

Summary of the Operation Performance Evaluation Review (December 2008)

The project

In December 2001 the European Bank for Reconstruction and Development (EBRD) approved an investment operation to a real estate development and management company in the amount of €105 million. This amount was split into an equity commitment of approximately €26.3 million and quasi-equity (a subordinated shareholders loan) of €78.7 million.

The EBRD's investment had two components:

- the acquisition of a 35 per cent stake in the asset management company's existing real estate portfolio for an amount of €36.7 million
- new investments, supported by the remaining portion, on the basis of 65 per cent of equity contributed by the bank and 35 per cent by the EBRD.

The fund was established with the objective to further expand real estate investment activities in more EBRD countries of operations. An investment committee with four representatives (two from the bank and two from the EBRD) was established to implement the policies and approve specific proposals that would meet the investment criteria.

The operation encompassed the following goals:

- further development and expansion of the asset management company's portfolio
- regional diversification into new countries
- diversification into new real estate market segments, such as business parks, distribution/warehousing, retail and leisure
- diversification of activities into new development projects.

Project rationale

The EBRD's involvement was motivated by the desire to contribute through specific investment guidelines in order to achieve a higher transition impact. It was also expected that the Bank's involvement would create more liquid secondary domestic and regional property markets. At that time this was considered one of the key transition challenges in the property sector of the advanced countries of operations.

Achievement of objectives

The OPER team rates the overall achievement of the Bank's project objectives as *Good*.

Development of a portfolio of 15 to 20 assets including development and investment assets in the region (Fully Achieved)

Over the five-year investment period the portfolio grew to 27 projects with a total asset value of about €1 billion (this includes the 2001 buy-in portfolio of 11 sub-projects plus the 16 sub-projects newly approved by the investment committee). The total capital committed towards the operation has been fully utilised/earmarked for investment committee approved sub-projects.

Development of liquid secondary property market in the region (Achieved)

The total investment volume of the operation, including the two sub-portfolios that were sold in 2005 and 2006, amounts to approximately €1 billion. This represents around 2.5 per cent of cumulative overall market volume as of 2007 in the Central and Eastern Europe (CEE) region. The strong decrease in the operation's market share since 2001 indicates the growth of both primary and secondary CEE real estate markets in the last seven years.

Through the fund's portfolio of real estate developments and the completion of two large portfolio divestments, the company played a key role in the expansion of the CEE real estate market volume. The fund helped increase the confidence of institutional investor in real estate in the region. This objective was rather ambitious, and there were various other market participants and key events (like the expansion of the European Union) which provided the basis for the large growth.

Portfolio expansion into secondary cities, new countries and new developments (Fully Achieved)

The investment committee of the asset management company has ensured that the diversification targets (as defined at the time of Board approval) of the portfolio have been achieved. At the end of the investment period in 2006, around 31 per cent of assets were invested in offices, 44 per cent in business parks, 17.5 per cent in logistics and 7.5 per cent in retail.

The portfolio was significantly expanded outside the Tier A markets, and 43 per cent of the funds were allocated into Tier B countries. The objective of achieving a well-balanced portfolio across sub-sectors as well as Tier A and Tier B countries has been achieved in full.

Long-term capital appreciation (Fully Achieved)

This objective encompassed an internal rate of return (IRR) target of 9 to 17 per cent at project level and of 15 to 25 per cent at equity level. It is expected that the overall cash IRR on the operation portfolio will be in the order of 20 per cent. This expectation is based on

- the successful sale of two sub-portfolios to large property investors in 2005 and 2006
- the anticipated full exit of the remaining 50 per cent of the equity portfolio by the end of 2009.

This would compare well to the IRR target at the project level of 9 to 17 per cent at the time of Board approval.

Overall assessment

The *Successful* overall performance rating is based on the Evaluation Department's (EvD) internal methodology, which takes into account transition impact (*Good*), achievement of objectives (*Excellent*), environmental impact (*Excellent* performance, *Some* change), company and project performance (*Good* and *Excellent*), Bank handling of the project (*Good*) and investment performance (*Good*).

Transition impact and additionality

The OPER team rates the project's overall transition impact as *Good*. The operation has achieved, and in some cases exceeded, the objectives as presented at the time of Board approval.

In particular, the operation was one of the early real estate funds in the EBRD's countries of operations. Thanks to the EBRD's participation it gained a momentum that was big enough to have a relevant impact in the various target markets.

The EBRD fulfilled its additionality requirement. The sponsor had reached its maximum investment limit and depended on the EBRD's help because it could not increase the investments to a properly sized fund (over €1 billion) by itself. The EBRD's additionality can also be seen in the provision of equity for greenfield development projects and transactions in Tier B countries. Equity funds for Tier B countries were not yet readily available from commercial sources at the beginning of the operation's investment period.

