FINANCING OF REAL ESTATE

ALTERNATIVE REAL ESTATE FINANCING

In most member states, the share of alternative financing increased again in 2016.

In its report on pension funds, the OECD identified the Czech Republic as the country with the highest proportion of conservative investments among all its members (97.7% of assets at the end of 2018).

The amount of newly registered real estate, mixed or other investment funds and sub-funds investing in (or also in) all types of real estate is increasing in the Czech Republic.

Due to the considerable resources that the Church receives from the state as severance, and which will be invested in some way, the Sustainability Fund of the Roman Catholic Church may become a major player in the market.

Alternative financing should aim to strengthen the structure of resources in the balance, use non-bank debt instruments and ideally increase equity. The resulting positive impact on market stability and security will be all the more appreciated the further the current economic cycle is passed its peak, particularly when estimates continue to grow – especially in the United States, the usual indicator of economic development – when it will decline to recession. For example, one recent reputable survey among US and global investors[1] shows that 73% of them expect a recession within two years.

At the same time, the OECD report on Financing SMEs and Entrepreneurs published last year states that in most member states the share of alternative funding has risen again in 2016, either as venture capital inputs, private entity loans or peer-to-peer, crowdfunding, leases, factoring and other forms. Although newer data are not yet available, we expect this trend to continue in the coming years, and real estate transactions, the vast majority of which fall into this segment, were no exception. The Czech market was also no exception[2].

In this context, greater allocation of pension funds and insurance company capital into real estate has been called for. However, nothing has happened so far, which we have unfortunately been repeating in the same wording since the beginning of this chapter in Trend Report. Most recently in its report on pension funds, the OECD devoted a special paragraph to the Czech Republic, in which it described it as the country with the highest proportion of conservative investments among all its members (97.7% of assets at the end of 2018).[3]

One of the reasons for this are the still valid requirements to guarantee a non-negative appreciation of savings in transformed pension funds, whose portfolios represent the vast majority of pension company assets (about 90% at the end of 2018)[4]. At the moment there is no way to get managers of these portfolios to invest in more profitable but at the same time riskier and less liquid alternative assets, including real estate. Only legal regulation of parameters would help.

The new subscription pension funds, which allow for a dynamic investment strategy, have about 10% of assets worth almost 45 billion CZK. Even with this volume, we still cannot find a single direct real estate investment among them for the valorization of resources. The proportion of real estate in the investment portfolios of local pension funds is close to zero (0.38% at the end of 2018), with 5 to 10% considered as the standard level[5]. However, it is not possible to determine how much was invested indirectly through mutual funds from Czech statistics.

Czech insurance companies have more favorable legislation. However, this does not correspond with the approach of their portfolio managers, and the reported share of real estate acquired for valorization is 0.25%[6]. Here it is also impossible to determine from the statistics how much could have been invested indirectly. Given the need for higher liquidity compared to pension funds, the expected share should be between 2% and 5%, but the only insurance company in the real estate market with noteworthy activity – since long ago – has been Kooperativa of the VIG Group.

REAL ESTATE INVESTMENT FUNDS

The capital of private investors can also be used through investment funds. The Czech National Bank as the regulator in this area registered a total of 114 investment funds and sub-funds in the category of real estate, mixed or other investors in all types of real estate at the end of January 2019. This represents a year-

[1] 10th Annual Investor Survey, Boston Consulting Group, October 2018
[2] Alternative Financing Instruments for SMEs and Entrepreneurs, OECD, 2018
[3] Pension Funds in Figures, OECD, June 2018
[4] As of December 31. In 2018, pension companies managed assets totaling 470.328 billion CZK in their funds, of which 425.724 billion CZK was transformed and 44.604 billion was subscribed.
[5] For comparison: According to an analysis of pension systems of OECD member countries for 2017 (data were not available during the writing of this text), the share of direct real estate investments in pension fund portfolios was an average of 3.2%, ranging from 0 to 11.2% per country. Finland (11.2%), Switzerland and the Netherlands (8.7%) ranked the highest in Europe. After adding indirect investments through collective investment structures (mutual funds), the total exposure of OECD member country pension systems against the real estate sector was an average of 4.3% per country, ranging from 0 to 18.8%. The highest ranking European countries were Switzerland (18.8%), Portugal (12.3%) and Finland (11.2%). In the largest European economies, this amount was 6.4% in Germany, 2.5% in Italy and 0.1% in Spain. Averages were calculated only including countries that provided the necessary data – for example, the statistics supplied by the Czech Republic lack a breakdown of the underlying assets of mutual funds.

-on-year increase of 16%. Seventeen of them are self-governing, and the rest are managed by 22 investment companies.

In terms of capital variability, 99 funds are open-end and 15 are closed-end. However, some of them are entities whose portfolio consists of corporate securities of real estate companies, so they do not invest in specific real estate (directly or through Special Purpose Vehicles - SPV). The figures above include both qualified investor funds (FKI) and mutual funds aimed at small investors - consumers, but not private equity funds established by Czech entities abroad, or foreign funds operating in our market.

International Securities Identification Numbers (ISIN) have been assigned to fifty registered funds for trading purposes, and more than a third have entered the Prague Stock Exchange, even though they are not active. Since the change in law in 2015, legislation allows the FKI to continue to pay 5% income tax under certain conditions, including trading in a regulated market. However, the 2016 statement of the Ministry of Finance of the CR indicates that if an FKI with shares received but not traded in a regulated market applies the reduced 5% rate without meeting other conditions, this is a violation of the rules. According to this statement, tax administration will be based on the principle of the prevalence of content over form pursuant to § 8, paragraph 3 of the Tax Code and the principle of prohibition of abuse of rights. However, the funds could and can legally benefit from a reduced tax rate even if they do not hold real estate directly but through a SPV, or if they are in the form of an open-end fund. The amendment to the law effective from 2016 also added the form of a closed-end mutual fund, thus more or less putting an end to these tax games.

At present, 20 to 30 billion korunas are allocated in real estate FKI, and this amount is increasing year-on-year. Despite repeated efforts to raise taxes for FKI, they lost no capital in recent years. On the contrary, thanks to the acceleration of economic growth, low interest rates and the resulting overpressure of free money, our prediction that funds aimed at qualified private investors will increase was confirmed once again.

Some of them were or are being founded by strong companies that provide their name, know-how, or seed money, i.e. start-up capital or assets (such as CIMEX and their Edulios fund, NOVA Real Estate and NOVA Hotels from the Arca Capital group, the RSJ Investments Real Estate sub-fund and others); others arise for the purpose of acquiring capital through creditworthy distribution networks (typically real estate funds of Komerční banka and Raiffeisenbank as products intended for clients of their private banking, or Generali Investments CEE Real Estate Fund). They usually promise their investors an annual yield of between 3% and 8% – NOVA Real Estate with a volume of about 2.5 billion CZK was appreciated by 8.65% last year, the first of Komerční banka's funds with about 2.3 billion CZK by 7.33%, and the Generali Investments CEE fund (amount not publicized) by 5.44%. According to available data, but without a demand for completeness, Accolade Industrial Fund was the most efficient in 2018 with a volume of about 3.8 billion koruna, with 8.96% of issued koruna shares and 9.58% of issued euro shares.

Fond udržitelnosti Římskokatolické církve (Sustainability Fund of the Roman Catholic Church) is a specific entity that expanded its focus to the real estate sub-fund in February 2017. This does not only mean investing in the usual real estate sectors, such as offices or business centers, it also includes plans more typical of church properties, such as farmland or forests. However, due to the considerable resources the Church receives

TABLE 1 Open-ended mutual real estate funds in the Czech Republic

Source: ARTN and funds websites

Name of fund	Administration	Founded	Fund capital as of February 28, 2019 (billions of CZK)	Performance over last 3 years (% per annum)
ČS nemovitostní fond	REICO České spořitelny	2007	22.31	2.78
ZFP realitní fond	ZFP Investments	2013	7.29	5.83
Investika realitní fond	Investika investiční spol.	2015	2.96	5.64*
Czech Real Estate Investment Fund	CAIAC Fund Management FL / DRFG	2016	2.80	5.33*
Conseq Realitní	Conseq Funds investiční spol.	2008	1.96	3.15
Realita	Tesla investiční spol.	2009	1.87	3.91*
Raiffeisen realitní fond	Raiffeisen investiční spol.	2017	1.12	3.72**
IAD Korunový realitný fond	IAD Investments SK	2017	0.09	3.50**
IAD Prvý realitný fond (EUR)	IAD Investments SK	2006	5.05	3.41
Conseq realitní (EUR)	Conseq Funds investiční spol.	2018	0	0

* The fund does not report 3-year performance, it is an arithmetic average of appreciation over the last 36 months

** Annual performance since foundation

[6] At the end of 2017 (newer data were not available during the writing of this text), insurance companies had 0.72% of assets in real estate, totaling 3.4 billion CZK. However, two-thirds of them were their own operating sites; after their deduction, the exposure was only 0.25%. Year-on-year, these investments remained almost stable. The largest volume of non-operating real estate - 40% of the above-mentioned exposure in the amount of 476 million CZK, is reported by Generali Pojišťovna. For comparison: OECD insurance companies had an average of 1.79% of their total investment in real estate in the same period, including 90% directly and 10% through collective investment structures. Slovakia (17.2%) reported the highest share among European countries, followed by Switzerland (11.1%) and Norway (8%). In the largest European economies, this share was 3.8% in Spain, 3.1% in Germany and 2.4% in the UK.

from the state within the separation and which will be invested in some way, this fund can gradually become one of the major players in the market. The Church as an investor is also starting to cooperate with established developers; for example, the Diocese of Hradec Králové met with Serge Borenstein in a multifunctional house project in Karlín, Prague.

