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HEITMAN

PERSPECTIVE

Central & Eastern Europe and the Financial Crisis

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Stock investors now spend less time with companies' income statements and more time with their balance sheets, looking for ticking debt bombs. In the same way, investors in international real estate must expand their analysis of countries beyond GDP growth prospects (the income statement) to include issues such as balance of payments and levels of debt (the balance sheet). Countries with the strongest balance sheets are expected to best weather the current economic crisis, and to emerge from it most quickly and vigorously.

In the long-run, Central and Eastern European (CEE) countries have favorable prospects as their lower cost of labor helps to generate catch-up economic growth. Most CEE countries boast an accompanying structural need for more and better office, industrial, residential, and retail space.[1] But at the moment, the financial crisis appears to have overshadowed any expectation of favorable outcomes, leaving perceptions of the CEE region skewed by the headline-grabbing troubles of the least stable, most vulnerable countries, such as Ukraine and Latvia. There is, however, wide variability among these countries in the health of their national balance sheets. How does one evaluate a country's financial strength and stability? We present a summary of Heitman's approach in the pages that follow.[2]

We analyze the degree of systemic risk evident in CEE countries, classifying them into three categories based on variables related to their income statement (i.e., GDP growth), balance sheet (i.e., current account deficit) and political stability:

- **Relative Stability** (RS): Countries in this category have the least susceptibility to the global financial crisis. They include Poland, Czech Republic, and Slovakia.
- **Moderate Risk** (MR): Croatia, Estonia, Hungary, Lithuania, Romania, Russia and Slovenia have characteristics that raise concerns regarding macroeconomic and financing risk, but also have mitigating factors that provide some offset to these risks.
- **Downside Exposure** (DE): Ukraine and Latvia have shown the greatest vulnerability to refinance risk and most potential for further downside.

We then propose real estate investment strategies appropriate for the current environment, with a focus on managing risks. Here we note that a Relative Stability classification is not an automatic buy recommendation for all assets in this country. Careful due diligence on an asset and its competitive position are prerequisites for any acquisition recommendation. Similarly, we will occasionally consider an acquisition within a country with a Downside Exposure rating. However, we expect these to be rare; we will approach prospective investments in the DE countries with great caution and the hurdles will be higher. The real estate characteristics, including quality of location, design and construction, and tenancy, must be best in class. In such investments, we will seek to mitigate risk through structuring mechanisms agreed to by sellers and joint venture partners.

The real estate capital market environment has undeniably changed. Debt availability is lower; investment transaction activity in 2008 relative to 2007 decreased by 53% throughout Europe and by 37% in CEE, according to CBRE. As a result, a number of tactical approaches are appropriate in addition to the strategic considerations involving market targeting. For example, we anticipate buying assets from distressed owners of real estate that face pressure from lenders, or eventually buying distressed assets themselves. There are also opportunities to establish joint venture partnerships with top-quality real estate operators and developers. Larger transactions may be available on more favorable terms, given the acute lack of debt capital. All of these tactics involve taking advantage of the current market situation to achieve more favorable pricing and downside protection.

The Income Statement: GDP Growth to Exceed Eurozone Rate

Growth in CEE countries will flirt with zero, or worse, in 2009, according to the Economist Intelligence Unit (EIU). Some countries, such as Latvia and Ukraine, are expected to suffer dismal GDP performance, while others, such as Poland and Slovakia, appear likely to muddle through with modestly positive growth despite recession-like conditions.[3] Taking a longer view, growth over the next five years will slow relative to the prior five years, although nearly every CEE country listed is expected to outpace the eurozone average.

