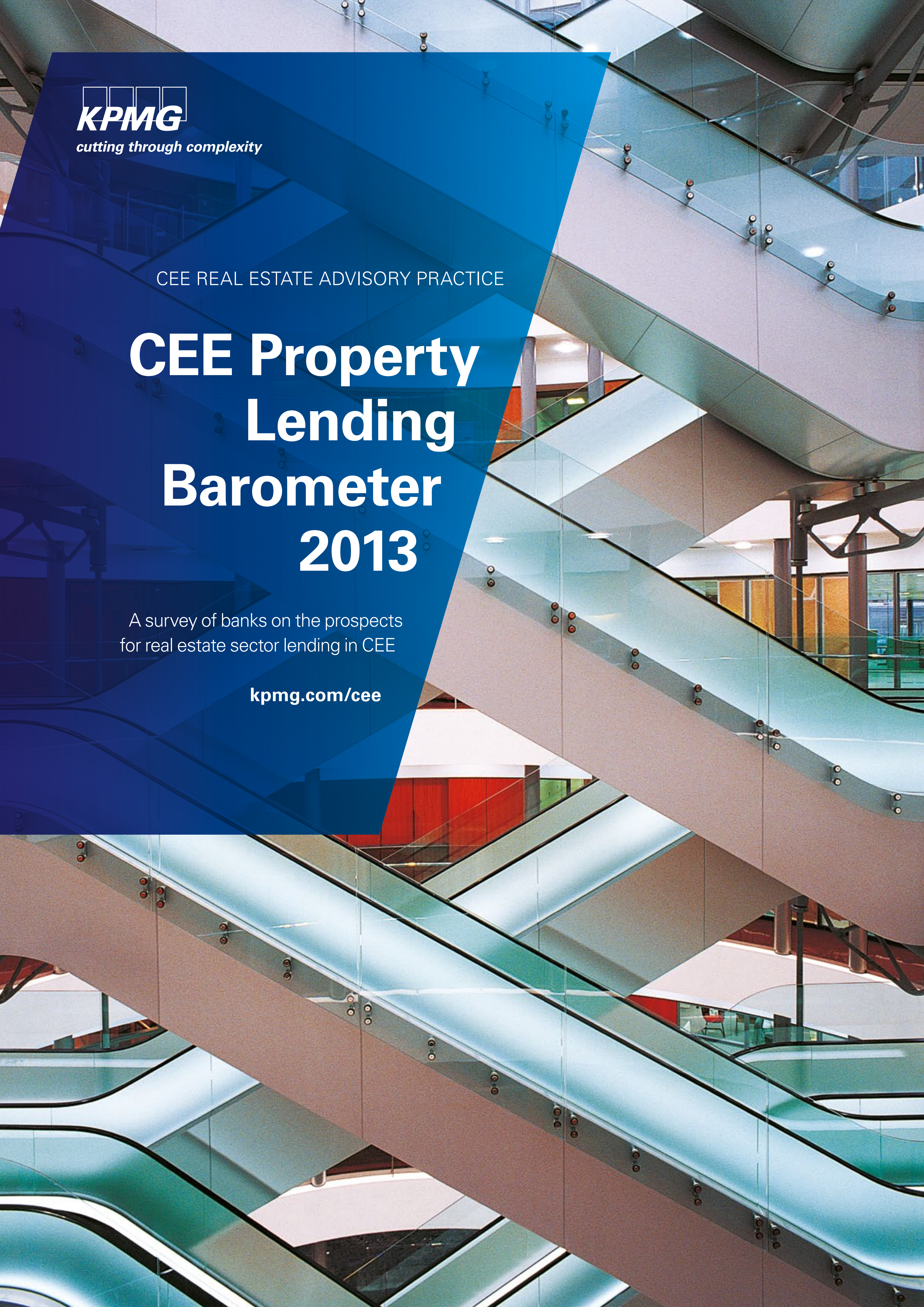

cutting through complexity

CEE REAL ESTATE ADVISORY PRACTICE

CEE Property Lending Barometer 2013

A survey of banks on the prospects for real estate sector lending in CEE

kpmg.com/cee

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Dear Reader,

I am delighted to present the fourth edition of the Central and Eastern European (CEE) Property Lending Barometer.

The economic climate within the CEE region continued to be varied last year. Increasing concern over the potential effects of the Eurozone debt crisis caused a temporary setback. However, improved stability within the EU had a positive effect. The most recent forecasts predict an improvement in economic performance for 2013, and 2014 is likely to bring even more improvements. According to various forecasts, the CEE region will greatly outperform the EU and euro-zone in terms of GDP growth in the future. However, this positive outlook is not yet reflected in banks' sentiments towards real estate financing which appears to be at the same level as last year.

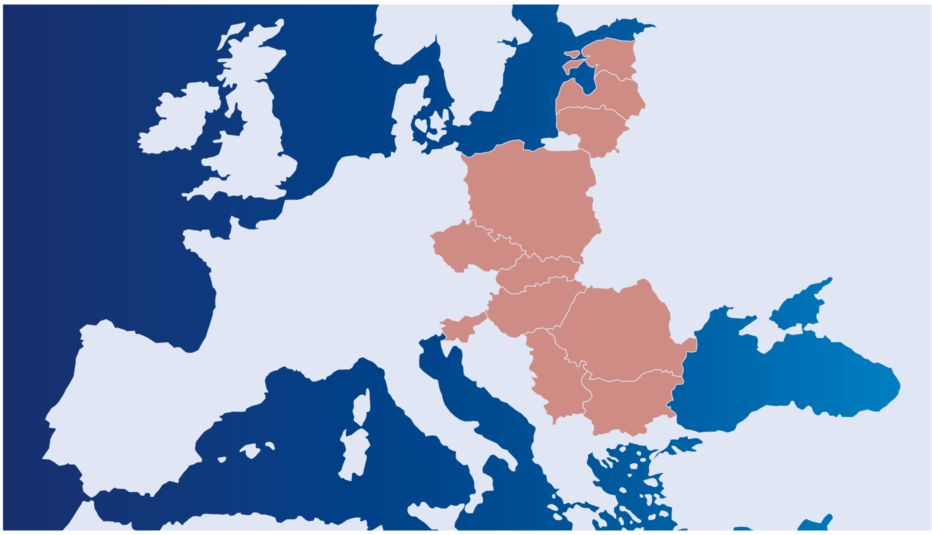
Currently, most investment and financing activity is restricted to the main markets within the region, such as Poland and the Czech Republic. In order to give a more comprehensive view on these two markets, we have included separate, dedicated analyses to them.

As in previous years, this is a report of the findings from our survey of the leading banks, who are active in the region, with the purpose of assessing the prospects for bank financing in the real estate sector. The barometer includes input from more than 40 banks active in these markets, mainly collected via in-depth interviews.

Representatives of leading financial institutions have provided their views on the key issues affecting property lending. The following countries were included in the 4th edition of the survey: the Baltics (Estonia, Latvia and Lithuania), Bulgaria, the Czech Republic, Hungary, Poland, Romania, Serbia, Slovakia and Slovenia.

The performance of the segment varies drastically, depending on the country and asset class in question. Many banks still have significant non-performing real estate loans to manage. In this report, we first focus on how banks are managing these non-performing loans; we then assess how banks are strategically approaching real estate lending and present what they expect for the next 18 months. Finally, we address the prospects and terms available for developers and investors to finance new real estate developments and income-generating properties.

■ Surveyed countries in CEE



The survey provides insights for developers and investors alike on the future prospects for real estate financing, and should enable banks to benchmark their practices based upon that of their peers.

Some highlights from the CEE Property Lending Barometer 2013 include:

- In terms of lending and investment activity, Poland and the Czech Republic are the biggest players in the region (excluding Russia), providing approximately 80% of the overall investment volume during the first half of 2013. -
- The macroeconomic outlook and the perceived risk profile of a given country generally impact the prospects for its real estate market.
- Restructuring existing loans rather than seeking foreclosure is still the preferred way to handle problematic loans. Good quality projects with a potentially strong business model and additional equity have a better chance for successful restructuring.
- After a temporary slump last year, the focus of banks on real estate financing has increased. However, the strategic importance of real estate financing has continued to decrease in those countries which have been consistently surveyed since 2010.
- Compared to 1 year ago, banks are showing increasing openness to refinance loans coming due in the next 2 years.
- Banks are still more interested in financing income-generating projects than development projects, although their openness to finance new developments has increased slightly in comparison to last year.
- Banks expect that the size of their real estate loan portfolios will not significantly change in the next 12–18 months.
- This year the majority of respondents from Poland, the Czech Republic and Hungary indicated “office” as the most favourable asset class, followed by “industrial” and “retail”. The hotel sector remains the least preferred by banks in terms of financing, but again good projects can obtain reasonable terms.

I would like to take this opportunity to thank all of the participants in this survey. Their co-operation is key to the success of this initiative.

As the initiator and coordinator of the survey, I hope you will find our report informative and enlightening in supporting your future business decisions related to real estate financing.

If you would like to receive any clarification or discuss this year’s survey results, please feel free to contact any member of the Real Estate Advisory Practice of KPMG in Central and Eastern Europe or myself.

Andrea Sartori

Abbreviations	
BAL	The Baltics
BUL	Bulgaria
CZE	Czech Republic
HUN	Hungary
POL	Poland
ROM	Romania
SRB	Serbia
SVK	Slovakia
SLV	Slovenia

Methodology, sample profile and survey limitations

This survey aims to provide an analytical overview of the approach of banks to real estate financing in the Central and Eastern European region. The following countries are represented in the 2013 survey: the Baltics[1], Bulgaria, the Czech Republic, Hungary, Poland, Romania, Serbia, Slovakia and Slovenia.

Data for the survey was primarily collected through in-depth interviews with bank representatives. Depending on the organisational structure, interviewees were the heads of real estate, project financing or risk management departments. Banks were selected from among the leading financial institutions operating in each individual country. The survey participants included over 40 banks, which are active in the real estate market in CEE. Data collection for this survey took place May-July 2013.

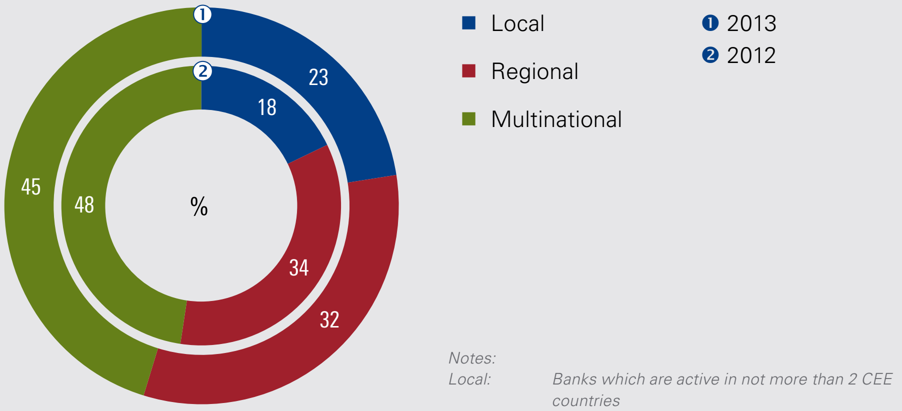
Approximately 25% of survey participant banks were local banks, i.e. those operating predominantly in one country within CEE, whilst regional or multinational banks comprise larger shares of the respondent mix.