A significant increase in volumes also applied to open-end mutual funds with a consumer-oriented public offer, which are subject to more stringent operating rules than FKIs. Their capital exceeded 40 billion CZK, and increased by more than one third year-on-year. Until recently, unlike in Western Europe, they played a marginal role; today, ČS Real Estate Fund from the Česká spořitelna group, with a capital of 22.3 billion CZK and property worth 30.5 billion CZK, is the largest Czech real estate fund ever. In the last three years it has considerably increased its investment appetite and concluded extensive transactions both at home and abroad, crowned last year with the purchase of Nová Karolina in Ostrava for 5.4 billion CZK. On the other hand, it is true that this group of funds does not have serious competition in terms of volume. However, it is at least worth mentioning the 7-billion ZFP fund with assets spread over the entire Visegrád Four territory, as well as foreign funds – two Slovak IADs, and Czech Real Estate based in Liechtenstein (although it belongs to DRFG in Brno). There is also a new option of denominating consumer investments into euros.

SECURITIES

The issue of securities may be another source of alternative funding. After the infamous end of Orco Property Group and ECM in the stock market, corporate and project bonds – bonds usually issued in cooperation with a bank, which also places them on the market – are successful in our country. They can be traded both on the stock exchange and elsewhere. Although they don't generate equity as such, they usefully complement the financing structure of a company or a particular project in the form of subordinated debt. The primary target group of their offer are private investors or private banking clients, but institutions that are allowed to buy riskier securities also show interest.

Given the market capital surplus, the number of bond issuers has started to increase visibly in recent years, and the volume of programs and bond issues outside CPI (see below) was almost 17 billion korunas at the beginning of 2018, including those already paid. Last year the growth continued – confirming our prediction – and of the 66 prospectuses approved by the CNB over the past 12 months, one-third belonged to the real estate sector. The issuers did not limit themselves and added another 20 billion CZK in one year, resulting in a total amount of approximately 37 billion CZK.

However, the bonds were not sold for this amount, it is the sum of the maximum, only partially used limits. Moreover, we believe that for many issuers, their idea was more of a wish than a real calculation. We therefore estimate that securities for about one third of the stated amount, i.e. 12 billion CZK, have found an owner. Some of them have already been repaid. We also expect new issues to continue to grow.

We should also mention the courageous act of UDI CEE, which released 587,000 shares last autumn and let them launch on the newly opened, unregulated Prague START market for emerging small and medium-sized Czech companies. During the initial auction, the entire issue was rewritten, and more than 250 million CZK was collected from investors, which promises a dividend yield of 9.4% per year, among other things. This is a company primarily engaged in the development of commercial, residential and logistics projects in the Czech Republic, Slovakia and Serbia.

Czech Property Investments (CPIPG) has been using bond financing for longer and more intensively than the rest of the market. Since 2005, it has prepared programs with a total limit sum of about 161 billion CZK, with their frequency and volume accelerating over the past seven years. This included issues of corporate bonds by parent company CPI for more than 15 billion CZK, and secured project bonds of CPI Alfa, CPI BYTY and CPI Retail Portfolio. Today, its real estate portfolio is spread across ten European countries – although two-thirds of it is still in the Czech Republic – and the vast majority of bonds sold are already held by foreign investors, so we started to keep the statistics separate.

Last year and the year before that, it broke through to foreign capital markets. In October 2017 it offered 7-year bonds worth 600 million euros (15 billion korunas) in London, which it increased two months later by a second tranche of almost 6 billion crowns. Due to high demand, it managed to get an interest of 2.125%. From the revenues of new issues, it began massively repaying previously issued more expensive bonds, as well as selected bank loans, which it continues to do today. Both tranches were part of the EMTN program designed to issue medium-term eurobonds approved by the Central Bank of Ireland with a total limit of 1.25 billion euros (32 billion korunas).

In April 2018, another EMTN program was set up with a limit of 3 billion EUR (77 billion CZK), in which it gradually issued hybrid bonds in the volume of 550 million euro with a 5-year fixed interest of 4.355%, 3.5-year bonds worth 600 million EUR with an interest of 1.45%, 5-year bonds worth 135 million Swiss francs with 1.65% interest, and two Japanese tranches in the volume of 11 billion yen – 10-year tranche with an interest of 1.995% (i.e. lower than the Czech state's loan interest), and a 3-year tranche with an interest of 1.414%. All of last year's issues amounted to almost 35 billion CZK.

In February this year, the CPIPG issued 5-year bonds worth 450 million Hong Kong dollars (about 1.3 billion korunas) under the same program with an interest of 4.51%, and in March it made another 5-year issue worth 350 million USD (8 billion CZK) with an interest of 4.75%. It therefore already denominated its bonds into six currencies – koruna, euro, yen, Swiss franc and two kinds of dollars. The obligations of the entire group from the issued bonds were around 35 billion CZK at the end of 2018 (newer data were not available during the writing of this text), but this year's issues, last year's Swiss and Japanese issues, and repayment of earlier issues, which took place in the meantime, were not included

Another big European player, Slovak group HB Reavis, which is also active in the Czech Republic, has received more than 311 million euros (7.8 billion korunas) in capital markets in Poland and Slovakia since 2013, two thirds of which are thanks to seven issues from the year before last. In May 2016, one Czech one in the amount of 1.25 billion CZK with a maturity in 2021 and a current floating yield of approximately 6% was successfully added. Then, in November 2018 it launched a new bond program with a limit of 150 million euros (almost 4 billion korunas), from which it issued the first 6-year tranche in the amount of 15 million euros (400 million korunas) in January this year, with an interest of 3.25%. The funds are intended to finance projects in the group, so they can also appear in the Czech market.

Established Prague developers Central Group, SATPO, Passerinvest, GES Real and Trigema have also tried issuing medium-sized securities over the past seven years. FINEP was the most active, which first issued 4-year project bonds for 201 million koruna with an interest rate of 3.75% in 2016, and a year later RED Thirteen - a joint venture with RSJ Investments – continued with a 4.5-year issue in the volume of 210 million CZK and an interest of 4.8%. Last year FINEP Hloubětín offered investors 5-year project bonds for 150 million CZK with an interest of 5%.

The RSJ Group also provided last year's most exotic issue in the amount of 18 million USD (400 million CZK), with a maturity of five years and an interest rate of 7%. It is secured by five-star beach resort Zuri on Zanzibar Island in the Indian Ocean, which was opened only a few months after the bond was issued and is owned by RSJ. It should be repaid from the operating revenues of this resort.

Activity is also constantly increasing outside the capital, especially in Brno. Since 2009, corporate bonds have been issued by the local real estate concern e-Finance, which introduced 17 new small issues this year and last year forming part of the program with a duration of 25 years and a limit of 1 billion CZK. Sixteen of them have a maturity of 3 to 3.5 years and an interest rate of 4.5%; the latest one from April 2019 is a 7-year bond with an interest of 5.6%.

In 2017 the first 10-year, 1 billion CZK bond program was approved for major local group DRFG, which is already listed among consumer mutual funds; it fully drew it down with six issues with a maturity of 3 to 7 years and an interest of 4.5% to 7%. This was followed by another ten-year program with a limit of 2 billion CZK, under which it issued three bonds totaling 500 million CZK this year, with a maturity of 3 to 7 years and interest of 4.5% to 6.5%.

At the end of 2017, brno-based group NWD launched its first ten-year program in the amount of 300 million CZK with two issues totaling 70 million CZK, with maturities of 3 and 5 years and an interest of 3.1% and 5.1%. In 2018, it continued with two more issues totaling 160 million CZK with the same maturity and interest. In addition, it launched a second ten-year program with a limit of 300 million CZK, of which it drew down 180 million CZK with a pair of issues with the same parameters as the previous.

From other Moravian representatives, it is also worth mentioning the Olomouc group Redstone Real Estate. In November 2017, RSRE Invest issued 5-year bonds with a volume of 20 million EUR (500 million CZK) with an interest of 5% from this group, and last year a program with a limit of 2 billion CZK was approved for its sister company Redstone Invest. So far, it has spent 500 million koruna with two issues last year and one issue this year with a maturity of 5 and 6 years and an interest rate of 4.7% and 5.1%.

