU,

Poland is the only country not to have entered recession thus far in the credit crunch. Indeed, in 2009, its worst year of economic growth, Polish GDP grew by 1.8%. So far in 2010 it is growing at 3.4%, according to the EC, and is tipped to top 4% in 2011. According to the IMF Poland is now Europe's seventh largest economy by GDP. This favourable economic backdrop has manifested itself in the rental income of our portfolio of properties in the region. Occupiers have remained robust throughout the credit crunch and we have only had two delinquencies of any note out of some 300 tenants.

We still believe Poland is where opportunity still lies. Yields on commercial property investments in the country are some 25% to 40% higher than comparable properties in the UK and the prospect for rental growth is better.

By way of example, research by CBRE using full year comparative data for 2009, concluded that when the higher yield available on prime offices in Warsaw is combined with its much lower rental rate, the capital value payable for such space in Warsaw is some 77% lower than comparable space in London's West End.

A high running rate of income return, based on relatively low rental levels, with the prospect of rental growth and therefore capital gain, is available very close to home in the EU's seventh largest economy: Poland.

**Jeremy Barks is Marketing Director of First Property Group PLC. Funds managed by First Property Asset Management Ltd (wholly owned by First Property Group PLC) ranked No.1 versus Investment Property Databank (IPD) Polish Benchmark for the four year period to 31 December 2009, and No.1 versus IPD CEE Benchmark over the three and four year period to 31 December 2008 and 31 December 2009.**



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