Gross Domestic Product 2004-2013

	GDP (billions)	GDP Growth (CAGR)				GDP per capita
	2008	2009	2010	2004-2008	2009-2013	2008
Bulgaria	$51	-0.6%	1.2%	6.2%	2.5%	$6,750
Croatia	$61	0.4%	1.8%	4.2%	2.7%	$13,520
Czech Republic	$216	-2.0%	1.6%	5.4%	2.2%	$21,170
Estonia	$25	-5.0%	1.1%	6.0%	1.3%	$18,570
Hungary	$154	-3.0%	0.4%	2.9%	1.3%	$15,470
Latvia	$34	-12.0%	-2.0%	7.2%	-1.2%	$14,980
Lithuania	$47	-8.0%	-2.5%	7.0%	-0.3%	$14,090
Poland	$528	0.7%	2.2%	5.3%	2.7%	$13,860
Romania	$196	-1.8%	3.1%	6.8%	3.4%	$9,140
Russia	$1,671	-2.0%	3.0%	7.0%	2.9%	$11,790
Slovakia	$88	2.0%	2.8%	7.5%	3.7%	$16,130
Slovenia	$55	0.5%	1.5%	5.1%	2.4%	$27,580
Ukraine	$180	-6.0%	2.0%	6.4%	1.8%	$3,900
Eurozone	$13,589	-2.5%	0.0%	2.1%	0.4%	$41,920
France	$2,864	-2.5%	0.0%	1.9%	0.5%	$46,240
Germany	$3,663	-3.3%	-0.2%	1.7%	0.2%	$44,290
Italy	$2,306	-2.5%	0.0%	0.9%	0.0%	$39,660

Source: Economist Intelligence Unit; Heitman Research

Forecasts of GDP growth have shown remarkable decreases in a short period. For example, the EIU forecast for Latvian GDP growth fell from 3.0% to -12.0% in just over six months. The Latvia example points out the difficulty of making accurate forecasts about economic activity, with inflection points and

1 Heitman has documented the secular growth prospects and fundamental undersupply of real estate in the region in other published research. See for example, David Watkins, CFA and Gordon Black, "Russia: An Introduction for Prospective Investors," Heitman Perspective, February 2008.
2 A longer white paper version of this article, "Varying Prospects in Central & Eastern Europe: A Country-Level Approach to Real Estate Investment Strategy in Turbulent Times," which provides a more comprehensive analysis, is available upon request from Heitman.
3 Heitman's rule of thumb is that growth of less than 2.0% in the CEE region represents a recession.

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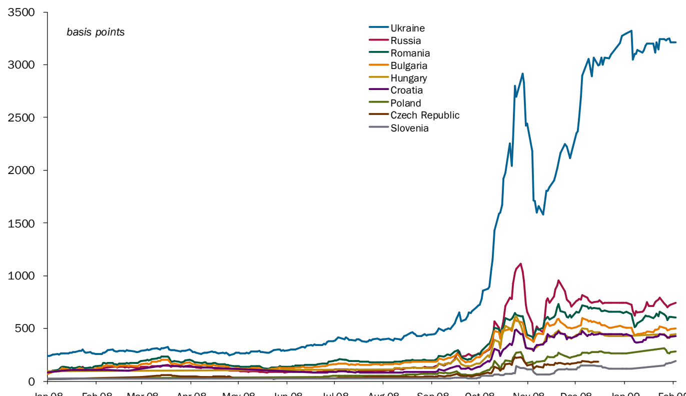
steep upward or downward movements being the most challenging periods. While the entire world suffers from poor credit conditions and weak demand, imbalances in certain CEE countries' balance sheets lie at the root of the lowered expectations.

The Balance Sheet: Markets See Heightened Risk

Spreads on sovereign credit default swaps (CDS) provide a real-time, market-based indication of country risk.[1] CDS spreads remained low and fairly stable in CEE through September 2008, but going into October, countries with large fiscal and economic imbalances (particularly those with a need for external finance), saw large increases in CDS spreads. Spreads declined since late October 2008, after the announcement of IMF, World Bank, and ECB aid in the region, although they shot up again in late November and have since stabilized at a higher level.

Sovereign CDS Spreads (5-year protection)
CEE Countries 1 Jan 08 - 2 Feb 09



Source: CDS indices; Heitman Research

Despite their usefulness as thermometers, CDS spreads do nothing to indicate why a country is risky. We examine several interrelated economic factors—the need for external finance, currency stability, and banking sector health—in an effort to answer this question.