Also small issuers from different regions, some of whom are returning to the market repeatedly, confirm growing awareness of this form of funding. The attached table shows selected examples from the last two years.

KAMIL KOSMAN
KAAP Media

TABLE 2 Selected small bond issues

Source: ARTN

Issuer	Date of issue	Volume (millions of CZK)	Maturity (years)	Yield (% per annum)	Subscription	Purpose
Prague						
Rezidence Halas	2018	18	2.5	8	ongoing	construction of residential house in Budějovická area
Heřmanova 595	2018	24.5	1.5	9,.6	subscribed	renovation of residential house in Letná
K&K Invest Group	2018	12	2	8	subscribed	extension of underground garages in Londýnská
Činžovní domy Praha II	2018	25	2	8	subscribed	construction of loft apartments Korunovační 11
Na Doubkové 2	2017	12.5	2.5	8.5	subscribed	renovation of residential villa
Outside Prague						
I.D.C. Dvojdomy I	2018	10	3	9.2	ongoing	development construction of double family house near Opava
Market Balance	2018	9	3	9	subscribed	purchase of land in Frýdlant nad Ostravicí
Endeka	2018	20	5	5.05	ongoing	renovation and extension of 12 residential houses in Brno
Sovinvest	2018	6	2.5	8.1	ongoing	purchase and renovation of three family houses in the Moravian-Silesian Region
Capital for you	2017	22	1.5	9	subscribed	construction of family houses in Český Brod

FINANCING LEGAL PERSONS AND REAL ESTATE

In 2018 there was a 27% decline in investments compared to the previous year, but the result still exceeds the long-term annual average.

The parameters / structure of real estate project financing is essentially unchanged.

The market continues to be characterized by high liquidity, but low CZK interest rates are over.

The volume of bond real estate financing is almost doubled in comparison with the previous year, but it is still an insignificant source of external financing compared to the volume of loans.

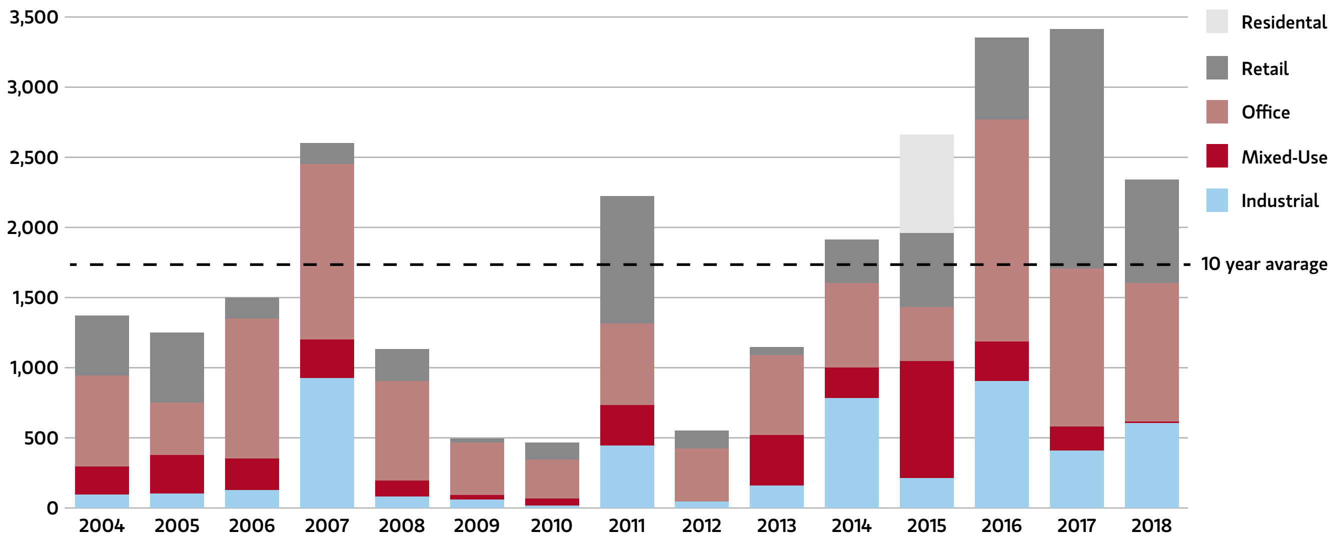
BANK FINANCING

2018 was characterized by a year-on-year decline of 27% in the Czech real estate market. However, the result still exceeds the long-term annual average. Offices were the most traded asset in 2018 (44%), followed by retail (30%) and warehouses (22%). The decrease in the volume of transactions is due to a shortage of projects for sale rather than the small appetite of buyers.

The average transaction worth reached about 40 million EUR, which corresponds with the long-term average. The Czech market's stability is supported by a large share of domestic investors (around 62%), accompanied by the interest of institutional investors from Germany (22%), the US (3%), Austria (3%), South Korea (2%), Norway (2%) and Lebanon (2%).

GRAPH The volume of investment transactions in the Czech Republic in the period of 2010–2018 in millions of EUR

Source: Knight Frank



Czech commercial real estate is still in high demand, as it still generates slightly more interesting returns than in Western Europe. Moreover, the local environment is synonymous with economic stability and security in terms of legal certainty for investors.

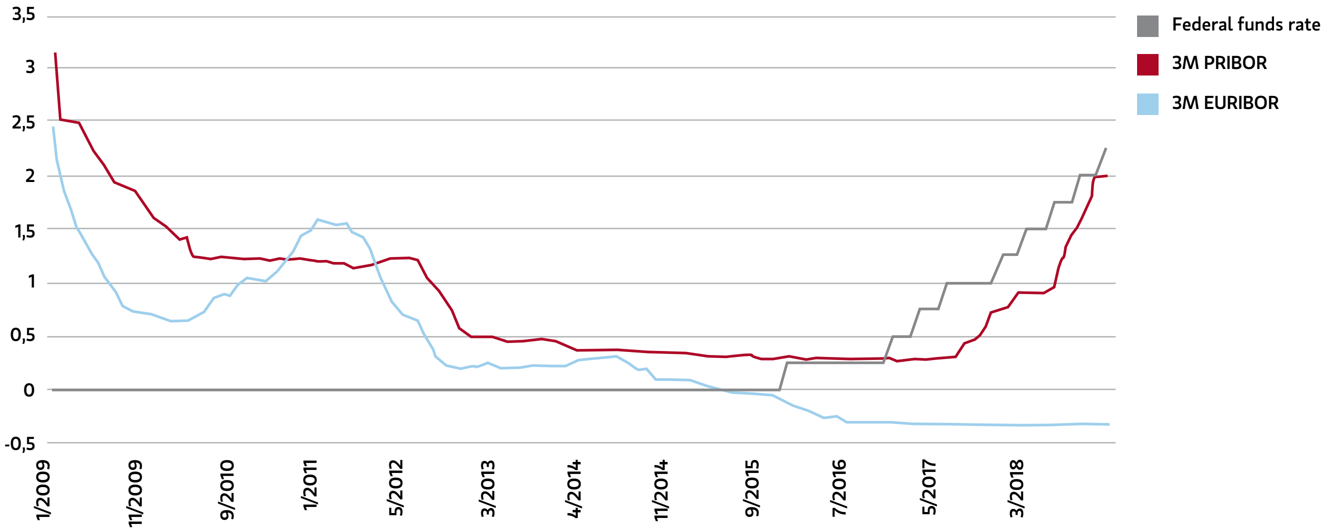
The yield rate remains more stable in the Czech Republic. However, with rising CZK interest rates, the yield rate in CZK is expected to slightly increase, which may mean a slight decrease in CZK real estate prices. The graph below shows the development of CZK interest rates in comparison with EUR and USD rates (source: KPMG).

Investment and development in the domestic real estate market is supported by the appetite of financing banks. The main stimulus is the current surplus of liquidity and a stable economic and legal environment, both of which lead to healthy competition between banks, from which clients profit in the end (margin pressure). Loan financing is relatively affordable for good projects and experienced players. Investment transactions supported by demonstrable cash flow are preferred by banks to development financing.

Banks have learned to work with the regulator's requirement (i.e. the Basel III criterion) that requires banks to maintain the

GRAPH Development of reference interest rates 2009–2018

Source: ECB, ČNB, FED (bottom interval boundary)



necessary amount of risk-weighted assets/regulatory capital (RWA) compared to the amount and quality of the credit exposure. The more conservative the financing structure (i.e. lower loan to cost (LTC) or loan to value (LTV)) and the better the asset (strong and stable cash flow), the lower the consumption of regulatory capital (RWA) and the lower the margin for clients.

It can be said that the credit conditions of banks operating in the Czech market do not differ significantly from one another. Speculative transactions continue to be financed in a very limited manner. Building plots are mostly bought by developers with their own resources, without loans. One of the main reasons for this is that both speculative development and the purchase of land on credit lead to large consumption of regulatory capital, which banks operating in the real estate market are forced to conserve.

