

THE STRAIGHT TALKING

# CURVED THINKING

REPORT



TANTALUM  
CAPITAL

ISSUE 24

September 2019

## CEE-ING OPPORTUNITY?



A consistently soft domestic economic environment has pushed several South African listed property counters to seek out higher growth opportunities abroad. Central Eastern Europe (CEE) has emerged as a favoured destination for the allocation of South African capital with over 40% of the domestically listed property sector exposed to the region as at June 2019. Following a site visit to Romania and Poland we explore the key factors at play in the CEE office and retail sectors and compare these to the South African market.

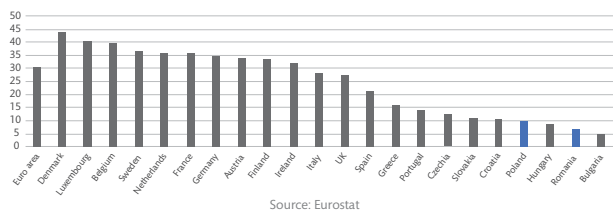
### OFFICE SECTOR

Bucharest's Floreasca Barbu Văcărescu district is a hive of activity. Located in the northern part of the city, on major metro and bus lines, Bucharest's New Central Business District is filled with cranes and construction crews. Romania has not only benefited from manufacturing by companies such as Continental, Siemens, Bosch, Dacia (Renault) and Ford in recent years, but has also become a popular IT outsourcing destination (now 40% of the leasing market) as tech-savvy graduates with good language skills are far less expensive than their Western European counterparts. The situation has been similar in Poland, which

has profited from business process outsourcing, especially in the financial services sector, with multinational audit and consulting firms choosing Warsaw as the location for their regional headquarters. Cities such as Wrocław have also become popular locations for back and middle-offices. Despite wage growth of 5.3% p.a. from 2006 until 2019, Polish wages are only 33.0% of those in the Euro area (which includes the first 19 countries to have adopted the euro), whereas Romanian wages are 22.5% of the Euro area average.

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Chart 1:  
Estimated hourly labour costs (2018)



The disparity in earnings potential in the east and the west of the continent has meant that both Poland and Romania have seen net emigration since the communist era. Consequently, both regional and multinational corporates now use attractive office space as a strategic HR tool. The modern Warsaw or Bucharest office is anything but conventional. Corporates try to create spaces to enhance employees' creativity, effectiveness and wellbeing. This could be in the form of a tranquil Black Sea inspired pause room or a 21st century-style scalextrics track.

Though not as far advanced, the trend towards more 'human-centric' offices is also evident in South Africa's premium office sector, despite slightly different drivers. In South Africa, landlords compete for tenants more than tenants (employers) compete for employees. Weak business confidence, muted employment growth and diminishing foreign direct investment have dampened the local office sector's prospects of a short-term recovery. Tenants can choose to occupy modern offices with fitness centres, plenty of meeting areas and elements of nature, both indoors and out, over those that do not offer any of these benefits. The effect is clear when comparing vacancies of poorer quality B- and C-grade offices at 14.1% and 15.8% respectively (as at June 2019) versus P-grade and A-grade offices at 7.8% and 8.9%. Despite financial pressures domestically, tenants are willing to pay up for a better offering. P-grade (premium) offices command R130/sqm higher rental on average than B-grade offices. Globally, design differences between these categories go beyond aesthetics. Green certification has become increasingly important for the types of multinational tenants across CBDs, which serve to validate the sustainability value and resource (water, waste and electricity) efficiency of buildings.



Source: Tantalum Capital

The CEE region is also benefitting from one of the most important trends in the office market across global metropolises - flexible and serviced offices. The likes of Mindspace combine serviced offices with a coworking component in a contemporary setting with amenities such as baristas, soda and coffee bars, event planning support and, of course, flexible contracts. Demand is also picking up in South Africa. Perch, Workshop 17 and WeWork (from December 2019) are some of the flex-office providers that focus on popular areas such as Maboneng, Rosebank and Cape Town's V&A.

Creating these modern offices ('flex' or not), comes at a cost. In Romania, tenant fit-outs cost around €875/sqm, with landlords contributing a minimum of €50/sqm for prime-grade offices. In Poland the cost of fit-outs can reach €1,100/sqm and landlords will typically contribute at least €200/sqm. This compares to CBD office rents of €17 - 19/sqm in Bucharest and Warsaw premium office rentals of €20 - 24/sqm per month. Excluding rent-free periods, which currently range between 1.5 and 1.7 months for every year of the lease, landlords in Warsaw are on average 'giving away' 10 months' rental in the form of fit-out

contributions, compared to roughly 3 months' rental in Bucharest. In South Africa, landlords' contributions vary greatly across nodes and are usually offered in lieu of or in combination with rent-free periods, the maximum of which can reach 2.4 months per year of the lease, or 12 months' 'free' rental on a 5-year lease.