The Need for External Finance

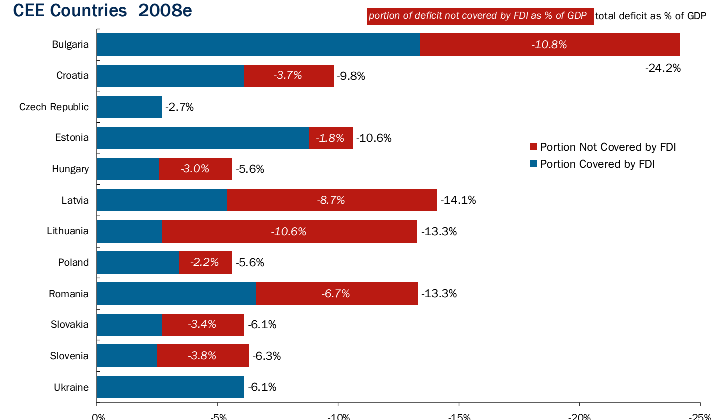
As is the case for companies, countries that face shortfalls of current income against current spending must finance those gaps with a capital infusion. For countries, the indicators and relationships that govern these flows are called the balance of payments. A deficit (more imports than exports) in the current account balance must be financed by a net inflow of capital. If a country is able to attract sufficient outside capital to cover its current account deficit, consumers, businesses, and governments may spend and invest beyond their own current resources, under the presumption that future growth will allow them to pay back the debt they take on.

This works well as long as the capital continues to flow in. However, an external shock, such as a global credit crisis, can lead to an abrupt end to capital inflows. The economy then faces a sudden lack of financing, derailing growth and curtailing consumption, investment, and government spending. Furthermore, if inflows of capital are insufficient to finance the rollover of the nation's existing debt, the slowdown will be even sharper, as resources that would have contributed to current growth are diverted to cover past growth.

However, not all capital inflows are created equal. The most reliable form of foreign capital inflow is foreign direct investment (FDI). Because FDI consists of investment in real assets like property, plant, and equipment—for example, the establishment of a Volkswagen automobile plant in Slovakia—the chance that such capital will quickly flee a country is minimal. The portion of a current account deficit not financed by FDI, then, must be covered by bank lending and other shorter-horizon types of capital.

The following chart illustrates current account deficits in each CEE country, with the red portion of each bar representing the portion of its deficit not covered by FDI. The more red in the bar, the more the country relies on external finance other than FDI. Russia does not appear on this chart because of its current account surplus in 2008, although it is likely to have a negative current account balance in 2009 due to the decrease in the price of oil and other natural resources. Looking at the current account balances, Bulgaria, Romania, Latvia, Lithuania, and Estonia appear most at risk; Czech Republic, Poland, Slovenia, Hungary, Ukraine, and Slovakia have stronger positions.

Current Account Balance as % of GDP
CEE Countries 2008e



Source: Economist Intelligence Unit; Heitman Research
Russia and Eurozone not shown, as they have non-negative current account balances.

A more fine-grained look at the balance sheet and external financing needs of countries is necessary to see which sectors of the economy–governments, businesses, consumers– are the most at risk in each country. The source of the larger imbalances has important implications regarding the risks in each economy.

1 Although technically they indicate the risk of default on a government's debt, CDS spreads also serve as summary indicators of investor sentiment toward a country. If a government's default risk has increased, the risk of other assets in the national economy has likely increased as well.

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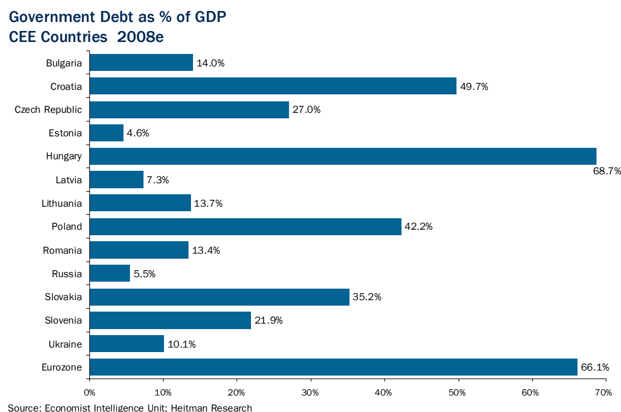
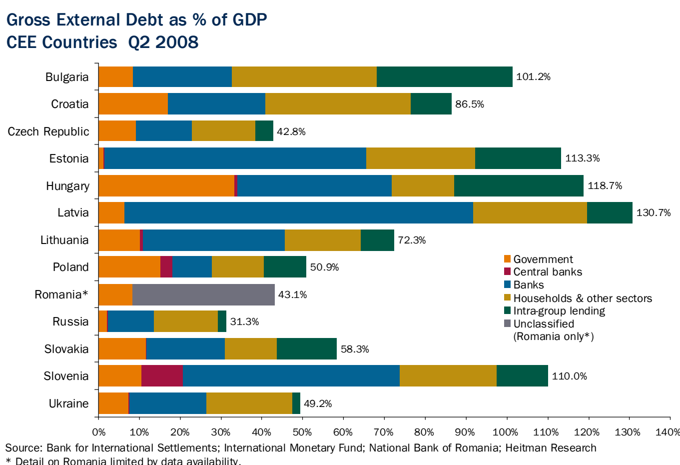
Governments that run budget deficits generate a need for capital to finance the deficit, burdening their economies by pushing up interest rates and absorbing capital inflows. Sustained deficits lead governments to accumulate a large national debt, and those with heavy debt burdens are constrained in crisis situations because they will be less able to deliver the appropriate fiscal stimulus. They will also be more vulnerable to political instability created by service cuts, lower social transfer payments, or higher taxes.