REACTION TO REGULATION – BOND ISSUANCE[1]

The current real estate financing market in the Czech Republic can be characterized as highly concentrated: a relatively narrow group of highly experienced players such as Penta, HB Reavis, CTP, CPI, etc. are operating in it; these players are active in the Czech and Slovak Republic, as well as in Poland, Hungary, Germany and the United Kingdom. Regardless of the willingness of financing banks to finance the projects of these experienced players, the credit needs of these entities may hit bank loan limits for regulatory reasons (concentration). This is why, in addition to loans, many of them try to provide the means for their growth in the form of bond issuance, whether these are corporate (which is the case of most bonds) or project bonds.

CPI is an example of successful corporate bond issues in real estate financing: Since 2017, CPI has issued seven bonds in a total volume of approx. 2.250 million EUR in four currencies and with different maturity dates (see the table below). A key prerequisite for similarly successful bond issues is obtaining an investment rating. CPI received its first Baa3 rating by Moody's in 2017 (first investment rating). In 2018, CPI received a second BBB rating by S&P (second investment level), they upgraded their rating by Moody's to Baa2 (the same level as BBB) and earned special A- rating in Japan. As far as banks are concerned, CPI has issued bonds with Deutsche Bank, Societe Generale, UniCredit, Credit Suisse, Nomura, JP Morgan, HSBC, Barclays and RBI.

In addition to a group of developers and investors with international ambitions, a variety of top-quality local companies are operating in the market, and they are also currently looking for ways to source external sources by issuing corporate bonds. The excessive concentration of the loan limits of banks is not the issue here, but rather the type of activity that banks have trouble financing for regulatory reasons – such as the purchase

TABLE Overview of CPI bond issuance

Source: CPIPG International Bond Issuance

Issue	Ranking	M S JCR	Ccy	Size (m)	Cpn	Mty		
12 Feb 2019	Senior Unsecured	Baa2	BBB	--	HKD	450	4.51	Feb-24
10 Dec 2018	Senior Unsecured	Baa2	BBB	A-	JPY	8,000	1.414	Dec-21
10 Dec 2018	Senior Unsecured	Baa2	BBB	--	JPY	3.000	1.995	Dec-28
25 Oct 2018	Senior Unsecured	Baa2	BBB	--	CHF	165	1.630	Oct-22
17 Oct 2018	Senior Unsecured	Baa2	BBB	--	EUR	600	1.450	Apr-22
9 May 2018	Junior Subordinated	Ba1	BB+	--	EUR	550	4.375	Perp
4 Oct 2017	Senior Unsecured	Baa2	--	--	EUR	825	2.125	Oct-24

[1] See more about bond issuance in chapter Alternative financing sources on page 80.

REAL ESTATE MARKET AND BOND FINANCING

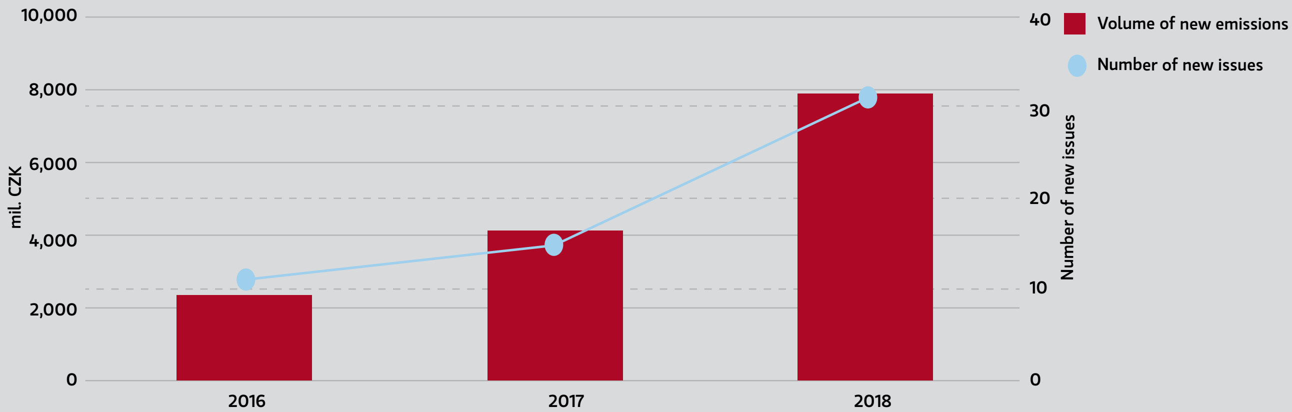
An analysis by consultancy firm EY suggests that the corporate bond market associated with development financing and property investment is exponentially growing. According to data from the CNB's prospectus register, the volume of funds issued through bonds increased by more than 245% from 2.3 billion CZK to almost 8 billion CZK between 2016 and 2018, and this activity continues in 2019.

Along with the rising monetary policy rates of the CNB, a rise in the rates of fixed coupon rate bonds can also be observed from 2018 onwards. The statistics presented in the graph below represent the values of the range of coupon rates (1st to 3rd quarters) of Czech real estate bonds with a prospectus of 4.5–6.0% according to the type of project, the issuer's creditworthiness and the collateral offered. Compared to these rates, CPI Group is able to provide finances in the European market at a cheaper rate than other Czech companies due to its investment rating through bonds.

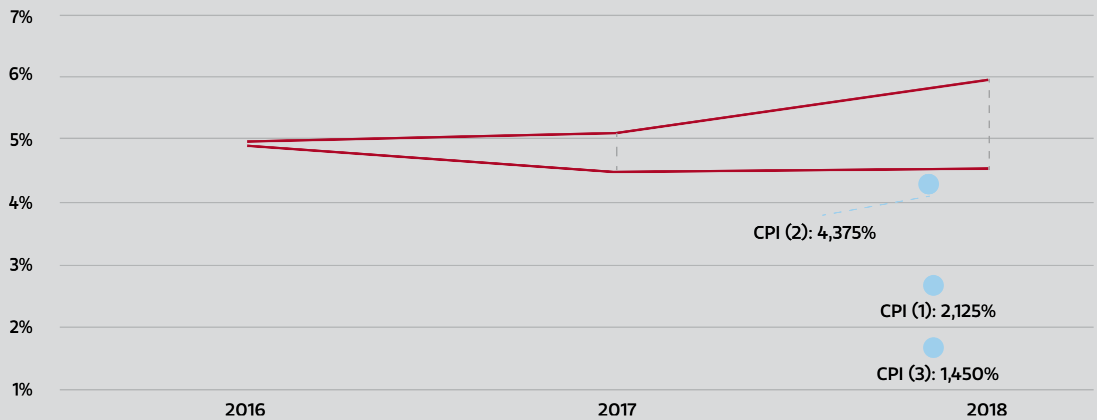
In the Czech bond market, real estate issuers continue to be heavily dominated by unsecured bonds over secured bonds, indicating the nature of bond financing as a complementary form of external financing to bank loans. In the case of collateral, we often observe shares or other instruments, the use of which is rather limited in the case of insolvency. According to the below published bond issuance statistics with prospectus for the last three years, real estate market companies use the obtained funds primarily for development purposes, but the share of bonds for investment real estate financing is increasing. Bonds are mostly issued in Czech korunas, which corresponds with the preference of Czech investors to invest in Czech korunas.

Jan Vrabčák, David Zlámal, EY

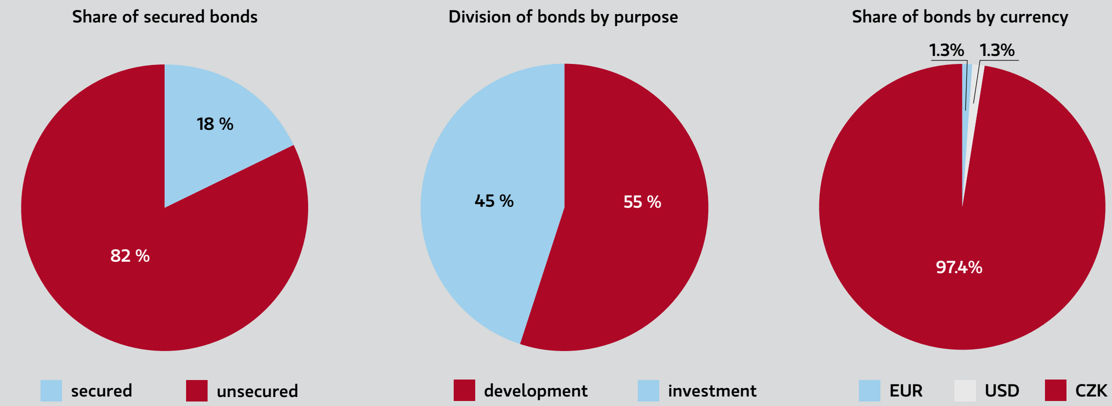
GRAPH Development of the volume and number of new bonds in real estate



GRAPH Range of coupon rates in the monitored period



GRAPH Amount of unsecured bonds: - secured – unsecured



Source: EY; data from the CNB's prospectus register (only bonds with prospectus) of land, speculative transactions from the perspective of the bank, etc. An example of successful corporate bond issuance in this category is the Trigema group, for which UniCredit Bank issued 3-year unsecured corporate bonds in the amount of 300 million CZK with a floating- rate note in the amount of PRIBOR + 2.95% per annum. However, compared to the volume of loans in the Czech economy, this is still an insignificant percentage of external resources that companies use to finance their activities

DEVELOPMENT OF LOAN FINANCING CONDITIONS REQUIRED BY BANKS

Let's return to the prevailing classic bank loans. For development financing, banks require 25-35% of an entity's own resources (i.e. 65–75% LTC) as a condition for drawing a loan. The amount of (pre)leases or (pre)sales varies according to sector: 70–90% is required for logistics, 50–70% for commercial premises and 50–60% for offices. The higher the pre-lease, the lower the equity the bank is willing to accept. However, banks do not often provide more than 80% LTC for a fully pre-leased project.

