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Risks and Rewards of Leverage in Romanian Real Estate Investment

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Abstract

Emerging markets real estate performance is nowadays heavily affected by lack of investor confidence, risk perceptions, increasing cost of finance and finally market fundamentals. In turn, banks have looked away from real estate as their balance sheets are loaded with non-performing commercial real estate loans. While the blame for debt excesses is being placed on one party (banks) or another (investors) we take an in depth look at a real estate development company active in Romania in order to understand the effects of leverage. We are trying to answer basic questions in real estate investment, in a Romanian context: is there an intrinsic need for debt financing in real estate? What should be considered a sustainable level of debt in an emerging market such as Romania? What are the risks stemming from too much debt and how should they be managed? The conclusions are limited by the focus on a single company but the company is what could be called a representative case for the Romanian investment market.

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Keywords: Romanian Real Estate; Risks, Leverage, Financing

1. Introduction

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The last real estate driven financial crisis has been thoroughly investigated and conclusions were drawn about behavioral economics, interest rates, risk management and many other interesting subjects. Romanian real estate, as a phenomenon at the frontier of the Western born real estate boom, was however rarely considered for research bar for the international consultancies assisting investors in the region. Distant as it is from the center, the real estate development and investment spree worked however in much the same manner as in more mature economies, fueled by bank lending and strong demand, only that everything happened on a fast track forward during the course of, say, 4-5 years. We are trying to shed light into the rationality that led to such a fast expansion and contraction of a market that was simply non-existent at the end of the 90s by investigating the characteristics of decision making related to the projects developed by the local subsidiary of a European developer. In doing so we are trying to understand the decision making rationality at work when significant levels of debt are accessed, risks are overlooked and rewards are overestimated.

Regarding the methodology, we start by taking a look at the Romanian real estate financing market as the root of the property investment meta-narrative and move to the concrete company level approach in trying to understand the risk/reward trade-off and the consequences for the company. At company level we have conducted a series of non-structured interviews with management and operational staff in the local subsidiary and we also had several meetings with the general management of the group. We have gathered data about the projects and we had access to project calculation sheets, financing contracts, cost variance reports. We interpreted the data in relation to the wider market context.

2. Romanian Real Estate financing market

Generally speaking, real estate investment markets start developing in countries which have a stable institutional system, transparent economy, growth, liquid capital markets and stable financing and socio-economic environment. There is a wide consensus in the literature that the rapid development of the financial sector in the CEE played a major role in the growth and convergence of the real estate industries in these countries Gardo and Martin, 2010. To understand the reasons for which even as late as the end of 2008 the Romanian real estate investment market was still attractive for investors we can take a look at a construction market analysis by Deloitte, 2008, after the start of the subprime crises, quoting a number of reasons which make the CEE real estate market attractive for foreign capital:

- low vacancy levels in commercial real estate, as an example Romania and Bulgaria standing at 5% for prime office locations.
- in the retail sector, an existing stock below the levels of European average, with a Romanian average at 25 sqm/1000 inhabitants while Poland had 142 sqm, Spain 248, Netherlands 319 and the EU 27 average standing at 205 sqm.
- the hotel sector experienced a steady increase in the number of tourists for years (annual increase between 2000 and 2007 standing at 4.7% compared with European average at 2.7%)
- in the industrial sector, the demand for industrial spaces was on the rise following growth in commerce, infrastructure development and transit of goods between Eastern and Western Europe.

As a newly arrived member in the club of countries that were targeted by international real estate investment, Romania had a less sophisticated range of financing products- mainly straightforward mortgage loans. The products available in Romania were in a way maybe closer to the German financing market, for years dominated by pure mortgage lending Ilblher and Lucios, 2003 -in this case probably due to the conservative nature of the financial system. In early 2000 conditions were set for Romania to be on the way towards a steep aggressive development of the real estate financing sector. In the beginning the residential market saw what was perceived as an exotic product - widely available mortgages - and asset prices responded quickly to the liquidity splash. Subsequently the commercial real estate sector, still in its infancy at the end of 90s, saw the first commercial developments financed with the help of the classic combination between equity and bank loans. In relative terms, while the markets of Poland, Check Republic and Hungary where already