Given significant tenant incentives demanded in the SA and CEE markets, rental growth is unlikely to be material over the medium term, as one expects tenant incentives to firstly erode before base rentals increase. Where annual rent-escalations are in effect and market rental growth lags, there is potential for negative reversions at lease

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expiry. Typically, in South Africa, office leases increase by 7.0% – 8.0% annually for the duration of the lease. Since the average market rental has only grown by 2.8% over the past year (SAPOA, June 2019), any rental that escalated by 7.0% over the past 12 months will be 4.0% higher than the market rate. The effect is compounded for every year that contractual escalations outpace market rental growth. Annual escalations in CEE are predominantly linked to extended EU CPI, which includes those Eurozone countries that do not use the euro. At about 1.5%, annual contractual rental growth seems pedestrian compared to South Africa. However, the negative reversion risk is much lower as rental growth in CEE has been stable to slightly positive, with a similar outlook over the medium term.

South African prime office yields of 8.0% – 9.5% could come under pressure as landlords strive to attract and maintain tenants and negative reversions materialise. In CEE though, the lack of rental growth does not mean that there aren't attractive investment returns to be made in the office sector. Global commercial real estate services firm JLL expects office yields in Poland's capital and key regional cities to compress from current yields of 4.5% to 5.5% to sub 4.75%/ 4.50%, as 2019 is expected to top the record volume of investment seen in 2018 (€2,777 million). While the perception is often different, South African investors account for only 2.0% of investments across Poland since 2004, while German capital has accounted for the lion's share (33.0%), followed by the USA (11.0%) and the United Kingdom (9.0%). Foreign investment has been a key driver of the Polish property market as Polish pension funds are restricted from owning property directly. In Romania, Bucharest prime yields of 7.0% are expected to remain stable and possibly trend closer to 6.5% due to strong demand from companies in the technology and telecommunications, banking and financial services sectors, despite increasing supply of approximately 300,000 sqm to be added to a market of 3 million sqm. South Korean investors are the latest to show interest in the Bucharest office market, joining the likes of Austrian investors Immofinanz and CA Immo.

## RETAIL SECTOR

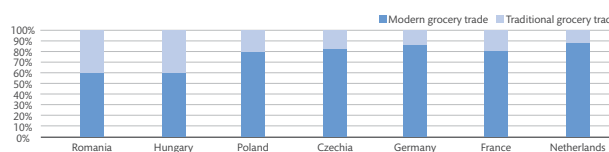
Unlike South Africa where spending power is highly concentrated to four large cities, Poland has very strong secondary cities such as Kraków, Łódź, Wrocław, Poznań, Szczecin and Tricity, each with a population in excess of 500,000 people. When considering the immediate surrounding towns and villages, catchment areas are often closer to 1 million people. EU funds under the block's cohesion policy have funded improvements and extension in public infrastructure including road and rail in Poland, accelerating growth in major regional cities. While Bucharest accounts for just under a third of Romania's total consumption, cities such as Iași, Cluj-Napoca and Timisoara are growing both in population and spending power. The opportunity to capitalise on the Romanian consumer's growth (as GDP per capita has increased 40.5% since 2010) includes capturing more of the traditional grocery trade through modern retail. Modern retail is bricks & mortar retail, versus traditional retail which is market based. Modern formats account for only 60% of Romania's grocery trade, compared to 80% in France. Accordingly, convenience retail has been the fastest growing 'modern retail' format in Romania.

Over the past five years, convenience retail (community centres of



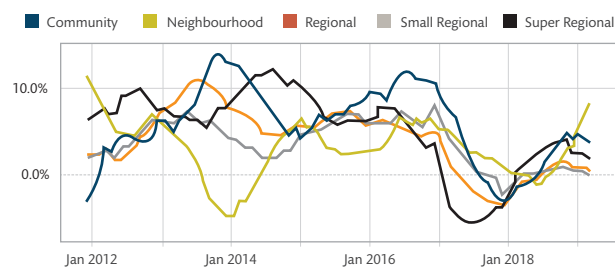
between 12,000 sqm and 25,000 sqm) have also shown the strongest trading density growth in South Africa, possibly supported by consumers trading down as household budgets remain under pressure.