Survey limitations

The following limiting factors should be noted:

- When the answers provided to specific questions were not sufficient to provide reliable information on a specific country, we have indicated this, or the country was omitted from that part of the analysis.
- In the case of some parameters and some cross tabulations, the output of the survey may be considered indicative but not representative due to the low number of responses.
- Difference between the regional average values are influenced by the changes in the research sample of banks for each country, and also by changes in the list of countries represented in the survey over the years.
- As in past years, our assessment of the residential sector excluded residential projects with construction costs below EUR 10 million.
- Some of the answers to the survey's queries should be considered as an expression of opinion, or may be timely market information that is subject to change over time.

Geographic orientation of the banks included in the surveyed sample



Notes:
Local: Banks which are active in not more than 2 CEE countries
Regional: Banks which are active in at least 3 CEE countries excluding multinationals
Multinational: Banks which are active on at least 3 continents

Source: KPMG in CEE Property Lending Barometer 2013

[1] Based on responses received from the banks surveyed, the Baltic countries may be grouped together from the point of view of bank financing.

Overview of the CEE Real Estate market

The economic difficulties in the Eurozone, Central and Eastern Europe's key export market, have jeopardised immediate growth prospects, but the medium to long-term outlook is more upbeat. The compounded effect of faltering external demand, weak outlook for credit and high unemployment caused a slowdown in economic activity in 2012. However, the effect of a reduction in global growth in 2013 is expected to be more modest on these countries than in 2009, as most have reduced or eliminated their external imbalances.

Most of the countries in CEE are still experiencing difficulties in achieving GDP growth and this trend is forecast to continue in 2013. There are some bright spots, however, and the general consensus is that 2014 may see a change of fortune in Central and Eastern Europe.

According to the Economist Intelligence Unit, growth in the region in 2014 is forecasted to pick up by an average of 2–2.5% annually.

Real GDP change among surveyed countries (%)

	2011	2012	2013(f)	2014(f)
Bulgaria	2.0	0.8	0.9	2.5
Estonia	8.3	3.2	2.3	3.2
Czech Republic	1.8	-1.2	-0.7	1.3
Hungary	1.6	-1.7	0.4	1.6
Latvia	5.5	5.6	3.9	4.4
Lithuania	5.9	3.7	2.3	3.0
Poland	4.5	2.0	1.0	2.3
Romania	2.3	0.7	2.4	3.0
Serbia	1.6	-1.7	2.0	3.0
Slovakia	3.2	2.0	0.7	2.3
Slovenia	1.0	-2.2	-2.6	-0.2

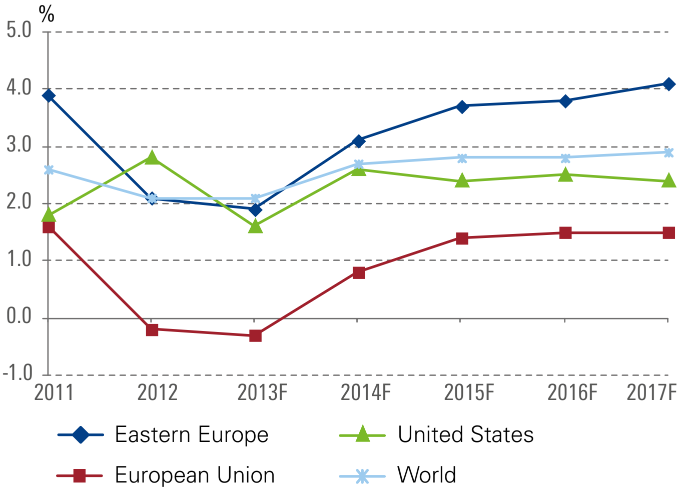
Source: Economist Intelligence Unit, 27 August 2013

The region shows big differences in terms of forecasted economic growth for 2013, as for example Latvia, Lithuania and Estonia are expected to become the best performers on the continent, achieving growth of 3.9%, 2.3% and 2.3% respectively, followed by Romania with an expected 2.4% increase. The worst performers are expected to be Slovenia (-2.6%), the Czech Republic (-0.7%) and Hungary (0.4%).

- After a moderate 2.0% growth in 2012, **Poland** is exhibiting some weakening as real GDP growth is expected to slow to 1% in 2013. There is a chance that this change will lead several market players in the sector to reconsider their approach to the Polish market. The banking sector, which is 70% owned by foreign banks, was coping well with the effects of the financial crisis. Now, the sector is facing significant structural and regulatory changes, both in Poland and in the rest of the EU.
- **The Czech Republic** is one of the more mature markets in the CEE region, but is heavily dependent on exports to the slowly growing German economy. After a drop of -1.2% in 2012, it is expected that real GDP will contract in 2013, by approximately -0.7%, which makes the country, in terms of GDP growth prospects, the second worst performing in the region following Slovenia.
- After a drop of -1.7% in 2012, the **Hungarian** economy is expected to avoid recession in 2013, as GDP is expected to grow by approximately 0.4%. Banks there experienced severe losses in 2012. Despite the sector doubling its combined profits in the first quarter of 2013, there is no sign of a solid recovery yet. Although the banks are well capitalised, revenues are declining and deleveraging continues. Simultaneously, the volume of bad debt is rising, especially among households. A new Central Bank programme to increase the appetite for corporate lending has started, but there are doubts whether it can make a real impact on the country's economic growth or boost the financial sector, which is under a heavy burden from special "crisis taxes".

- Economic growth in **Bulgaria** is expected to improve only slightly in 2013 from a subdued rate in 2012. Unemployment remains high after the loss of 430,000 jobs over the past 4 years; the unemployment rate climbed to 13.8% in the first quarter of 2013. Bulgaria has the lowest GDP per capita in the EU, according to Eurostat. An increase in exports and higher absorption of European Union (EU) funds are providing much needed support to the economy. However, there are risks overshadowing the general outlook of the country, including uncertainties in the euro area and an unstable domestic political situation.
- According to Eurostat in the first quarter of 2013 **Romania** recorded the third fastest rate of seasonally adjusted year-on-year growth in the EU at 1.3%. Growth was mainly driven by the recovery of manufacturing output and the growth in retail sales of non-food goods. The country suffered one of the most severe fallbacks in the EU during 2008–2010, but now analysts predict that it is on course to make a faster recovery than other countries in the region.
- After two years of economic growth, the **Serbian** economy experienced a significant drop of 1.7% in 2012. The recession was mainly caused by a weak agricultural harvest and economic instability within Europe. The biggest fall was recorded in the construction sector. The unemployment rate also rose in 2012, reaching almost 25%. The country aims to enter into a new IMF agreement in 2013, and the EU has announced that it will begin accession negotiations with Serbia by the end of January 2014.

GDP growth: global outlook



Note: In this table Eastern Europe includes Azerbaijan, Bulgaria, Croatia, Czech Republic, Estonia, Hungary, Kazakhstan, Latvia, Lithuania, Poland, Romania, Russia, Serbia, Slovakia, Slovenia and Ukraine

Source: Economist Intelligence Unit, 05 September 2013

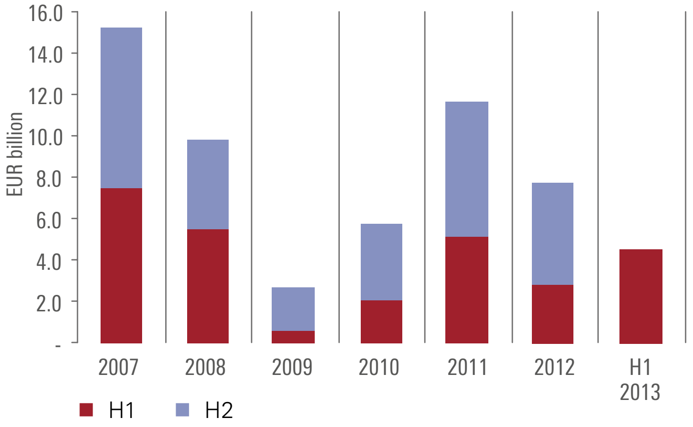
Foreign direct investment and external bank loans, both of which have been drivers for growth in the real estate market during the pre-crisis years, are not expected to significantly increase this year, as local credit growth will likely be restricted further by the foreign parent banks.

Although, the second half of 2012 saw some increased investment activity, the overall annual commercial property investment volume in Central and Eastern Europe (including Russia) reached only EUR 7.4 billion, 35% lower than in 2011, according to CBRE. Notwithstanding the decrease in each market compared to 2011, investor interest remains strong in Poland and the Czech capital, while other CEE markets continue to struggle.

In 2012, a total of EUR 3.71 billion was invested in the core CEE markets (Poland, Czech Republic, Slovakia, Hungary and Romania), a significant drop compared to EUR 6.29 billion in 2011; however, this is 25% higher than the equivalent investment in 2010.

Almost half of the volume of transactions was focussed on the office market; however, investors also showed increasing interest towards the retail and industrial sectors, as well as some hotel assets.

Total real estate investment transactions in CEE 2007 – H1 2013

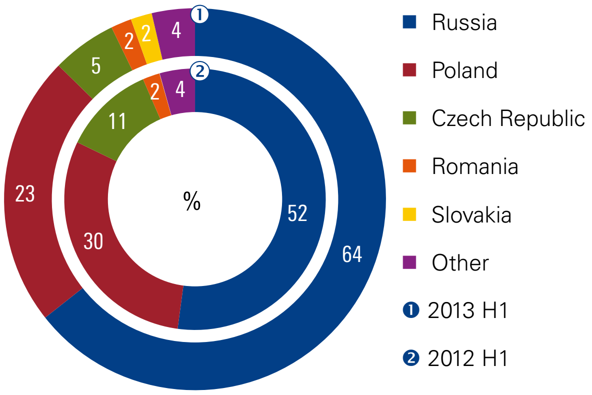


Note: In this table CEE includes Bulgaria, Croatia, Czech Republic, Hungary, Poland, Romania, Russia, Serbia, Slovakia and Ukraine
Source: CBRE

CEE investment has surged during H1 2013, with interest starting to move beyond prime assets. All main asset classes showed increasing volumes. The total investment volume reached EUR 4.5 billion in the first half of the year, 60% above the same period in 2012. Russia, Poland and the Czech Republic were again at the centre of interest. The Russian market was the most active with approximately EUR 2.9 billion of transactions. -

The South-East European countries (i.e. Serbia and Bulgaria) offer a significant premium compared to more established markets, due to the perceived greater risk associated with real estate investments there. Investors still have concerns about the level of corruption, which makes the planning and development process expensive and lengthy in these countries. Another drawback is the lack of access to accurate market information as many deals take place off-market and little information is available about the terms.

CEE real estate transactions broken down by countries



Note: In this table CEE includes Bulgaria, Czech Republic, Hungary, Poland, Romania, Russia, Slovakia, The Baltics and Ukraine
Source: CBRE

Managing impaired loans

The combined impact of the global economic crisis and the Eurozone sovereign debt crisis has been detrimental to the financing of the real estate sector outside core markets, especially in the CEE region. However, many banks in the region still have large real estate portfolios, a sizeable proportion of which are non performing. In this part of the survey, we focus on banks' opportunities to manage real estate loans where debtors cannot pay their capital and/or interest on time, or there is a technical breach of contract terms.