The chart below shows total government debt as a percentage of GDP for CEE countries, compared to the eurozone. Hungary has the highest level, matching that of the wealthier, more stable eurozone. Croatia's debt level flashes a warning signal as well. Bulgaria, Estonia, Latvia, Lithuania, Ukraine and Russia have the most conservative levels of government debt.



Source: Economist Intelligence Unit; Heitman Research

Government debt alone does not provide the whole picture. Households and businesses can contribute substantially to a country's external debt burden—the portion of debt owed to creditors in other countries. A large external debt balance suggests dependence on outside capital and adds to financing risk. The following chart shows the amount of gross external debt owed by various sectors of the economy. Adding the other sources of debt illustrates the extent to which Bulgaria, Estonia, Hungary, Latvia, and Slovenia have run up IOUs to foreigners. Czech Republic, Poland, Romania, and Russia had external debt of less than 50% of their GDPs, a more sustainable level.

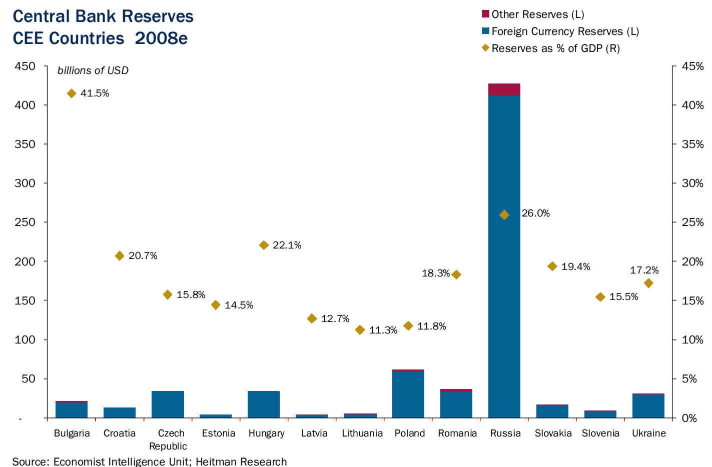


Source: Bank for International Settlements; International Monetary Fund; National Bank of Romania; Heitman Research
* Detail on Romania limited by data availability.

The Foreign Exchange Effect

Most CEE economies face one of two situations: Either their currencies are experiencing significant downward pressure and volatility, or their pegged currencies inhibit an effective response to the economic crisis by constraining the tools of monetary policy. And given diminishing central bank reserve resources, some countries may have to devalue their currencies, which would spell trouble for borrowers who took out foreign currency loans.

Central bank reserves – whether used for constant FX intervention (maintaining a currency peg) or for selective intervention (defending a floating currency against speculative attack) – support a country's currency. Hard currency reserves allow a central bank to boost the local currency by selling foreign currency and buying the local one. The chart below shows central bank reserves, in absolute terms (on the left scale) and relative to the size of the economy (on the right scale).