**Chart 2:**  
Modern vs traditional grocery trade in the CEE (2016)



Source: Tantalum Capital

**Chart 3:**  
Annualised Trading Density Growth Trend

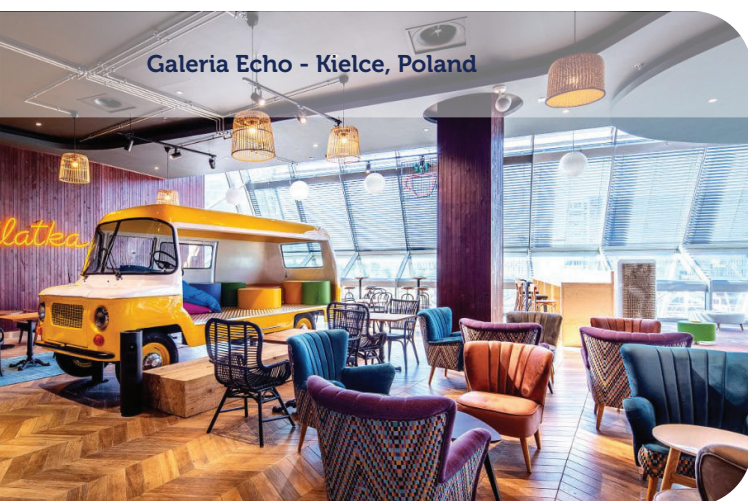


Source: MSCI Real Estate



In the large retail formats, landlords have to work harder to attract the financially strained urban shopper in South Africa and the increasingly sophisticated urban shopper in Poland and Bucharest. Much like in South Africa, CEE landlords don't generally create a differentiated offering through apparel retailers. To stay relevant, landlords are increasingly focused on improving the total customer experience. Events are becoming common and include fashion shows, live music, outdoor cinemas and comedy shows.

Tied to the entertainment component is the food & beverage offering. The food court concept has been totally refreshed in the top CEE malls. The emphasis has shifted from fast to 'slow' food – often prepared in front of customers in curated stalls, kiosks or food trucks. Plastic seating areas have been replaced by creative spaces where shoppers and diners alike are encouraged to linger. This new configuration serves Polish landlords well as the country's ban on Sunday trading (currently three Sundays a month and all Sundays from 2020) means that apparel retailers' doors are shut and that the food, beverage and entertainment offering needs to draw in customers on the last day of the week. Secondly, this enhanced offering is part of what JLL has dubbed the "Magic Triangle" of gastronomy, leisure and overall retail offering necessary to create an innovative, desirable retail centre.



The retailers in CEE are ahead of those in South Africa in offering shoppers additional benefits. Carrefour has added a virtual sommelier in their Poznań store, Empik has a digital assistant to sell books in its Future Concept stores and Polish footwear retailer Eubowie offers shoppers a virtual store through kiosks which measure feet and order the chosen product for delivery to the customer in the mall within minutes. Omnichannel approaches such as these will serve retailers well against the threat of online retail, which is low in Eastern Europe (3.0% of sales) compared to Western Europe (9.0%) but gaining traction. Online retail has greater potential to be disruptive in Poland with its well-developed Omnichannel approaches such as these will serve retailers well against the threat of online retail, which is low in Eastern Europe (3.0% of sales) compared to Western Europe (9.0%) but gaining traction. Online retail has greater potential to be disruptive in Poland with its well-developed,

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infrastructure, compared to Romania that still lacks national highways across large parts of the country. Less than 2.0% of retail sales in SA are made online. While online retail has the potential to grow off of a low base, the omnichannel- and 'added-benefits' approach could assist South African retailers to strengthen their brand and maintain market share in a tough economic environment where retail supply continues to grow. Retail space of 284,000 sqm is currently in the development pipeline, adding to roughly 24 million sqm over 2,000 shopping centres. As competition for the same shoppers increase, the outlook remains weak and a clear distinction between malls will emerge.

## THE OPPORTUNITY

In South Africa, competition for retail spend and office tenants remains fierce, while there are distinct opportunities in certain CEE sub-sectors. Area-dominant shopping centres with a high-quality gastronomy, leisure and overall retail offering should be able to capture their share of strong GDP growth expected to continue in both Romania and Poland. The roll out of modern convenience retail in Romania presents an additional opportunity. The potential for capital profits in Warsaw and Bucharest's office markets seems high and is increasingly attracting international interest. Though each of the South African-led investments into CEE present different opportunities and risks and the fundamentals of each property determine its attractiveness, the decision for major SA-listed landlords to allocate capital to CEE and away from South Africa appears clear-cut. The direction of capital flows is unlikely to turn in the near future.