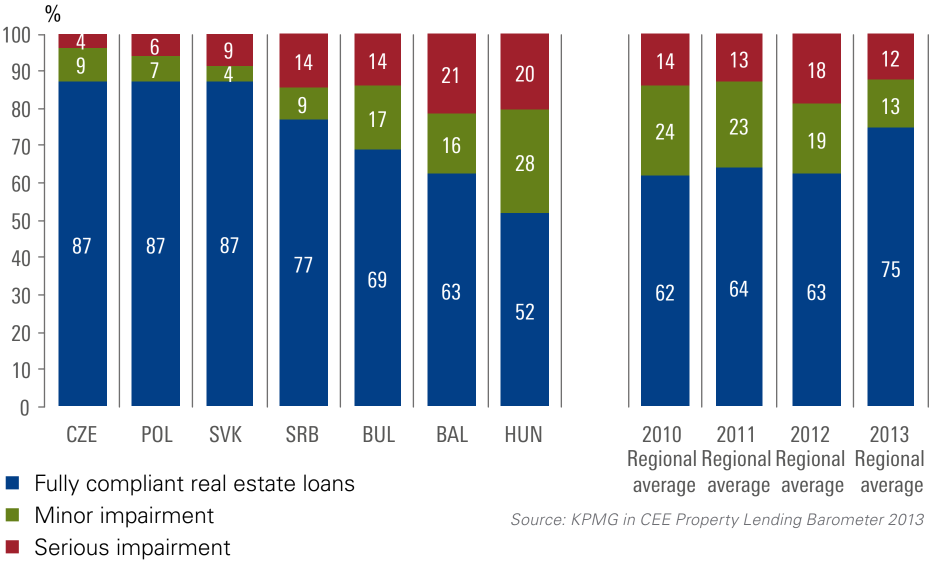
Current state of and future expectations for impaired loans

Based on responses collected this year, the largest amounts of impaired real estate loans are in Hungary (20% serious and 28% minor impairment). This is followed by the Baltics (21% serious and 16% minor impairment) and Bulgaria (14% serious and 17% minor impairment), while the highest proportion of fully compliant loans are in Poland, the Czech Republic and Slovakia, all at 87%.[2]

According to the results, the percentage of impaired real estate loans does not correlate with the macroeconomic indicators of the countries under review. In most countries there is no significant change this year in the proportion of impaired real estate loans although, in Bulgaria the proportion of impaired loans increased, whereas in the Baltics it decreased.

The regional average of fully compliant loans increased significantly in 2013.

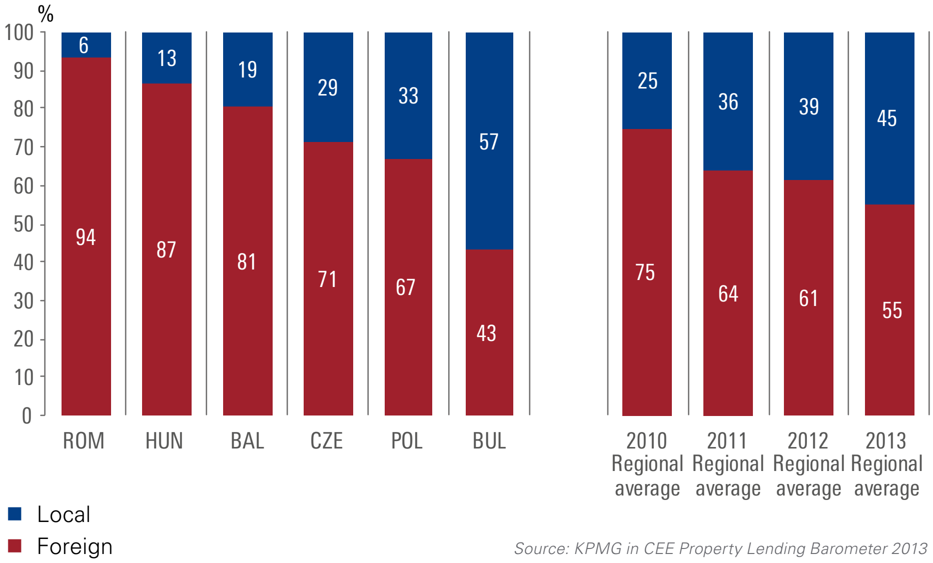
Proportion of impaired real estate loans per country



Source: KPMG in CEE Property Lending Barometer 2013

The regional average of foreign currency denominated loans is 55% in 2013, which is a significant decrease compared to the percentage for the previous year. The highest proportion of foreign currency loans (excluding Estonia, Slovenia and Slovakia where the euro is the local currency) is in Romania, at 94%. Bulgarian and Polish banks have the lowest proportion of foreign currency loans, at 43% and 67% respectively.

Proportion of foreign and local currency real estate loans

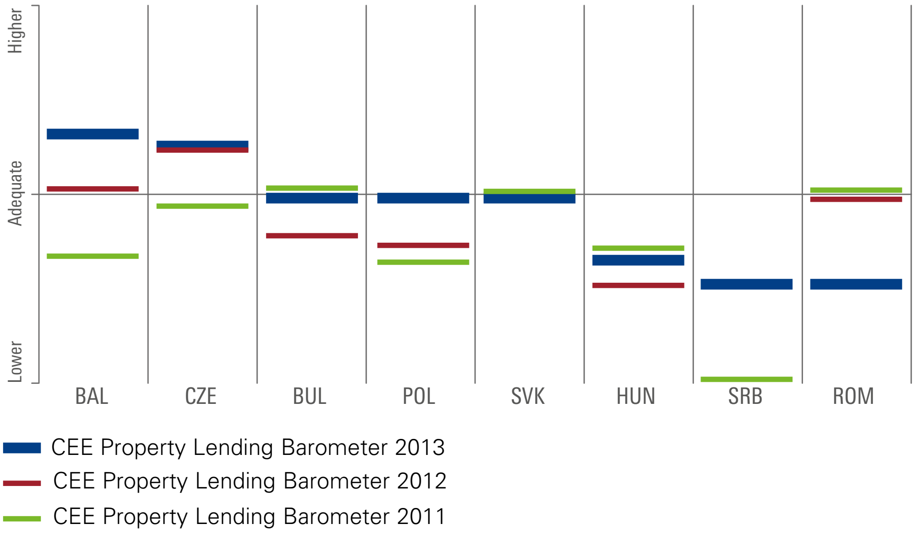


Source: KPMG in CEE Property Lending Barometer 2013

[2] For some counties (especially Bulgaria, Serbia) the results may be skewed by small sample sizes for this question and thus the results for them may not be representative.

The provision levels are considered less than adequate in Hungary and Serbia, while they are considered adequate in Slovakia, Poland and Bulgaria. Czech and Baltic banks indicated moderately higher than adequate provisions. There is no clear trend in Bulgaria as loan provision perception levels have varied between adequate and low levels in the last two years. In Romania, banks indicated a lower than adequate level of loan provisions, which shows a negative, downward shift from 2011 and 2012. However, Poland and the Baltics have exhibited a continuous positive shift in the perceived amount of necessary loan provisions since 2011.

Banks' perception of the level of real estate loan provisions

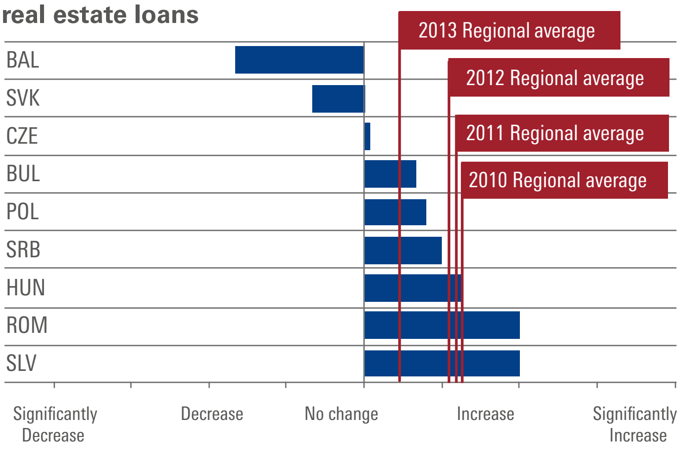


Source: KPMG in CEE Property Lending Barometer 2013

The level of loan provisions (loan value adjustments) is not expected to decrease significantly in any of the countries surveyed before the end of 2013. However, a slight decrease is expected in the Baltics and in Slovakia. In Serbia, Slovenia, Hungary and Romania, banks are expecting an increase in the level of provisions this year. The responses to a related question regarding the expected change in the proportion of problem loans as a percentage of the total real estate lending portfolio show a similar pattern.

On average, there is a decrease in the expectation for changes in the amount of real estate loan provisions compared to the sentiment for last year. The trend shows continuous improvement since 2010, which suggests a gradual improvement in the quality of loan portfolios.

Expectation for changes in the amount of provisions for real estate loans



Source: KPMG in CEE Property Lending Barometer 2013

Restructuring as an opportunity to manage impaired loans

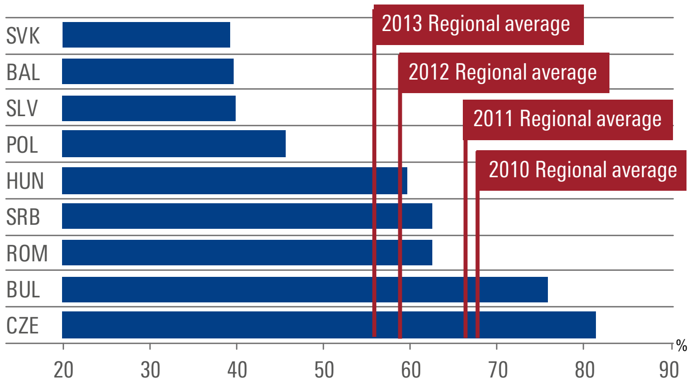
In all countries, most bank representatives think that a significant proportion of impaired loans may be managed successfully through restructuring. The results this year were very similar to those in 2012, where the most positive respondents were the Bulgarian and Czech banks. Respondents from these two countries consider that more than 75% of impaired loans may be restructured successfully.

The picture is less positive in Slovakia, Slovenia and in the Baltic countries, where, according to respondents, only around 40% or less of impaired loans may be successfully restructured. However, there has been a noticeable increase of 10% in positive sentiment in the Baltics compared with last year.

The regional average is lower than for last year, but the proportion of potentially manageable loans has not changed dramatically in the surveyed countries.

Over the 4-year period the estimate of the proportion of impaired real estate loans that may be managed successfully through restructuring is gradually decreasing, which may indicate that a number of borrowers who have fulfilled the most important criteria (strong business model, additional equity) have already implemented a successful restructuring, leaving the banks with higher proportion of weaker borrowers.

Proportion of impaired real estate loans that may be managed successfully through restructuring



Source: KPMG in CEE Property Lending Barometer 2013

Based on the results over the 4-year period, it is clear that banks in the region are more inclined to manage their real estate portfolios through restructuring than looking for immediate foreclosure. The rescheduling or restructuring of loans is thought to be a good approach, at least in the short term.

The primary precondition for any restructuring is cooperative behaviour on the part of the borrower. Once this condition has been met, a strong business model remained the next most important factor to drive a successful restructuring, together with additional equity being available. The top criteria for a successful restructuring have not changed since the previous edition of this survey.

Most important criteria for successfully restructuring non compliant real estate loans	
Strong business model/quality of the asset	●●●●
Additional equity	●●●
Market prospects	●●
Additional collateral available	●●
Opportunity to increase the bank's margin	●

Source: KPMG in CEE Property Lending Barometer 2013

Prospects for real estate loan portfolios

In this section, banks' expectations for the future of their real estate loan portfolios are assessed in light of recent developments and their strategic approach to real estate financing.