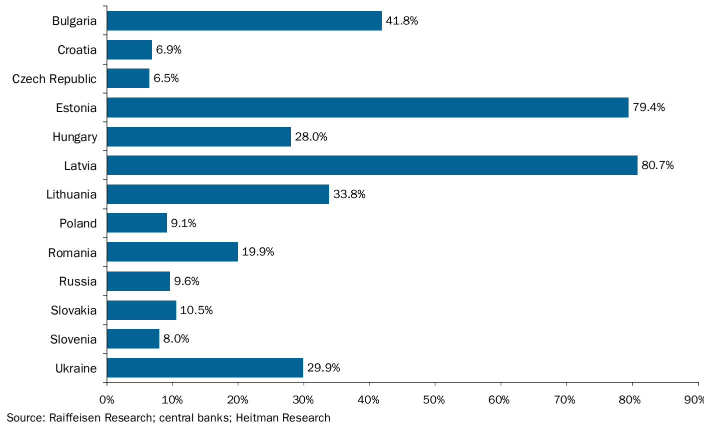
Source: Economist Intelligence Unit; Heitman Research

It is important to note that these data are estimated annual average levels and so do not reflect recent dynamics. For example, Russia's reserves decreased by $128 billion (to $455 billion) from August 2008 through the beginning of December, as the government bought rubles to support the currency even as it allowed the ruble to depreciate by more than 30% against the dollar. Russia faces current difficulty but has the benefit of its accumulated reserves, allowing an orderly transition to a weaker foreign exchange rate.

Foreign Currency Debt

A primary foreign exchange concern for CEE countries is the denomination of debt in foreign currencies. When exchange rates were stable and debt finance was plentiful, consumers and businesses in CEE found it advantageous to borrow in foreign currencies. They likely assumed that exchange rates would remain stable for the term of their loan, and therefore saw little downside to borrowing in euros or Swiss francs. Further, many likely monitored reports that suggested their countries would soon join the eurozone, rendering moot any currency mismatch.

For their part, many foreign banks likely did not fully consider the risk of lending to a borrower who is paid in a currency other than the one in which their loan is denominated. As a result, the foreign bank loaned at interest rates lower than those available from local banks in local currency. A meaningful number of borrowers opted to take advantage of the lower interest rate, generating large currency risks in aggregate. The next chart indicates the total outstanding loans in each country denominated in foreign currencies (as a percentage of GDP).



Countries with the largest exposure to loans in foreign currencies—Latvia, Estonia, Lithuania, and Bulgaria—tend to be those with currency pegs. This makes sense, given that borrowers expected no risk in taking on debt in a currency with which their own maintains a constant relationship. But recently the risk that CEE countries with pegged currencies will have to abandon their pegs has increased, as countries with low levels of central bank reserves and currency board regimes may come under both market and institutional pressure to abandon their currency boards. Peg abandonment raises the possibility of a wave of defaults on foreign currency loans at a time when many sectors of CEE economies are already strained. The consumer and housing sectors would be hit hard. As a result, politicians in CEE countries are likely to view the abandonment of a peg as an option of last resort.

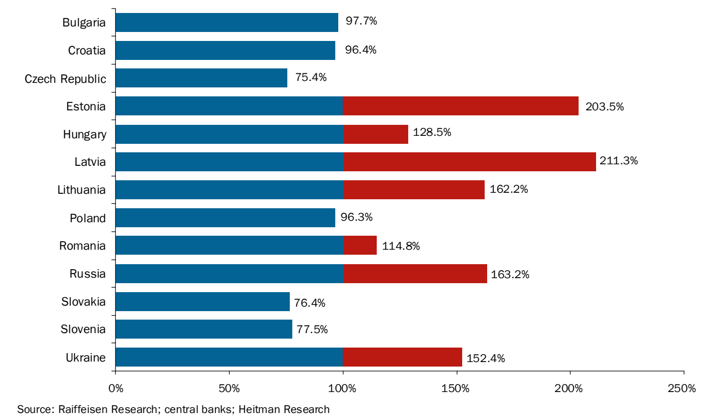
Meanwhile, countries with floating currencies and high exposures to foreign borrowing have already been punished by the market. Hungary, Romania, and Ukraine—CEE countries with floating currencies—face the greatest risk from foreign currency borrowing. In Hungary especially, many homebuyers took on mortgages in euros, Swiss francs, and Japanese yen. Lenders, either on the order of their own risk managers or that of government authorities, have largely stopped offering credit in foreign currencies. But the risk from the existing stock of foreign currency debt lingers.