In development, banks also require sponsors to guarantee all additional costs (Cost Overrun Guarantee) and the smooth completion of the project (i.e. Completion Guarantee). The guarantees are valid until the project is approved and real cash flow starts, underpinned by long-term lease agreements with quality lessees, or by residential development purchase contracts.

In the financing of investment transactions, the required LTV is most often between 55–70%. The willingness of banks to agree to higher LTV is very limited and rare in the market. The reason for this is the consumption of regulatory capital. Compared to previous years, we increasingly see "healthier" conservative LTV around 50%, which is also due to the surplus of market liquidity.

From the perspective of the structure of financing, amortization schedules, i.e. the period over which a loan is repayable, and the tenor (the length of the bank financing), are quite interesting. Amortization plans are essential to investors' economy: the longer the amortization schedule, the more they can use free cash flow to pay out dividends to investors who temporarily "entrust" their funds for a fee.

In common practice, there are reasonable compromises between the investor's requirements and the bank's options; for new real estate (offices and retail) the amortization schedule is stable between 20–25 years, and for older real estate it is up to 15 years. In logistics the payment schedule is shorter than for offices and retail, usually between 15–20 years, depending on the nature of the lease agreements, of course (duration / quality of the lessee).

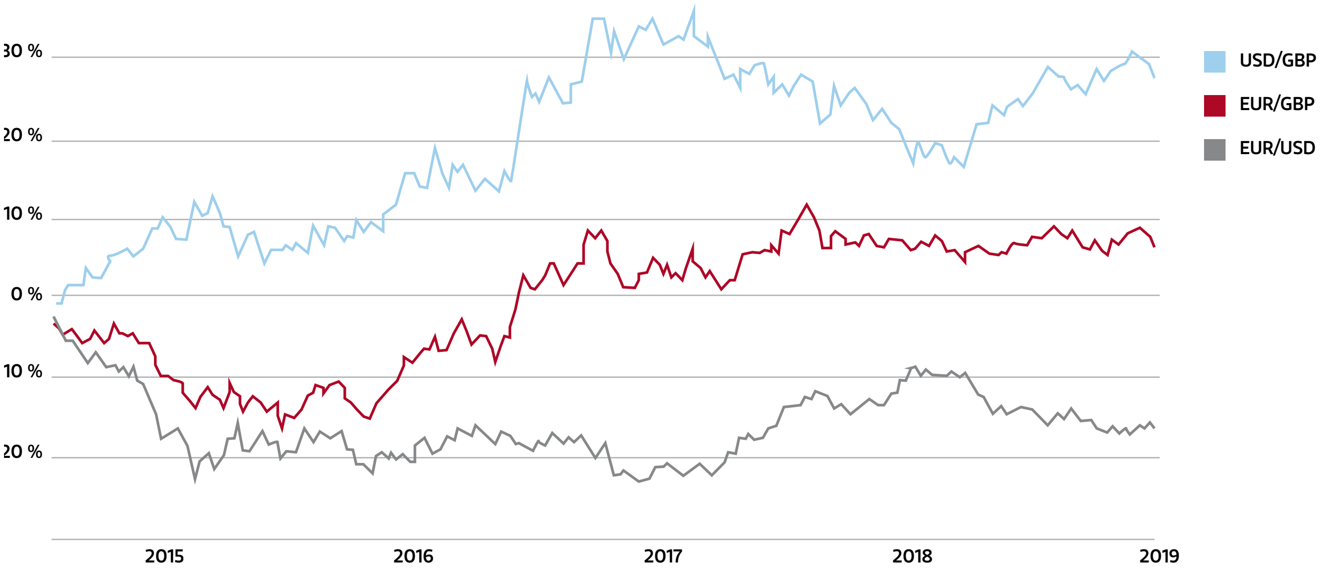
In most investment financing cases, banks offer clients financing with a 5-year tenor. It is assumed that the loan will be repayed at the end of the five-year period, according to the current situation of the project, the duration of lease agreements, the market price of money, etc. Long-term investors are also trying to get a ten-year commitment from banks (trying to fasten down the current low interest rates). However, banks rarely agree to this step; the conditions for this are generally long-term (10-year and more) lease agreements with financially strong tenants.

WHAT AFFECTS THE PRICE OF A LOAN?

A key element is the "price of money" (basic reference interest rate), see the graph of CZK, EUR and USD rates above. In the case of long-term financing, it is common practice for banks to ask clients to ensure any interest and currency movements with the appropriate hedging instrument. In view of the increase in the base interest rate of the koruna and the appreciation of the CZK exchange rate against the EUR and the USD (see the Development of exchange rates graph – source KPMG), this bank requirement is also favorable for clients – securing the stability of future returns.

GRAPH Development of exchange rates

Source: KPMG, Bloomberg



In the financing of investment transactions, banks place considerable emphasis on the quality and transparency of independent valuation, and technical, legal and tax audits of the real estate before the purchase (i.e. due diligence). Professional asset and property management are also key to sustaining the quality of an investment.

Development margins correspond to the structure of financing, currently ranging from 2.00–3.50% for CZK financing and 2.20–3.70% for EUR financing. Margins, which also include liquidity surcharges (resource acquisition costs), vary between banks.

In investment financing, margins did not significantly decline in comparison with 2017 despite the competitive environment. On the contrary, they stabilized, and a slight increase can be expected in the coming period of 2019–2012. Margins currently range from 1.70% to 2.50% for CZK, and in EUR financing the margins are about 0.20–0.30% higher.

Specific investment financing conditions always depend on the nature of the project, the client's history, the LTC/LTV amount, the lease contract parameters and the cash flow stability. In the structuring of financing, professionalism and the developer's/investor's previous experience, the quality of the repayment source, i.e. cash flow stability, the legal enforceability of collateral and the value of collateral, continue to be of significant importance. In this case it is also true that the lower the LTV, the lower the final margin may be.

CONCLUSION AND OUTLOOK

2018 confirmed that the real estate market in the Czech Republic is healthy and dynamic, and transparent enough for investors. It can be said that the only thing the Czech market "suffers" from is the lack of projects for sale. Assets in the Czech Republic and the yields achieved here are still interesting for investors. We'll see how much the impact of Brexit or other geopolitical connections are reflected in the parameters of real estate transactions. I personally expect a gradual slight tightening of financing conditions, both from a structural point of view (LTC/LTV) as well as due to the gradual increase in margins, especially with long-term CZK financing.