Compared to last year, in 2013 the surveyed countries exhibit a varied appetite for real estate financing, but on average the level of their interest remains stable.

With the exception of those in Bulgaria, the banks in our survey predict a sustained focus on real estate financing in their portfolio development.

Change in the focus on real estate financing within banks' lending activities in selected countries

	2010 2011	2011 2012	2012 2013
POL	↑	↔	↔
ROM	↑	↓	↔
CZE	↑	↔	↔
BAL	↔	↓	↔
HUN	↓	↔	↔
BUL	↓	↔	↓
Regional average	↑	↔	↔

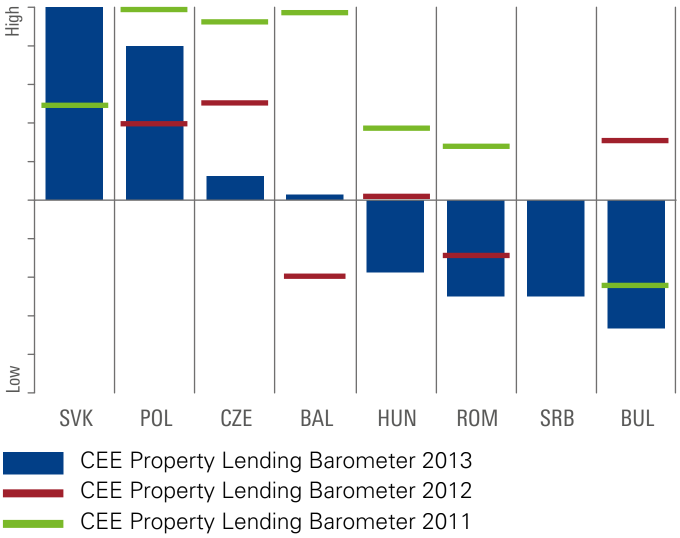
Source: KPMG in CEE Property Lending Barometer 2013

Real estate projects are more important strategically to banks in Slovakia, Poland and the Czech Republic. In most countries banks are less enthusiastic about the long-term prospects of the real estate market than in the past and continue to monitor developments. Furthermore, the strategic importance of real estate financing may also reflect the fact that a number of banks have significant non-performing real estate loan portfolios that they have to manage.

Overall, there has been a gradual decrease in the strategic importance of real estate financing in the last 3 years. A significant change in attitude can be perceived in Bulgaria, where banks attributed moderately high strategic importance to real estate financing in 2012. The results this year show that the temporary positive sentiment in 2012 did not prove to be a lasting trend. A less positive sentiment in Hungary compared to the previous two years shows the deteriorating conditions of the financial sector in its domestic market. This negative outlook is also supported by a recent government announcement that it does not plan to withdraw the special crisis taxes for a few more years. Furthermore, the ongoing austerity measures (e.g. a transaction tax) have placed an even greater burden on the banking sector.

However, these findings do not fully reflect the underlying macroeconomic conditions of the surveyed countries and might not prove to be enduring.

Strategic importance of real estate financing for banks



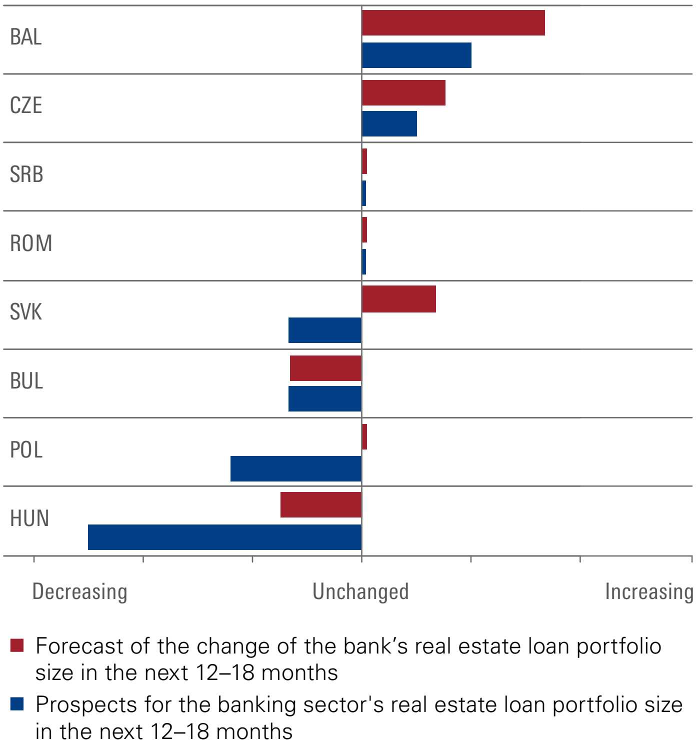
Source: KPMG in CEE Property Lending Barometer 2013

The future of real estate loan portfolios

In terms of the loan portfolio size, banks' sentiments differ greatly depending on the country. However, in all surveyed countries, banks see their own prospects in terms of loan portfolio size as being at least as good or better, than that of the whole sector for the next 12–18 months. This year's Romanian and Serbian responses indicated fairly neutral growth prospects in their own and the sector's real estate portfolio.

Hungarian banks expect the worst growth prospects expecting both the size of their own and the sector's portfolios to decrease. Slovak banks assume that they will considerably outperform the banking sector in terms of the size of their portfolio. Similarly to last year, Polish banks foresee decreasing loan portfolios at the sector level, but expect no change in their own loan portfolios. Results from the Czech Republic and the Baltics show an increase forecasted for the next 12–18 months.

Banks' forecast on the change in size of the loan portfolio in the next 12–18 months



🟥 Forecast of the change of the bank's real estate loan portfolio size in the next 12–18 months

🟦 Prospects for the banking sector's real estate loan portfolio size in the next 12–18 months

Source: KPMG in CEE Property Lending Barometer 2013

Banks were also asked to identify the key drivers affecting their real estate portfolios. As in 2012, the most significant factor identified was the local macroeconomic environment and macroeconomic conditions in Europe were seen as playing less of a role. This may be the consequence of more stable European economic conditions, with Greece and Portugal, countries which were jeopardizing the stability of the Eurozone, avoiding default for the moment. Lack of equity and active investors gained importance in comparison to the 2012 results. New strategies, a lack of prime properties, new limits on the maximum loan size/customer exposures and Basel III were viewed as less crucial factors.

Most important factors affecting real estate loan portfolios	
Macroeconomic conditions in the local market	●●●●
Lack of equity	●●●
Lack of active investors	●●●
Macroeconomic conditions in Europe	●●
New strategy	●
Lack of prime properties	●
New limits on maximum loan size/customer exposures	●
Basel III	●

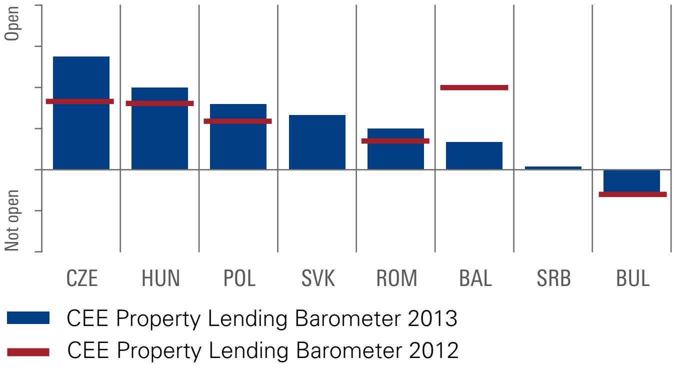
Source: KPMG in CEE Property Lending Barometer 2013

In respect of the question as to where banks expect additional funds to come from if the overall size of their share in financing decreases, the majority of banks indicated that they expect additional equity from developers/investors, followed by private equity as the second most relevant source. Furthermore, some banks mentioned bonds and foreign funds as other potential sources.

In terms of real estate loans maturing in the near future, on average approximately 15% of real estate loans are due in the next year and one-third are due within two years. Compared to data from 2012, the proportion of short-term loans decreased. This may be a consequence of the so-called "extend and pretend" strategy of the banks, as it is not unusual for banks, when dealing with borrowers who are not able to repay their loans coming due, to extend the maturity period instead of immediate foreclosure and hope that the borrowers will be able to repay later.

The willingness to refinance loans due in the next 2 years slightly increased in most countries, which was also the case in last year's survey. Banks are reasonably open to refinance loans, although respondents from Bulgaria and Serbia show less openness compared to other countries. The risk aversion of the banks in these two countries is probably linked to temporary downturns in economic development and the less transparent real estate markets.

Openness of banks to refinance loans coming due in the next 2 years



Source: KPMG in CEE Property Lending Barometer 2013

Approximately one-third of the banks surveyed are considering disposing of part of their commercial loan portfolios in the next 12–18 months, which is a significant, (approximately 4-fold) increase since last year. They have indicated strategic exits and new capital adequacy rules as key factors behind such disposals.

Bank representatives were also asked to comment on how Basel III regulations would impact their business. The majority responded that the new regulations would not have a significant effect; however, more than half of the respondents expect that the margin applied by banks will increase due to the regulatory changes. As a result, financing will become more expensive. Based on this year's answers, the regulation should not, however, significantly affect the size of their real estate loan portfolios.

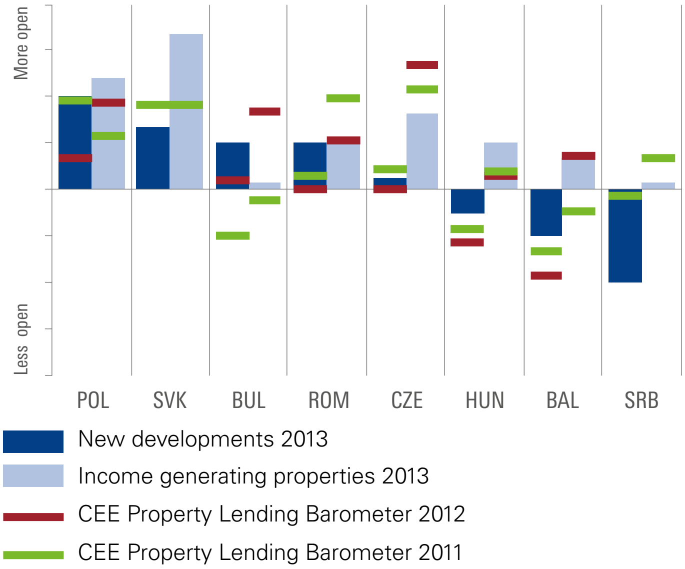
Opportunities for financing new real estate projects

This section assesses the opportunities for developers to obtain bank financing for real estate projects, as this is still the most important issue that they face in the current environment.

The majority of banks still consider the financing of income-generating projects as being more appealing than development projects.

However, after a general setback in 2012, the overall openness to finance new developments increased this year.