Banking Systems at Risk

Much of the news surrounding the credit crisis centers on developed country banks with exposure to toxic asset-backed securities and derivatives contracts. Once viewed as weak, the less sophisticated, locally-owned banks in CEE now benefit their home countries, as these institutions tend to have little, if any, exposure to the toxic securities hurting the large Western banks. The local banking subsidiaries of major international and global banks, once viewed as forces of modernization and growth, may actually be less-willing suppliers of credit than local banks in the near-term. The outcome will largely depend on whether multinational parent banks are willing and able to provide their local country branches with capital.

One way to measure the health and prospective stability of a country's banking sector is to look at the relationship between the value of the loans on its books and the customer deposits it holds. Banks that have loaned more than the deposits they hold are dependent on other forms of funding including short-term and foreign capital. This makes it less likely that they will be able to continue supplying credit in the short term. Banks whose deposits exceed their loan books exhibit greater stability and are better positioned to continue to supply credit. However, this does not mean they will elect to provide credit, especially given the perception of universally higher default risk.

The following chart shows the ratio of loans to deposits in CEE banking systems; the red portion of the bars indicates loans not covered by deposits. The countries most at risk from their banking exposure include Estonia, Latvia, Lithuania, Russia, and Ukraine; those with the strongest positions include Czech Republic, Poland, Slovakia, and Slovenia.



Summing Up: Country Risk Scoreboard

We rank the relative risk of each element of the balance sheet, income statement and political situation by country, using Relative Stability (RS – depicted in blue below), Moderate Risk (MR – depicted in light blue), and Downside Exposure (DE – depicted in yellow). Quantitative data and qualitative considerations enter the analysis and affect the resulting two-dimensional matrix, which we call the risk scoreboard. Strong countries cluster in the RS category and weak countries in DE; the ones in the middle default to MR. We then weight the

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individual factor scores to create a composite score that determines a country's classification. The weights[1] of each category represent the relative importance of that category to overall country risk.

As indicated below, Latvia and Ukraine fall in the Downside Exposure category as the countries most at risk in the current financial crisis. Czech Republic, Poland, and Slovakia appear best insulated and merit the Relative Stability designation. The remaining countries rank in the middle, Moderate Risk category.

The analytical process that led to the risk scoreboard holds implications for real estate investors in the CEE region. Heitman will spend most of its energy targeting investment opportunities in Relative Stability countries.

But we are likely to extend beyond the RS countries in certain circumstances. In the 1990s, Heitman's North American investment advisory unit initiated a quantitative market targeting process to rank US metropolitan areas. The resulting focus markets offered attractive investment opportunities, but we soon realized the practical limitations of completely eliminating certain markets from consideration.

Asset-specific factors, submarket conditions and transaction structuring can overcome many market concerns. We also saw attractive portfolios that included properties in non-targeted markets. A pragmatic approach evolved that acknowledged the market-level concern but proceeded with the transaction if mitigating factors were present. Likewise in CEE, we view the categorization process as an important tool to help identify and price risk at the macroeconomic level. A thorough and nuanced real estate analysis considers macro-conditions, but micro-level factors play an important role.

In short, a country classification of **Downside Exposure** means that Heitman will approach prospective investments with greater caution and that hurdles will be higher. That means acquisition of prime properties in prime locations and structures such as earnouts that mitigate risk. Similarly, Heitman will consider partnerships with successful, well-known entities in which the JV partner absorbs the first losses and the investor receives a preferred return. The expected returns, moreover, must be sufficient to compensate for the increased level of risk as indicated by the country's rating.

In the same way, a **Relative Stability** categorization does not mean that we will buy any and all assets in the country. RS simply means that the country's risk is less and the country appears better positioned to emerge from the global crisis at a relatively early stage. In an RS country, Heitman will use discretion to select appropriate assets with favorable locations and characteristics likely to appeal to users of the space for the long term. We will underwrite and control real estate risk, demanding appropriate returns for our clients' capital.

The **Moderate Risk** classification serves as the default category; absent compelling reasons to place the country in RS or DE, a country stays in the middle. Investment opportunities in MR countries will face scrutiny similar to those in DE countries, but the required return will fall somewhere between those offered in RS and DE countries.