LENKA KOSTROUNOVÁ
ČSOB

ZAOSTŘETE NA JASNOU HYPOTÉKU

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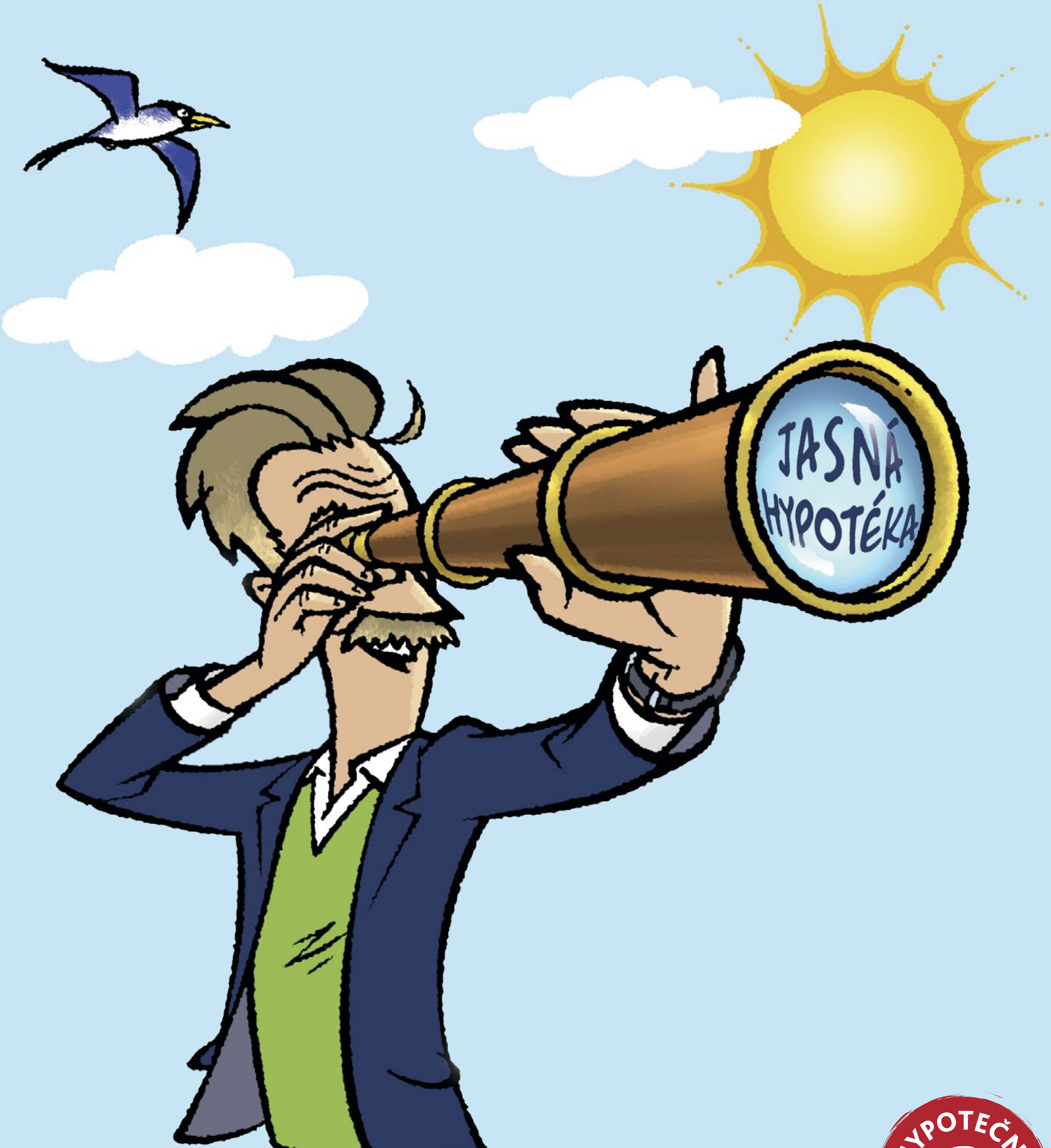

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Hypoteční banka
ZKRAŤTE SI CESTU DOMŮ

RESIDENTIAL REAL ESTATE FINANCING

The total volume of granted mortgage loans in the Czech Republic reached 210.6 billion korunas in 2018[1]. The slight decrease in comparison with 2017 was caused by rising prices of apartments and family houses, as well as the previously announced tightening of rules for granting mortgage loans by the Czech National Bank.

The CNB's interventions, which raised interest rates several times in 2018, had a major impact on the mortgage market. At the end of the year interest rates were around 2.91%.

The CNB's most significant intervention was the introduction of regulations that tightened conditions for obtaining a mortgage. The CNB's October regulation introduced rules according to which an applicant's total volume of loans may not exceed nine times his net annual income, while the monthly installment may not exceed 45% of his net monthly income.

Banks are becoming increasingly cautious in providing loans for investing in real estate, as they no longer believe in positive market developments and are aware of potential risks.

Jiří Pácal, CEH

RELATIVE STABILITY AND NEW CHALLENGES

Like last year, the central bank played an important role in the growth in interest rates this year. In 2018 it repeatedly used one of its pivotal instruments – increasing the two-week repo rate. The first increase came in February by 0.25 percentage points to the resulting 0.75%. The CNB thus continued to increase the rate from the end of 2017.

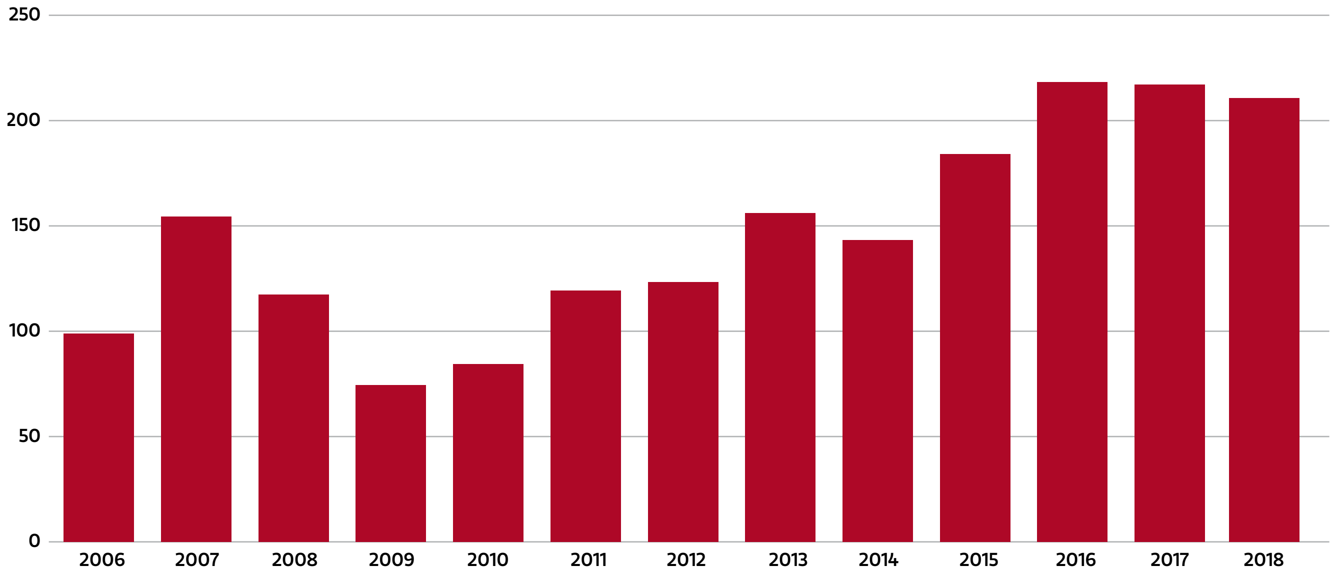
In July the two-week repo rate reached one percent. It then exceeded one percent and continued to grow. In November it reached 1.75% for the first time since 2009. The two-week repo rate therefore experienced a total increase of 1.25 percentage points. By comparison, in July 2017 its was only at 0.05%. The December average mortgage loan interest rate reached its annual high of 2.91%. This brought interest rates back to the level they were at in the spring of 2014.

However, 2018 did not only differ from the previous year with a significant increase in interest rates. The most interesting factor was the seasonal development of the closing of mortgage loans. While there were no significant monthly deviations in 2017, in 2018 we saw a significant increase in the number of closed loans during August and September. Interest in mortgages increased before the CNB's October regulations began to apply. According to these regulations, an applicant's total volume of loans may not exceed nine times his net annual income, while the monthly installment may not exceed 45% of his net monthly income.

In spite of the CNB's regulations, the fourth quarter was the strongest in terms of trade. Moreover, thanks to the increased interest in mortgages, especially in August and September, the initially anticipated loss was almost eradicated. People who were considering buying real estate at that moment often speeded up their decision and closed a loan while it was in their reach. According to Hypoteční banka's internal data, the introduction of the October restrictions affected more than 10% of mortgage applicants.

GRAPH 1 Development of the amount of granted mortgage loans in the period of 2006–2018 in billions of CZK

Source: Ministry of Regional Development of the CR



[1] Statistics of the Czech Ministry of Regional Development (MMR).

The real estate market is always determined by overall economic development. I therefore expect a gradual slowdown in the market. Mortgage loan interest rates are likely to continue to increase. The requirements of banks for people to have their own resources will result in a decline in interest in mortgages. People will be able to borrow less money, resulting in higher demand for small apartments or less attractive locations. I assume that this will significantly shift the perception of rental housing as an economically attractive alternative. However, this will gradually raise rents."

Monika Kofroňová, bnt

In the end, the fears of mortgage bankers from the beginning of the year did not materialize. Although the CNB's interventions were more pronounced this year than in the previous year when interventions were in the form of a recommendation, they did cause a significant decline in the market. The market's volume did not differ significantly from previous years. However, the consequences of interventions can be expected to become apparent, especially in the first quarter of 2019.

Continuing growth in residential property prices was another major factor in the mortgage market. It affected flats, the price of which increased by 10.4% on average. Family houses also experienced a smaller year-on-year increase in prices than in the previous year, namely 6.9%. Land, which is the most stable part of the residential segment, grew faster in the long term. In 2018 it increased by 7.3%, which is more than in 2017.