Openness of banks to finance development/ income-generating projects



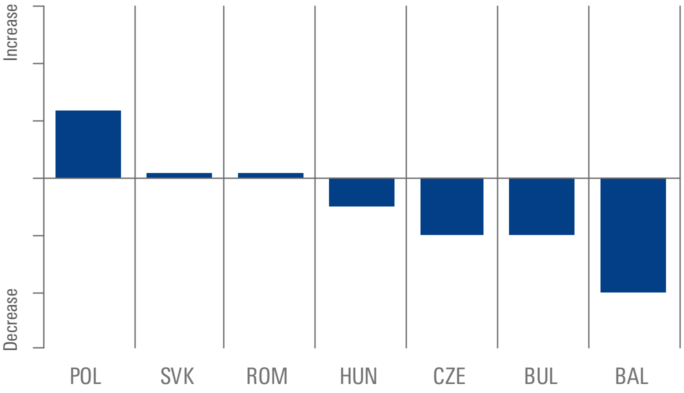
Source: KPMG in CEE Property Lending Barometer 2013

The majority of positive responses are from countries that have a high proportion of fully compliant real estate loans, ie. Czech Republic, Poland and Slovakia. Meanwhile, banks in Hungary, the Baltics and Serbia are less open to real estate financing than their regional peers.

According to recent reports in the business media, lenders in South-East Europe have expressed concerns on levels of corruption, which make the planning and development process expensive and lengthy in these countries. Another drawback is the lack of access to accurate market information as many deals are conducted off-market with little information being publicly announced. On the other hand, due to the perceived greater risk, these countries offer a significant premium compared to more established markets. The prime retail yield in Belgrade[3] and Sofia[4] is 9.00%, in contrast to 5.75% in Warsaw[5] and 6.25% in Prague[6]. In comparison with last year's results there is growing interest in new developments in Poland.

In respect of maximum loan size, Polish banks reported a slight increase, Hungarian, Czech, Bulgarian and Baltic banks indicated a moderate decrease, whilst in Slovakia and in Romania no significant change was reported. The responses from Polish banks are in line with the consensus in 2012 about an increased strategic importance for real estate lending compared to last year.

Change in limit of loan size compared to 3 years ago in selected countries



Source: KPMG in CEE Property Lending Barometer 2013

Survey participants were also asked if they were open to participate in and /or lead in club deals or syndication for real estate projects. Czech, Slovak and, to a lesser extent, Polish and Hungarian banks signalled they are open to such participation, whilst in Bulgaria banks are generally neutral regarding this form of financing. In Serbia and the Baltic countries banks are less open to any type of club deal or syndication with other banks. There is no significant change in any of the other surveyed countries.

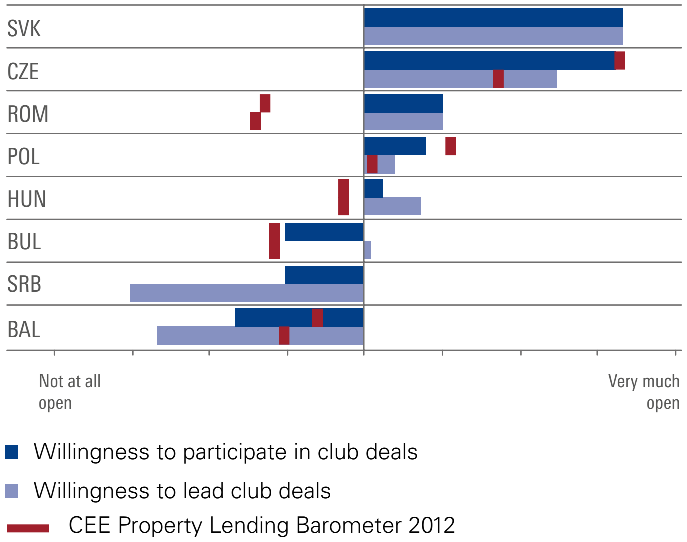
[3] *Jones Lang Lasalle – Belgrade City Report Q2 2013*

[4] *Colliers International – Market Briefing Report 2013*

[5] *Jones Lang Lasalle – Warsaw City Report Q2 2013*

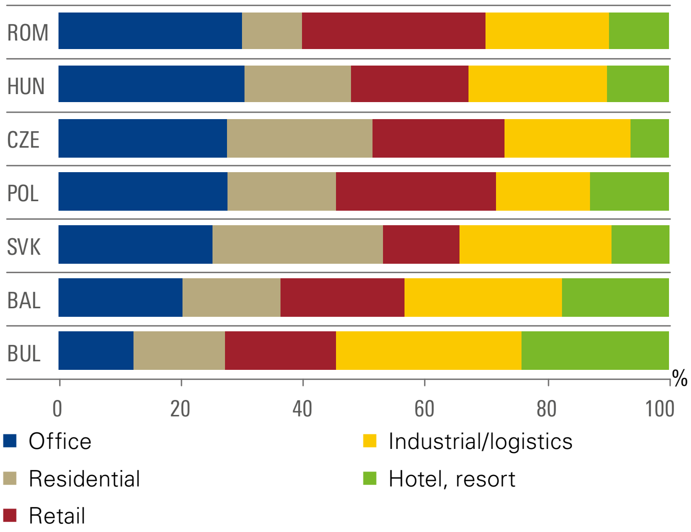
[6] *Jones Lang Lasalle – Prague City Report Q2 2013*

Banks' willingness to participate in and/or to lead club deals



Source: KPMG in CEE Property Lending Barometer 2013

Banks' sector preferences in providing development financing by asset class



Note: The longer the coloured bar, the more preferred the asset class is for the banks.
Source: KPMG in CEE Property Lending Barometer 2013

The willingness of banks to lead club deals/syndications has increased at a regional level since last year, while the willingness to participate in clubs deals decreased slightly since 2012. This year Slovakia shows the most openness regarding the maximum participation rate, followed by the Czech Republic and Poland. Similarly to last year, only half of respondents were open to taking a share of more than 50% of the total loan value.

Asset Class Preferences and Interest Premium

Banks were also asked about their preferred asset class in each country.

Based on the regional average data, "office" is the most preferred asset class followed by "industrial" and "retail". In Bulgaria and the Baltics, "industrial" is the most favoured, while in Poland, the Czech Republic and Hungary banks prefer the office sector. In Romania, office and retail are the preferred sectors. In Slovakia, banks are most open to residential projects, while in terms of commercial properties they are in favour of office and retail assets. Similarly to previous Lending Barometer surveys, the hotel segment clearly remains the least preferred, although there has been a slight positive shift since last year.

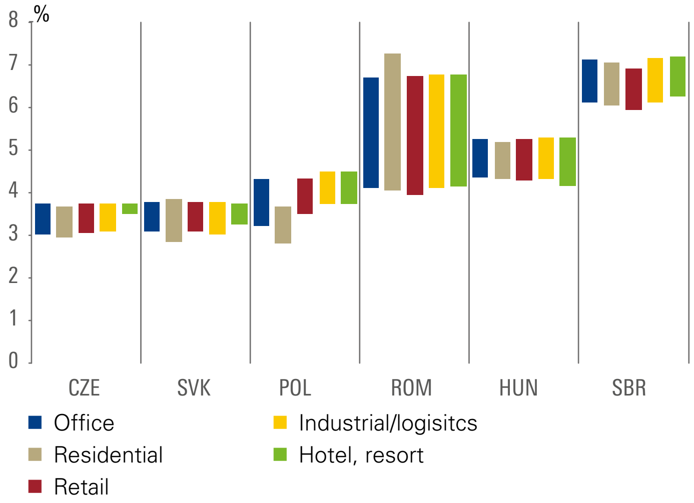
In addition to sector preferences, participants were asked to provide a range for the interest premium they would apply on a 3-month Euribor basis, if a developer or investor of outstanding reputation with a solid business plan approached them. Similarly to the findings from previous years, there was no meaningful average figure for the region, as premiums vary significantly among countries.

For new developments, the lowest loan interest premiums are in the Czech Republic, Slovakia and Poland, a phenomenon which may be associated with the lower risk profile of the countries and perhaps more competition from other banks to provide debt financing to highly rated real estate projects. Meanwhile, Serbia exhibited the highest premiums.

There are no major differences in the premia applied by banks across various asset classes, with the exception of the hotel sector, where the premium tends to be higher. A tendency to increase premia was visible in 2010 – 2012, but this may have stopped this year, as there was a decrease of 60–100 basis points among premia for all sectors compared to 2012. The most significant drop is in the hotel sector.

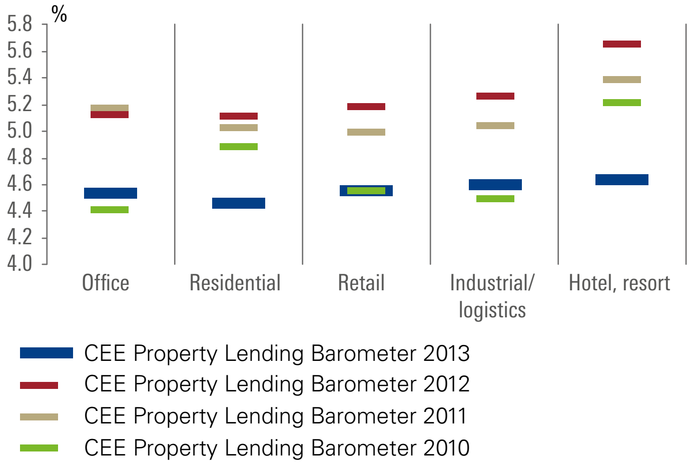
New development properties

Loan interest premium applied by banks for highly rated real estate development projects in selected countries



Source: KPMG in CEE Property Lending Barometer 2013

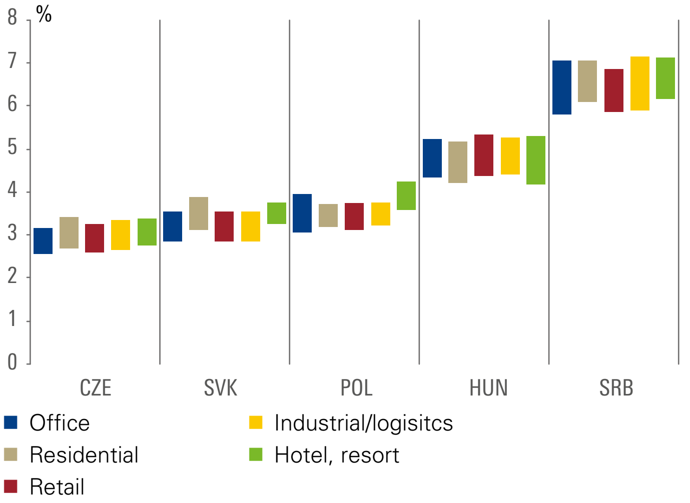
Regional averages



Source: KPMG in CEE Property Lending Barometer 2013

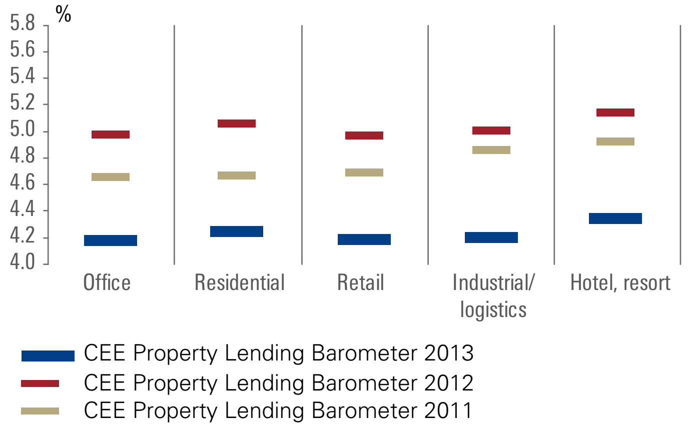
Income-generating properties

Loan interest premium applied by banks for highly rated income-generating real estate projects in selected countries



Source: KPMG in CEE Property Lending Barometer 2013

Regional averages



Source: KPMG in CEE Property Lending Barometer 2013

This may be partly attributable to growing confidence in and positive trading expectations for the sector in the next 2 years, as indicated in a recent hotel sentiment survey[7], which found that, there was a general improvement in financing conditions in a number of markets within the EMEA region, with new lenders entering the hotel sector, such as insurance companies and debt funds. To date, however, financing in the CEE region is still dependent on traditional sources.