Strategic Implications

Despite the current crisis and heightened short-term risks, both catch-up growth and secular economic growth-related demand are likely to remain characteristics of the CEE real estate market. These factors continue to distinguish the region from Western Europe, and support the case for continued long-term investment in CEE property. In the near term, greater focus on risk control means that the development pipeline is expected to shrink significantly, however, as developers, bankers and investors elect not to pursue projects with less certain outcomes. The pattern of continuing expansion of inventory is likely to be interrupted, with favorable implications for owners and investors of existing assets in the region.

But the global financial market crisis has created turmoil and distress, with the CEE region not immune from the challenges. At the same time, distress means an opportunity for strong real estate market participants with discipline to earn favorable returns. Heitman has been monitoring the situation and recommends acting in a cautiously

CEE Risk Scoreboard

	Bulgaria	Croatia	Czech Republic	Estonia	Hungary	Latvia	Lithuania	Poland	Romania	Russia	Slovakia	Slovenia	Ukraine
INCOME STATEMENT													
GDP growth	MR	MR	MR	DE	DE	DE	DE	MR	MR	MR	RS	MR	DE
Market size	MR	MR	RS	DE	RS	DE	MR	RS	RS	RS	MR	MR	RS
Growth forecast dispersion	RS	MR	DE	MR	RS	DE	MR	RS	DE	MR	RS	RS	DE
Growth forecast volatility	MR	MR	DE	MR	MR	DE	DE	RS	MR	MR	RS	RS	DE
MARKET RISK MEASURE													
CDS spreads	DE	MR	RS	MR	MR	DE	MR	RS	MR	DE	RS	RS	DE
EXTERNAL FINANCING REQUIREMENT													
Current account deficit	DE	MR	RS	DE	RS	DE	MR	RS	MR	RS	RS	RS	RS
FDI vs. current account deficit	DE	MR	RS	MR	RS	DE	DE	RS	DE	RS	MR	MR	RS
Government budget deficit	RS	MR	MR	MR	DE	MR	MR	MR	DE	RS	MR	RS	MR
Government debt	RS	MR	MR	RS	DE	RS	RS	MR	RS	RS	MR	MR	RS
Gross external debt	DE	DE	RS	DE	DE	DE	MR	MR	RS	RS	MR	DE	MR
Short-term external debt	DE	RS	MR	DE	MR	DE	MR	MR	MR	RS	MR	DE	MR
CURRENCY RISK													
Peg abandonment risk	DE	MR	RS	DE	RS	DE	MR	RS	RS	RS	RS	RS	RS
Exchange rate volatility	RS	RS	MR	RS	DE	RS	RS	DE	DE	DE	RS	RS	DE
Central bank reserves	RS	MR	MR	DE	MR	DE	DE	DE	MR	RS	MR	MR	MR
Foreign currency indebtedness	DE	RS	RS	DE	DE	DE	DE	MR	DE	MR	MR	RS	DE
BANKING & CREDIT													
Recent credit boom	DE	RS	RS	DE	RS	DE	DE	MR	DE	MR	RS	DE	DE
Aggregate leverage level	DE	DE	RS	DE	MR	DE	DE	RS	RS	RS	RS	DE	DE
Mortgage leverage level	RS	MR	RS	DE	MR	DE	MR	RS	RS	RS	RS	RS	RS
Bank health (agency ratings)	DE	MR	RS	RS	MR	MR	MR	MR	DE	DE	RS	MR	DE
Loans vs. deposits	RS	RS	RS	DE	MR	DE	DE	RS	MR	DE	RS	RS	DE
POLITICAL RISK													
Political Stability	RS	MR	RS	RS	RS	RS	RS	RS	RS	MR	RS	RS	DE
COMPOSITE SCORE	MR	MR	RS	MR	MR	DE	MR	RS	MR	MR	RS	MR	DE

1 The specific variable weights are presented in the white paper version.

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opportunistic manner. We advise approaching each prospective investment with due care, while remaining aware that unique situations are likely to become available.