The EBRD also refinanced a portion of the existing portfolio of the fund (acquisition of a stake of 35 per cent for €36.7 million). This portion of the EBRD's operation had no additionality since it was merely a refinancing. Considering both components of the EBRD's operation, additionality is rated as *Verified at Large*.

Bank handling

The EBRD's property and tourism team selected a sponsor/co-investor with a sizeable existing portfolio and a proven track record in the market. The client was receptive and willing to consider the EBRD's requirements and constraints in order to achieve growth. In light of the sponsor's existing, relatively conservative shareholders, this would not have been possible at that time.

The client welcomed the various EBRD contributions to the structuring of the fund. It also appreciated the ongoing constructive cooperation with EBRD representatives in the investment committee (where the EBRD had secured full veto rights).

Bank handling is rated as *Good*.

Main OPER issues and lessons learned

Balancing immediate cash flows and security considerations with the desire to allocate all EBRD resources to high priority projects in countries of operations

The Bank's property team structured this investment operation in a particular way. It first bought a 35 per cent share of the fund's property portfolio. The Bank subsequently participated with 35 per cent in a future project pipeline. This was in accordance with the new focus of the investment criteria stressing more diversification.

One could ask why the EBRD should buy into an existing portfolio at its own request, rather than allocating all its limited resources to projects in the target areas as recommended in the new investment committee guidelines. The client explained to the OPER team that this was a specific request from the EBRD and that the fund had no particular preference. The OPER team is of the view that this reduced both transition impact and additionality of the Bank.

Lesson

The project structures proposed in the Board report should more clearly spell out conflicts between various objectives:

- risk taking

- security requirements
- quick disbursement of EBRD operations
- maximum impact of EBRD operations.

A Board report should spell out structuring choices in more detail and explain why a specific mix of refinancing and new project pipeline (as in this case) was selected. The objective of achieving maximum effect through EBRD-supported facilities might be better served by not buying into an existing inventory of real estate projects that have already been financed.

Other EBRD guidelines regarding credit risk and the possibility to syndicate may conflict with the transition objective. Adequate explanations should be provided why a particular structure is chosen and whether the structure is requested by the EBRD or by the client.

Addressing specific sector framework issues via technical cooperation (TC) and/or joint operations

The EBRD is expected to target transition impact both directly through the project and through additional efforts (possibly TC operations) that address general sector issues or information shortfalls.

For example, the EBRD could have teamed up with a specialised company and jointly set up a useful market index based on market size and a set of relevant criteria. These could have also included investment climate and other pertinent factors. A case in point is the Investment Property Databank (IPD) index for central and eastern European property which has been published since 2005. The fund would have liked to receive more real estate market information from the EBRD regarding opportunities in different markets. They also thought that other market participants would have appreciated this information.

Lesson

Transition impact can be enhanced by addressing specific sector issues that affect potential market participants. Enhancing transition impact by including further components in a project operation is an important task of an international finance institution (IFI). Private sector initiatives may be limited to specific investment operations and may not be able to properly address specific sector shortcomings such as the lack of information.

An EBRD investment operation can enhance competition and provide demonstration effects. However, it is very important that the structuring teams search for additional sector framework contributions. These can be delivered through a TC operation that facilitates the set up of such a system. It could also be delivered through a joint venture with an international company active in the field as this would provide incentives to go further into the regions.

In this case the client suggested that the creation of a real estate market index in 2001 would have improved the flow of information. Such an index could have:

- corrected information bottlenecks for all market participants
- significantly enhanced transition impact.
- provided the EBRD with feedback for the periodic review of its strategy in this sector.

Flexibility of investment criteria at the time of Board approval

The investment criteria were defined in great detail upfront. There are a number of questions that need to be considered:

- To what extent does it make sense for the EBRD to force the fund into shallow markets?
- Is the EBRD willing to accept lower returns for that?
- Should such investment criteria be reviewed regularly, for example, every two years?
- Should investment criteria be reviewed each time a new fund is created by the EBRD with a new Board decision?

Lessons

Periodic review of investment criteria of real estate fund

The EBRD may need to periodically review detailed investment criteria prescribed at the time of approval of a real estate fund investment. This is particularly important in fast changing markets with strong downward pressure on yields. The client is of the view that projects in regional cities often pose bigger challenges than projects in capital cities.

In regional cities it is often more difficult to raise debt. Furthermore, development is more difficult because a less “sophisticated” municipality may need more support from the developer. In addition, it may also be more difficult for the developer to exit after project completion.

Enhancing regional real estate development efforts through combined approach by different Bank teams

Regional real estate development goes beyond normal fund management activity. In some cases this may require support from the banking team, which provides debt, the infrastructure team, which assists in the contacts with local and central government, and the energy efficiency team.