Banks were also asked about the interest premium that they would apply on a 3-month Euribor basis on loans for high quality income-generating properties.

The lowest premia are applied by Czech, Slovak and Polish banks. In comparison of the regional average of premia over the last 4 years, there is a noticeable decrease in all sectors for 2013. As a result, the average premia of all sectors are at their lowest level since the first Lending Barometer survey conducted in 2010. The average premium in case of new development projects ranges 4.46 to 4.64%, whereas for income generating properties it is between 4.17 and 4.34%. There is also a difference in average premia among the sectors, with the hotel/resorts sector exhibiting the highest premium, both for new development projects and for income generating properties.

The variance in premia may partly be explained by varying country risks, as reflected by credit default swap (CDS) values. In general, those countries perceived as high risk command the highest interest premia.

[7] Jones Lang Lasalle – Hotel Investor Sentiment Survey 2013

Average CDS premium in the period May July 2013, in selected countries (basis points)

Country		Country	
USA	20.0	Lithuania	117.4
Germany	30.9	Latvia	120.2
Austria	36.4	Ireland	160.2
Switzerland	36.7	Russia	160.3
United Kingdom	47.0	Romania	193.9
Netherlands	54.6	Spain	241.4
Estonia	60.8	Italy	253.8
Czech Republic	61.6	Slovenia	294.0
France	71.5	Hungary	294.5
Poland	84.7	Croatia	300.7
Slovakia	92.6	Serbia	328.8
Bulgaria	109.9	Portugal	342.8

Note: Average CDS rates over the period when the interviews were conducted (between 1 May 2012 and 31 July 2013)

Source: Thomson Reuters (average of 24 market maker spreads, 5Y senior CDS, end of day composite prices, USD)

Criteria for financing

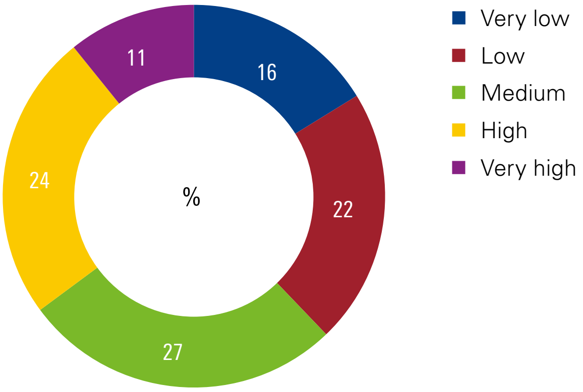
Having seen how open banks are to financing properties, and their sector preferences, the following section analyses the criteria being considered when selecting projects to finance. In order to successfully obtain financing for a project, a strong business model and high quality of the asset were the most important considerations. The level of equity and reputation of the developer/operator were in a tie for second place.

Banks most important criteria for considering real estate financing	
Strong business model/Quality of the asset	●●●●●
Level of owner’s equity	●●●●
Reputation and references of the developer/operator	●●●●
Financial background of the developer	●●●
Preletting pre-sale level	●●●
How well the project is planned, status of permitting process	●●●
Existence of an independent feasibility study/valuation	●●
Size of the requested loan	●

Source: KPMG in CEE Property Lending Barometer 2013

Independent valuation has gained more importance since last year, as about one-third of the participating banks reported high to very high reliance on valuations provided by external service providers. On the other hand, there was no observable decrease in the number of banks in the low to very low reliance segment, as approximately 40% of the responses were unchanged from 2012.

Banks' reliance on valuations provided by external service providers



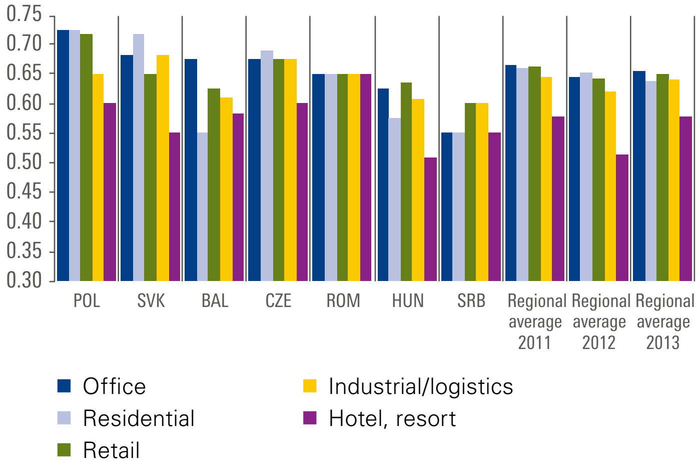
Source: KPMG in CEE Property Lending Barometer 2013

Banks were asked to spell out their technical criteria for financing. When questioned about loan-to-cost ratios, responses varied by country.

In case of the more mature CEE markets, the loan-to-cost ratios for the office, residential, retail and industrial/logistics sectors are between 0.58 and 0.73 (i.e. reflecting a capital structure of 58–73% debt and 42–27% equity). In countries with a higher risk profile (i.e. Serbia), the ratio is slightly lower, ranging from 0.55 and 0.60 (i.e. reflecting a capital structure of 55–60% debt and 45–40% equity). Due to the higher perceived risk, the hotel sector requires equity of 40–50%, but the ratio has improved compared to 2012, reflecting a more positive overall sentiment towards the sector.

New development properties

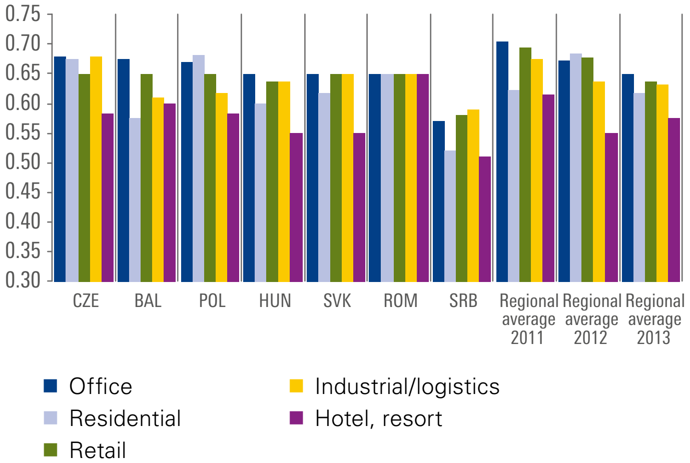
Loan-to-cost (LTC) ratio expectations for financing highly rated real estate development projects in the next 12–18 months



Source: KPMG in CEE Property Lending Barometer 2013

Income-generating properties

Loan-to-value (LTV) ratio expectations for financing highly rated income-generating real estate projects in the next 12–18 months



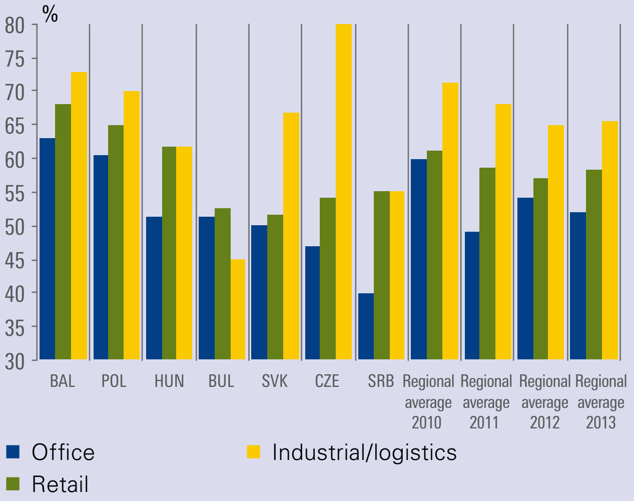
Source: KPMG in CEE Property Lending Barometer 2013

In more established CEE markets, the LTV ratios for the office, residential, retail and industrial/logistics sectors exhibit a maximum loan-to-value ratio of 0.6 to 0.68 (i.e. reflecting a capital structure of 60–68% debt and 40–32% equity). In Serbia, 40–50% equity is required for these asset classes due to the greater perceived country risk.

The equity required for hotel properties is even higher, close to an average of 40%, with much greater variance between countries. Despite the difference among the asset classes, the average loan-to-cost ratio is slightly higher than last year's. On the other hand, the average loan-to-value ratio decreased slightly compared to the previous year's.

Similarly to last year, banks are still demanding high pre-let and presale ratios. The expected ratios vary greatly among countries and sectors. The Baltics exhibit the highest ratios on average, followed by Poland and Hungary. The pre-let ratios for the office and retail sectors are similar, ranging from 40 to 65%. In general, most industrial and logistic projects are built to suit specific tenant requirements, where the number of speculative developments is very low.

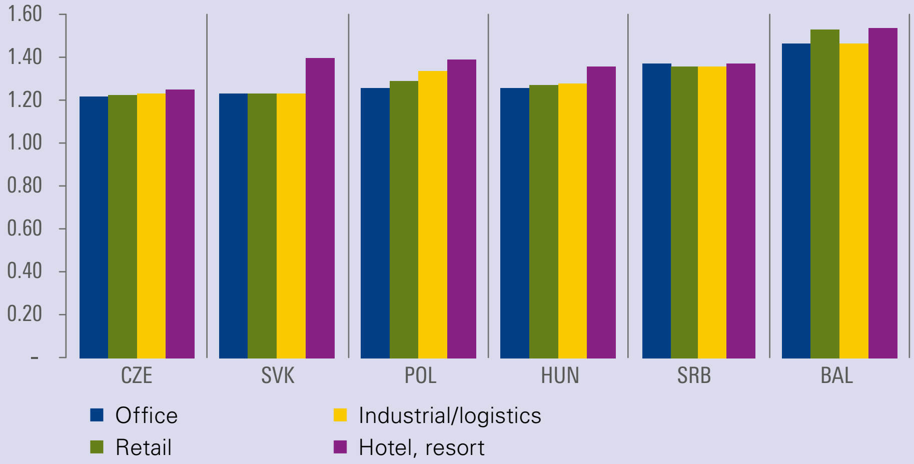
Pre-let ratio expectations for financing highly rated office, retail and logistics real estate development projects in the next 12–18 months



Source: KPMG in CEE Property Lending Barometer 2013

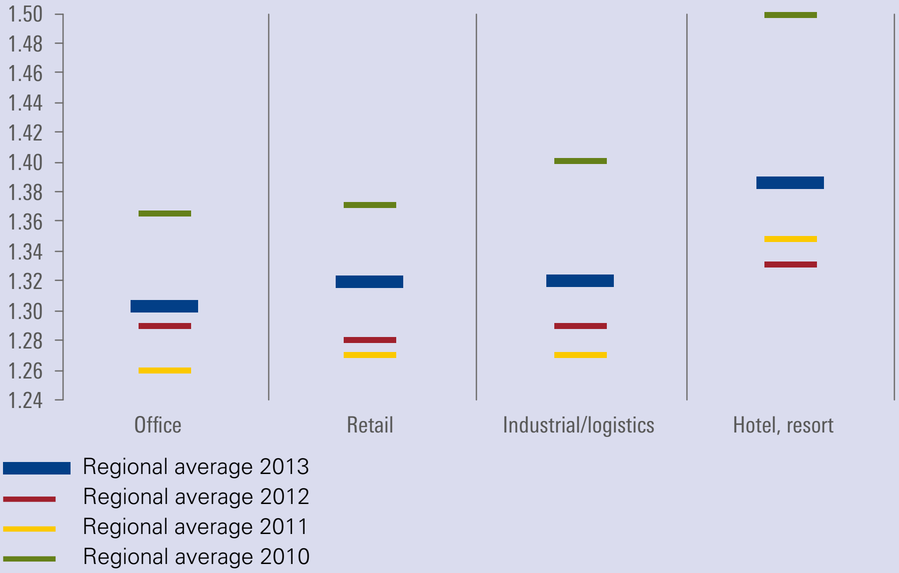
The debt service coverage ratios ('DSCR') expected for income-generating projects initiated by investors with an excellent reputation and sound business plan have also been examined. In almost all countries, hotel sector ratios tend to be higher than for any other asset class, exceeding 1.35 on average, which is a slight increase compared to last year.