FACTORS AFFECTING THE MARKET

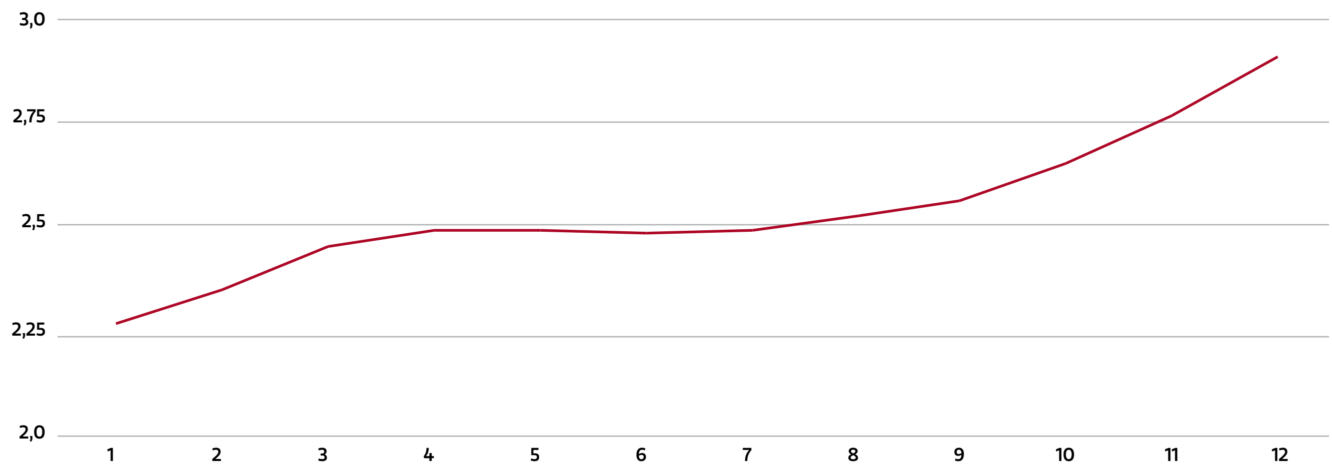
Macroeconomic environment

Let's take a closer look at all the macroeconomic factors that affected the mortgage market last year. The Czech economy recorded relatively high GDP growth again, which was estimated at 2.8% by the Ministry of Finance of the CR. The long-term downward trend of unemployment continued, reaching only 2.8% in October 2018. This nominally represented roughly 215,622 unemployed persons. On the other hand, the number of job vacancies slightly increased amounting to 316,900. The pressure to raise wages and pensions also continued.

Pension growth, and therefore also an increase in costs, naturally leads to inflationary pressures. The average inflation rate in 2018 was 2.1%, which is 0.4 percentage points less than in 2017. The koruna/euro exchange rate stayed between 25.50 EUR/CZK, which it exceeded at the end of 2017, and 26 EUR/CZK. The price of imported goods was also stable, as was the value of our exports, which mostly go to countries that use the euro, especially Germany. Not even the trade war between China and the US disrupted the overall stability, as it did not fundamentally affect the Czech Republic.

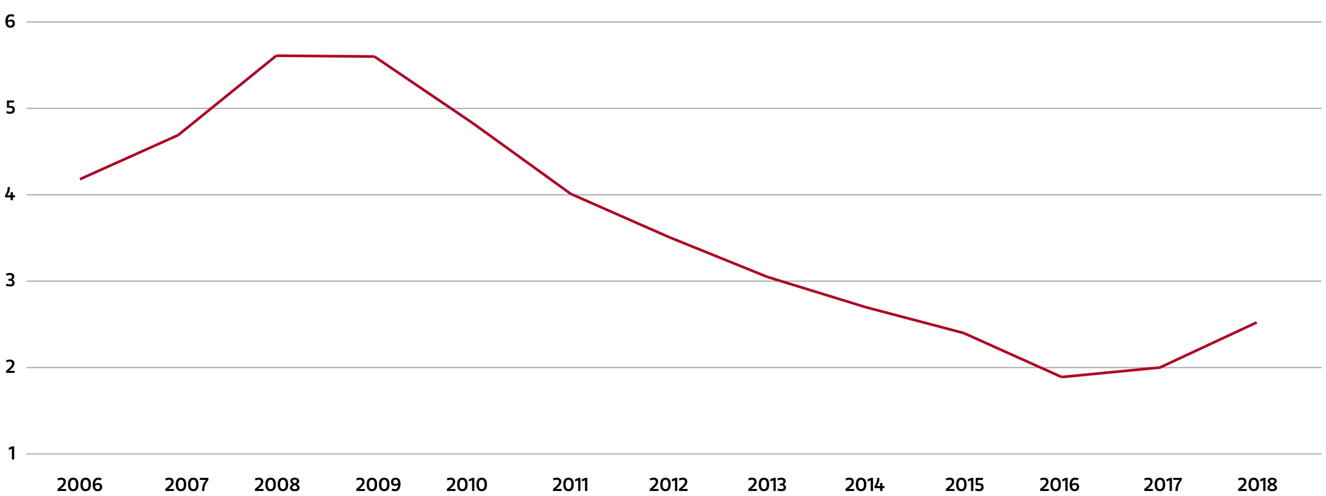
GRAPH 2 Development of mortgage interest rates in 2018 in %

Source: Hypoindex



GRAPH 3 Representation of average interest rates in 2006–2018 in %

Source: Hypoindex



The key macroeconomic factor was naturally the central bank's work with interest rates on the interbank market. In 2017 the CNB increased interest rates twice shortly after the other, continuing in these interventions in 2018. Although the impact on mortgage interest rates was obvious, it did not correspond proportionally to the level of intervention by the CNB. While the two-week repo rate increased by 1.25 percentage points in 2018, mortgage interest rates increased by only 0.72 percentage points year-on-year.

Development of interest rates

One of the key factors that fundamentally affects market performance is the low price of money on the interbank market. Although it increased thanks to the year-on-year increase in the two-week repo rate by 1.25 percentage points, its amount did not significantly slow down the Czech economy. In the long run, it is also worth recalling that the minimum interest rate of 0.05%, which applied until 2017, was already set by the central bank in November 2012. This means that it was maintained continuously for almost 5 years, and it had never been so low before.

We should also remember that the CNB has the long-term primary task of meeting inflation targets, which means that it only changes interest rates to meet its goals. The CNB's interest rate hike last year was also due to continuing economic growth of 2.8%, which the CNB did not feel the need to feed with the historically lowest price of money. The euro exchange rate was also relatively stable; it did not weaken as in the second half of 2017, but stayed below 26 korunas with the exception of minor fluctuations.

The development of the mortgage market in the second half of last year suggests that the CNB's interventions and the associated rise in interest rates have not had a major impact on the mortgage market as such. The only exception was the increase in sales in August and September before the bank's strictest regulations were in force. The CNB's pressure to gradually reduce LTV, which indicates an effort to reduce the total volume of mortgage loans, should be fully reflected next year. The October regulations should also manifest themselves later on.

Development of real estate prices

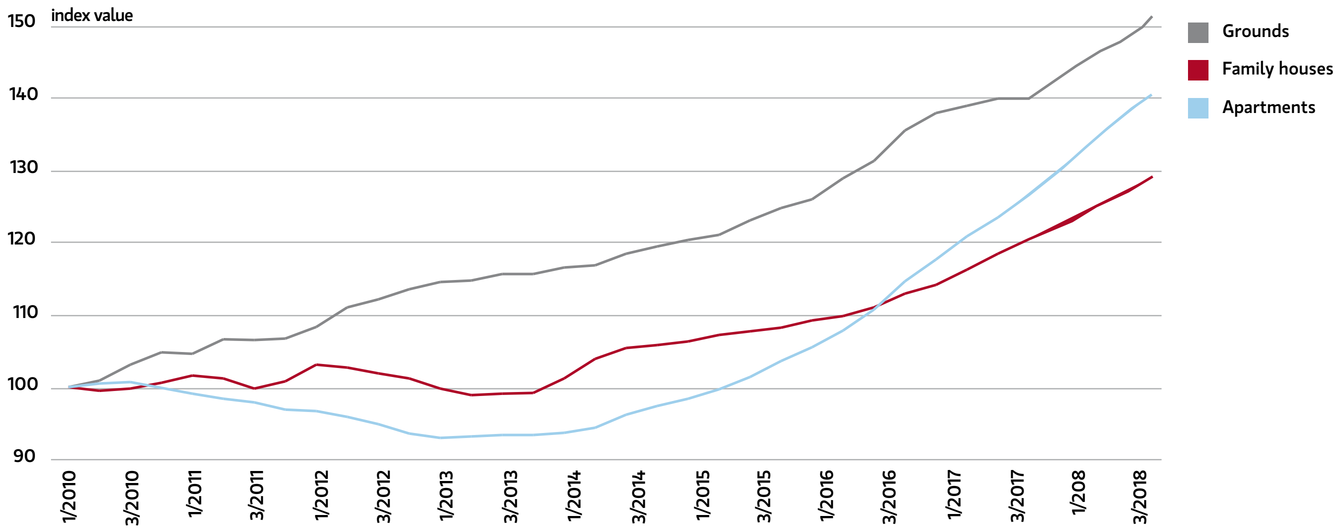
In 2018 apartment prices increased by 10.4 % year-on-year according to Hypoteční banka. Prices increased in all regions of the Czech Republic, with the highest increases in Prague, the Ústí, South Bohemian, Central Bohemian and Karlovy Vary regions. Prices of old tower block apartments grew more than those of brick apartments, which have already reached their price ceiling in many locations. The biggest interest was in small apartments; in Prague people were mostly interested in apartments with 2+1 or 2+kk layouts, and 3+1 and 3+kk layouts in other regions.