Investors' flight to quality calls for a return to the most basic real estate fundamentals. Sound principles to follow in the current investment environment include:

- Focus on high-quality location, property design and construction.
- Buy at or below replacement cost.
- Emphasize strength of tenant—both in terms of credit and optimal lease length. Pay attention to diversification of the tenant roster portfolio-wide, avoiding unintended industry concentrations.
- Use conservative levels of debt, making certain that debt is either in place and assumable or funded at the same time as the close. Alternatively, invest in properties that make sense to own on an all-equity basis.
- Create joint venture partnerships with best-in-class real estate companies with local expertise.
- Buy properties that generate a favorable going-in yield and a holding period total return that rewards investors for allocating their capital.
- Be prepared to manage the asset actively.
- Take a long-term view and assume a 5- to 7-year holding period; be prepared to sell earlier as conditions warrant.
- Pay attention to all sources of foreign exchange risk and hedge non-hard-currency exposure as appropriate.
- Underwrite multiple exit scenarios and leave options open.

Several specific strategies emerge for making investments that have the characteristics listed above. The current environment will likely increase the availability of attractive opportunities. The strategies include:

- *Buying assets from distressed owners of real estate.* These owners typically face pressure from banks on the refinance of their corporate-level financing and will be expected to sell their assets relatively quickly. This will make them likely to offer favorable pricing to buyers that have demonstrated an ability to perform. A quick and quiet direct transaction can benefit both buyer and seller.
- *Buying distressed assets.* These could include properties with too much debt or assets that have been taken back by lenders. Discounted pricing is expected, though a business plan will need to be in place to revive the property's reputation. Deferred maintenance and the risk of tenant defection need to be cured. Because of the inherent management complexity and additional risks, this approach is less attractive than buying fully let, high-quality assets from distressed sellers.
- *Establishing joint venture partnerships with successful local real estate operators.* The local partner will likely contribute assets while Heitman will contribute capital to purchase additional properties. Such a partnership will likely include terms favorable to Heitman's client capital, including a preferred return and a requirement that the partner bear leasing risk and/or other risk factors.
- *Establishing joint venture partnerships with developers with strong track records.* Construction financing is likely to be available only to proven developers with the best projects, meaning that delivery of new space will likely be limited once the current pipeline empties in late 2009 and 2010. Investors with capital should be able to negotiate favorable terms with developers, offloading much of the risk (construction, cost overrun, and lease-up) onto the development partner. The developer will provide an attractive preferred return to the money partner while retaining upside participation.
- *Pursuing large transactions.* With bank financing in short supply and with banks reluctant to participate in syndicates to provide loans greater than €50 million euros, we expect to see favorable pricing on properties and portfolios valued at greater than €100 million. Making such investments implies greater concentration and greater risk, but also means returns in excess of the actual real estate and country risks. Portfolios that span several countries are expected to offer favorable returns.

While applying broad principles to each prospective acquisition, nuances remain within each property type. We discuss property type considerations in the white paper version of this paper.

Concluding Remarks

Investors are advised to consider a new set of tools in evaluating risk at the country level. Rather than focusing primarily on a country's GDP and GDP growth, investors will be wise to consider the size, structure and maturity of a country's external obligations, and its political risk. Reviewing current account balances, reliance on external finance, bank health, and fiscal responsibility, among other factors, creates a mosaic of a country's balance sheet risk. Factoring in the political environment indicates a country's willingness to make necessary changes, even if they prove painful. Poland, Czech Republic, and Slovakia emerge from the review as the most attractive and earn Relative Stability designations. Ukraine and Latvia land in the Downside Exposure category. The remaining countries (Croatia, Estonia, Hungary, Lithuania, Romania, Russia and Slovenia) earn Moderate Risk status. Country classifications are not permanent–Heitman plans to revisit the indicators on a regular basis and make changes as conditions change.

A designation in the MR or DE category does not mean prohibition or that investors must stay away. Heitman plans to use a pragmatic approach that considers special circumstances and portfolio-related factors. Heitman will still invest in MR or DE countries as long as the assets have favorable characteristics and also include safeguards that protect the certainty of the cash flows. Prospective investments in an MR or DE country will require increased scrutiny and an offer of incremental reward for bearing the risk. At the same time, Heitman recognizes the severity of the global economic crisis and understands that even RS countries merit allocation of capital only after careful screening and thorough due diligence and risk control.

The result of the cautiously opportunistic approach outlined in this paper is expected to be a portfolio of strong real estate assets that will be well-positioned to benefit from the eventual worldwide economic recovery and expansion.

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