Debt service coverage ratio expectations for financing highly rated income-generating real estate projects for selected countries in the region



Source: KPMG in CEE Property Lending Barometer 2013

Regional averages



Source: KPMG in CEE Property Lending Barometer 2013

Property lending trends in Poland

After moderate growth of 2% in 2012, Poland is exhibiting some weakening as real GDP growth is expected to slow to 1% in 2013.

Poland's banking sector, which is 70% owned by foreign banks, was coping well with the effects of the financial crisis. The sector faces significant structural and regulatory changes, both in Poland and in the rest of the EU.

Investors still consider the Polish market as the most attractive in the region. In terms of investment volume, Poland (excluding Russia) is the market leader in CEE, providing approximately 64% of all investment volume in the first half of 2013, outpacing the same period in 2012. The largest volume of transactions has been realised in the office sector, followed by the industrial and retail sectors. The amount of hotel transactions was not significant compared to other asset classes. Prime investment yields[8] for the best trade products remained stable.

- Office: 6.25%
- Retail: 5.75%
- Industrial: 8.00%

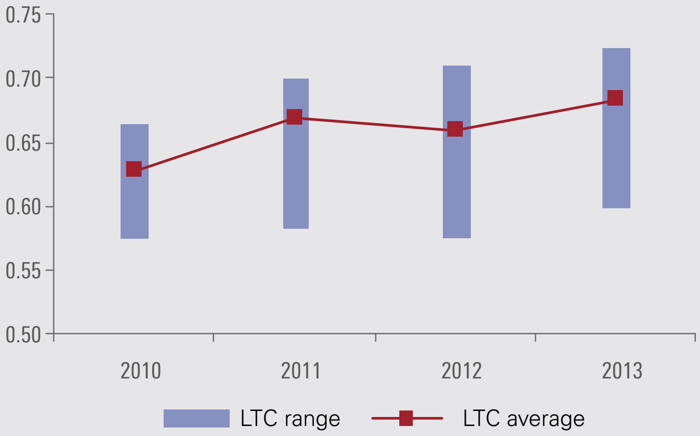
Key findings of the survey

After a decrease in 2011, interest premia are showing an upward trend, currently in the range of 2.8–4.5%. Banks' have a similar pre-let requirement to 2010. After a decrease in the average DSCR in 2011, this has remained stable and currently ranges from 1.21 to 1.47.

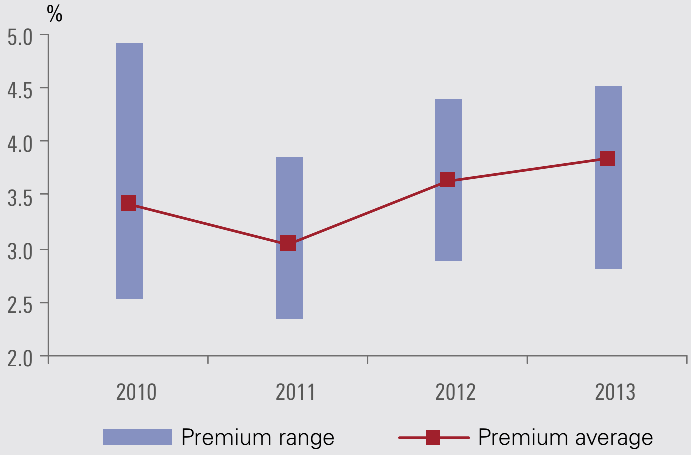
The loan-to-cost ratio for new developments shows a slight improvement compared to 2012. Interest premia is narrowing although, after a fall in 2011, premia appear to be increasing and currently range between 2.8 and 4.5%. Following an easing in 2011, banks seem to be more cautious about speculative development and require a higher pre-let rate from developers. There is a clear consensus on DSCR's ranging from 1.2 to 1.4, with office at the lower end and hotel at the higher end of the range. The average DSCR has stabilised at approximately 1.3 over the last 3 years.

The strategic focus on real estate financing increased significantly in 2013, after a temporary setback in 2012. At the same time, the expectation for a decrease in the proportion of problem loans as a percentage of total real estate lending portfolio is more positive compared to 2011

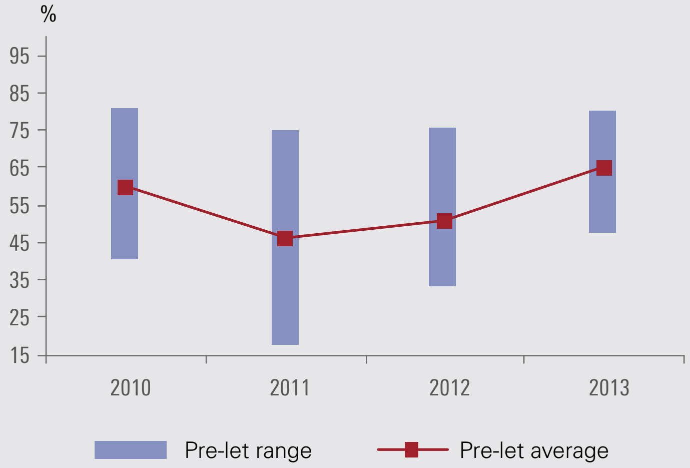
Loan to cost ratio (new developments) 2010–2013



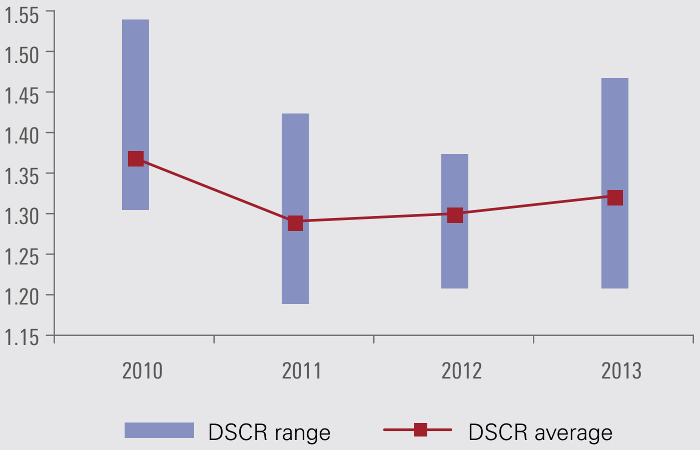
Loan interest premium (new developments) 2010–2013



Pre-let ratio 2010–2013



Debt service coverage ratio 2010–2013



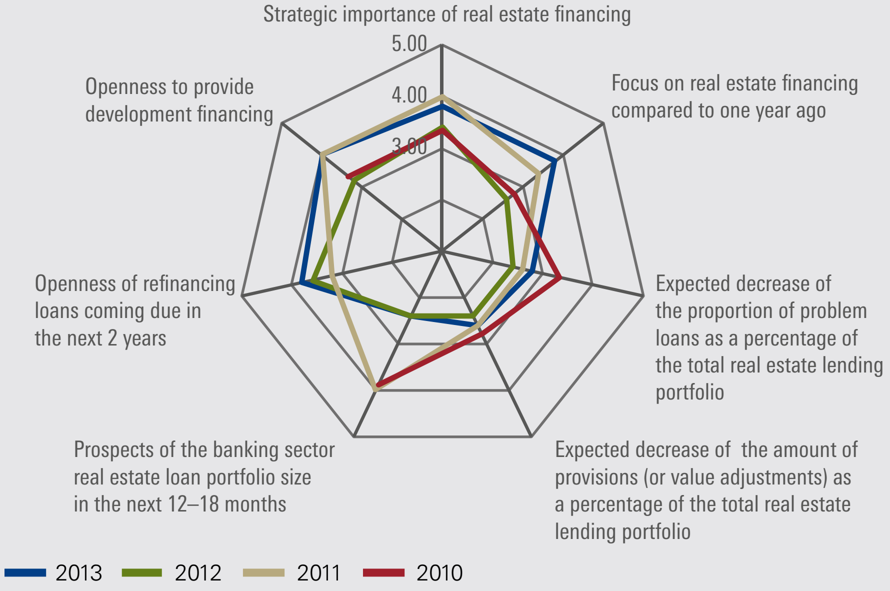
Note: Residential is not included in Pre-let ratio chart.
Source: KPMG in CEE Property Lending Barometer 2013

[8] *Jones Lang Lasalle – Warsaw City Report Q2 2013*

and 2012, although not as positive as it was in 2010. The openness of banks to refinancing loans coming due in the next 2 years is also at a peak this year. Banks seem to be still open to development financing in the next 12–18 months for projects with a solid business plans where developer has an outstanding reputation. The prospects for the banking sector's loan portfolio size in the next 12–18 months remained stable in 2013 after decreasing significantly in 2012.

Overall, for most issues there has been a positive shift since 2010 and general sentiment towards the market has improved.

Lending sentiment in Poland



Source: KPMG in CEE Property Lending Barometer 2013

Property lending trends in the Czech Republic

The Czech Republic is one of the most established markets in the CEE region, but it is highly dependent on exports to the German economy. The Czech economy contracted by approximately 2% during 2012 and it is expected that real GDP will contract in 2013, by 0.7%. This would make the country, in terms of GDP growth prospects, the second worst performing in the region, following Slovenia. Construction activity has dropped and the unemployment rate continued to rise. On the other hand, investment activity in the first half of 2013 remained at a high level compared to other countries in the region, although at a slightly lower level than in the same period in 2012.[9] There were a number of significant transactions mainly focussed on office and retail assets. Prime assets remain the most sought after by the investors, with limited interest for secondary properties. Prime investment yields[10] for best trade products are stable.

- Office 6.25%
- Retail 5.5–6.25%
- Industrial: 8–8.25%

Key findings of the survey

The average loan interest premium for new developments has increased by approximately 80 basis points since 2010. In contrast, the average pre-let requirement in the office and retail sectors has decreased. Except for minor fluctuations, the DSCR ratio remained stable in 2010–2013 and ranges between 1.17 and 1.30.

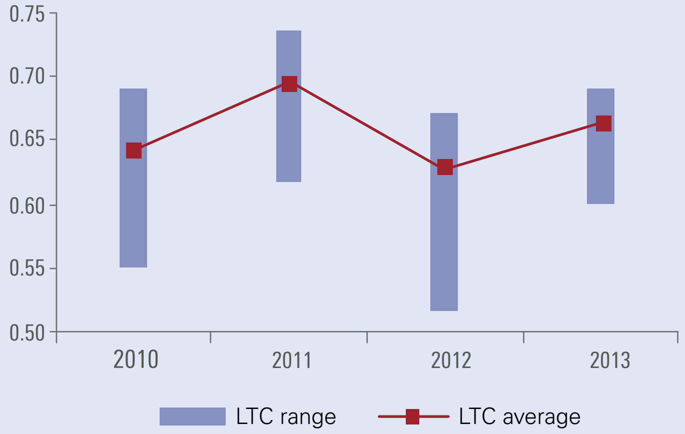
The average loan-to-cost ratio has fluctuated since 2010 and currently ranges between 60 and 70% with an average of 66%. Interest premia were on the rise in 2010 – 2012, but the trend has ceased this year and they have stabilized, now in a range of 3.0 to 3.8%, with office properties represented at the lower and hotel properties at the higher end of the range. The average pre-let ratio requirements have decreased, especially in the office sector, where it fell from an average of 66% in 2010 to below 50% in 2013. Retail properties exhibited a fall from 63% to 54%, on average. On the other hand, for industrial properties the pre-let ratio requirement is much higher: close to 90% on average. By common market practice, industrial properties are usually developed for built-to-suit; hence banks require a higher pre-let rate for this asset type. The range of the DSCR has become much narrower since 2010 and is between 1.2 and 1.3.

Since the first Lending Barometer survey conducted in 2010, the strategic importance of financing real estate projects fell to its lowest level this year. However, the focus on real estate financing is more important for banks than in 2012. Expectations in relation to a decrease in the proportion of problem loans as a percentage of total real estate loan portfolio are not as positive as they were in 2011, but definitely brighter than last year. The expectation of banks regarding the decrease in the amount of loan provisions follows a similar pattern.

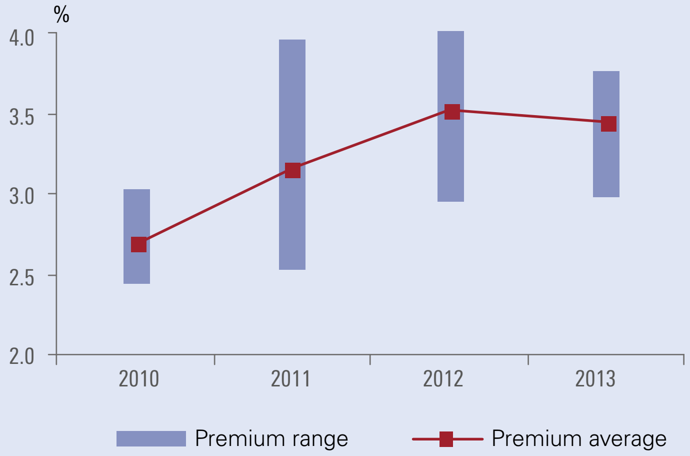
[9] CBRE – CEE Property Investment H1 2013 – (According to the JLL CEE Investment Market Pulse H1 2013, there was an increase of 24% since last year, due to a transaction, which is about to be closed by the end of H1 2013.

[10] Jones Lang Lasalle – Prague City Report Q2 2013

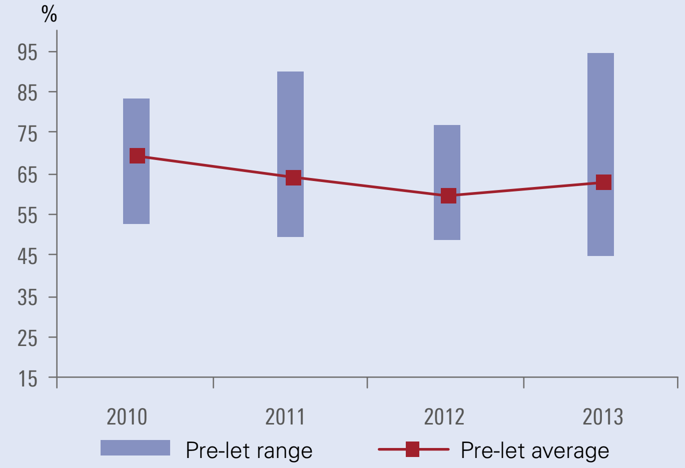
Loan to cost ratio (new developments) 2010–2013



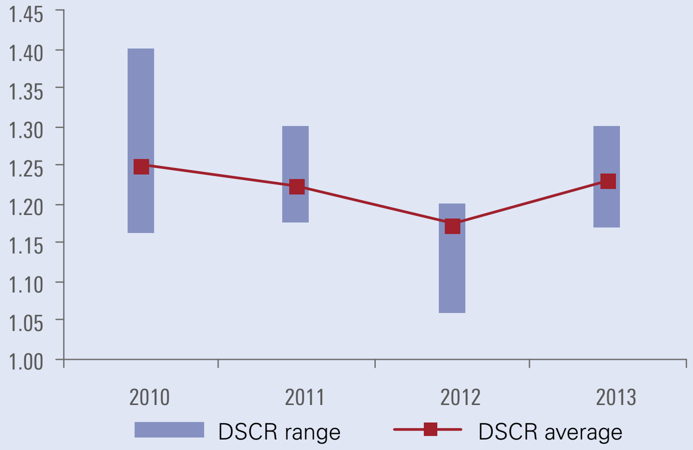
Loan interest premium (new developments) 2010–2013



Pre-let ratio 2010–2013



Debt service coverage ratio 2010–2013

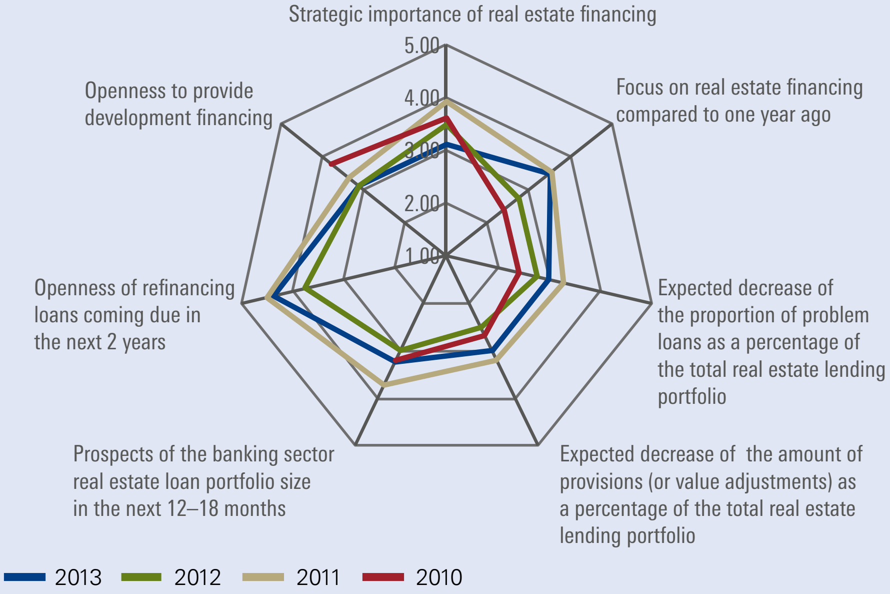


Note: Residential is not included in Pre-let ratio chart.
Source: KPMG in CEE Property Lending Barometer 2013

Czech banks are comparatively open to refinance loans in the next two years. The openness of banks has been under pressure since 2010, but it stabilized this year.

Among the seven highlighted issues no clear trend can be identified for any improvement or deterioration of real estate financing sentiment in the Czech Republic since 2010.

Lending sentiment in the Czech Republic



Source: KPMG in CEE Property Lending Barometer 2013

Conclusion

KPMG's Property Financing Sentiment Index illustrates how banks are approaching the financing of real estate projects in each country covered by this survey.

As in previous years, the Index has been calculated from responses to the following 10 issues:

- increase or decrease in focus on real estate financing within a bank's lending activities compared to one year ago;
- proportion of fully compliant, impaired and seriously impaired real estate loans per country;
- proportion of impaired loans, which can be managed successfully through restructuring;
- expected change (increase or decrease) in the size of real estate loan portfolios in the next 12–18 months;
- openness of banks to finance new development projects;
- openness of banks to finance income-generating properties;
- loan interest premium applied by banks for quality real estate projects;[11]
- loan-to-cost ratio expected by banks for quality real estate projects[11] in the next 12–18 months;
- pre-let ratio applied by banks for quality real estate projects[11] in the next 12–18 months; and
- debt service coverage ratio applied by banks for income-generating properties.

Based on a ranking of the surveyed countries for each of the 10 issues, the following rankings have been calculated for the last 4 years.

Property Financing Sentiment Index

Overall ranking in:	2010	2011	2012	2013
1	Poland	Czech Rep.	Czech Rep.	Czech Rep.
2	Czech Rep.	Poland	Poland	Slovakia
3	Slovakia	Slovakia	Bulgaria	Poland
4	Hungary	Romania	Romania	Romania
5	Bulgaria	Serbia	Hungary	Bulgaria
6	The Baltics	Hungary	Slovenia	Serbia
7	Romania	Bulgaria	The Baltics	Hungary
8		Slovenia		The Baltics
9		The Baltics		Slovenia

As in the last 2 years the Czech Republic was the top performer among the surveyed countries, while Poland dropped to 3rd place this year, behind Slovakia, in 2nd. However, the Sentiment Index results of the Czech Republic, Poland and Slovakia (when represented in the survey) were quite similar each year. Hungary is showing gradually worsening results since 2010 and now ranks 7th, while Romania has stabilised its 4th place position over the last 3 years. Although there are no clear signs of significant economic growth in most of the countries, results show that financial sentiment is more positive in areas with a lower risk profile and solid macroeconomic conditions. Slovakia has become more attractive to investors, as transaction volumes have soared compared with the same period last year. (EUR 81m in H1 2013 compared to EUR 1m during H1 2012).[12] Overall, there is a slight reversal of last year, when rising uncertainty in the Eurozone negatively affected the overall financing sentiment.

Currently, the prospects of the Eurozone seem less gloomy than last year. The immediate risk of the breakup of the monetary union has been reduced due to Greece and Portugal avoiding default, which was a serious threat to the region's economies. Furthermore, the bailout of Cyprus by the EU- IMF in early 2013 has had a stabilising effect upon the markets. Another positive sign is that the CEE's real estate transaction volume (including Russia) has risen by approximately 60%[13] year-on-year for the period of H1 2013 and H1 2012, although investors are still focussed on the region's main markets (Russia, Poland, Czech Republic). Prospects for macroeconomic development among the surveyed countries varies greatly, therefore the recovery of the real estate sector, which is closely tied to macroeconomic outlook, is different in each country.

Confidence has risen since last year, which is also reflected in a slight decrease in loan interest premia for new developments; although they are still higher than in 2010 and 2011. Overall, the results of our survey show that, while there is financing available for high quality real estate projects, the appetite for financing is still not close to that of the pre crisis years.

The Property Financing Sentiment Index reaffirms that Poland and the Czech Republic are clearly more attractive markets for real estate financing than other countries in the CEE region. Despite its smaller market size, banks in Slovakia have also expressed a relatively positive sentiment towards financing real estate projects this year; whether their appetite persists over the longer term, however, remains to be seen.

[11] Quality projects are defined in our survey as follows: a project initiated by a developer/investor with an outstanding reputation and a solid business plan.
[12] CBRE – CEE Property Investment H1 2013
[13] CBRE – CEE Property Investment H1 2013

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