Prague and Brno form over 60% of the new housing market, and the price level is such that many locations are unavailable to middle class citizens. New projects in Prague are already approaching a price of over 100,000 CZK/m^2, and around 72,000 CZK/m^2 in Brno. The situation in the capital is favorable for new housing projects emerging in the Central Bohemian Region, and the transfer of demand from the outskirts of Prague continues. The share of investment purchases of small apartments (in development projects) is also growing in Prague, which developers are adapting to by changing the structure of the supply of apartments in their projects (some projects also account for more than 80% of small flats). The purchase of starter apartments is no longer worthwhile in Prague, and potential buyers are moving into rental housing.

The prices of family houses also grew at a slightly faster rate than in 2017, with a year-on-year increase of 6.9%. The higher real estate prices were caused by a small supply and continuing stable demand (especially on the outskirts and in close proximity to big cities), as well as the growth of construction costs for new buildings and renovations. Mostly low-energy houses are being built, as well as passive houses to a lesser extent (subsidies from the Green Savings program). Hypoteční banka supports the interest in environmentally responsible housing through the Green Mortgage option.

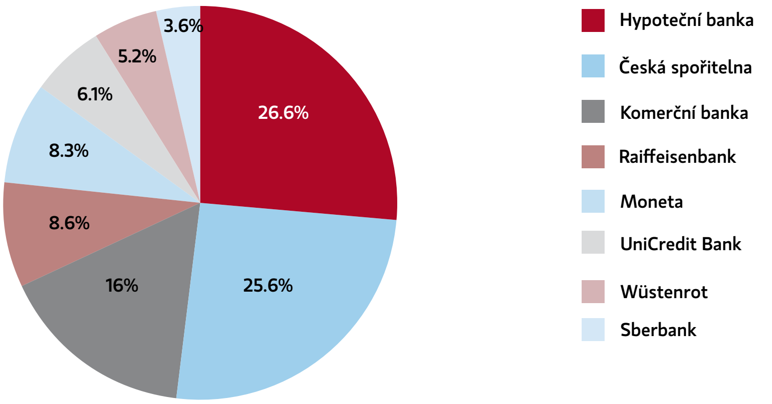
GRAPH 4 Real estate price development index (HB INDEX)

Source: HB Index



GRAPH 5 Market share of individual banks in terms of volume in %

Source: Ministry of Regional Development of the CR



The land segment recorded faster growth than in the previous year, increasing by 7.3% this year. Land continues to be the most stable residential real estate segment with the lowest maintenance costs. Demand remains stable as well, but high land prices in areas surrounding large cities continue to drive it to more remote locations.

HARD COMPETITION IN THE MORTGAGE MARKET

The mortgage market has long been concentrated in the hands of the three biggest players – Hypoteční banka, which belongs to the ČSOB Group, Česká spořitelna and Komerční banka. Hypoteční banka maintained its no. 1 position with a 26.6% market share. Česká spořitelna defended second place, and Komerční banka remained third. The market share of all three of these companies slightly declined. Raiffeisenbank, on the other hand, improved its position in the market and remained in fourth place; Moneta also improved, reaching fifth place. In addition to these, a market share was particularly attributed to small banking houses.

Not all banks in the Czech market report their results for official Ministry of Regional Development statistics. There are a number of smaller banks in the mortgage market that do not publicize their results.

AVERAGE MORTGAGE, INSTALLMENTS, REPAYMENT PERIOD

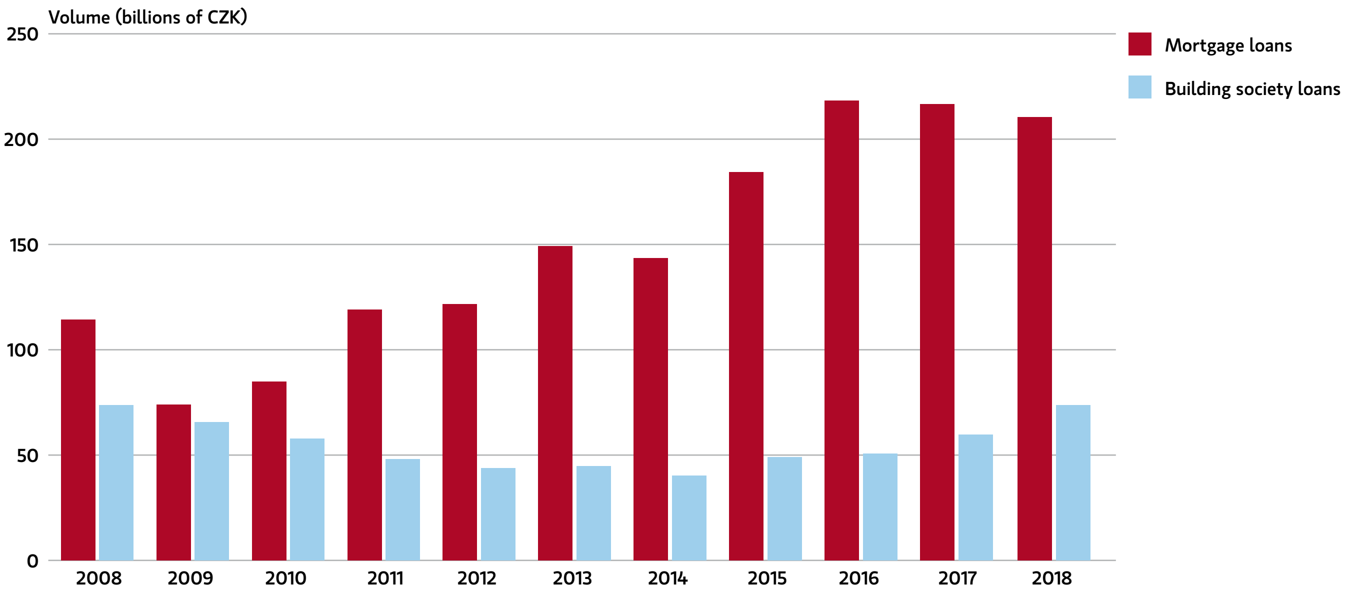
In 2018, the CNB took strict regulatory steps. According to the rules that came into force on October 1, an applicant's total loan volume may not exceed nine times his annual net income, and the monthly installment may not exceed 45% of his net monthly income.

Due to rising real estate prices, the average mortgage loan rate has increased despite the decreasing average LTV and CNB regulations. In the fourth quarter of 2018, the average mortgage value in the Czech Republic was 2.27 million CZK, representing a year-on-year increase of 8.4% compared to 2017. Hypoteční banka itself recorded a slightly higher value of the average loan among its clients, which reached 2.32 million CZK. Despite a slight increase in interest rates, the average maturity of loans did not change significantly, remaining at about 24 years.

According to available information from Hypoteční banka, 51% of newly granted mortgage loans were used to purchase real estate, 22% for construction, 20% for refinancing, and the remaining 7% for other purposes (renovation, settlement of ownership interest). Last year the typical client was a man aged

GRAPH 6 The ratio of building society loans to mortgage loans

Source: Hypoindex



37 with high school education, married with one child and with an average monthly income of 37,000 CZK. Most mortgage loans, namely 58%, were taken last year by people to purchase or renovate a family house.

SHARE OF BUILDING SOCIETIES

Building societies continued to expand their loans last year, and the volume of granted loans has increased for the seventh year in a row. They granted loans for almost 73 billion korunas, which represented a significant year-on-year growth of more than 22 percent, i.e. 13 billion korunas. This strong growth is mainly due to better interest rates and the need of Czech households to renovate housing.

FUTURE DEVELOPMENT ESTIMATE

What can the Czech mortgage market expect in 2019?

We expect interest rates that have increased several times last year to only increase slightly this year. We can also see this in the results of the last CNB Bank Board meetings, where the rates were left at their original level. Rates shown in Hypoindex are likely to go above 3% at the beginning of 2019 as a result of the rate hike by individual banks towards the end of 2018. However, in 2019 we expect significantly lower interest rate hikes by the CNB than in 2018, and this could also positively translate into the development of mortgage interest rates.

Last year, the new CNB recommendations for the ratio of monthly loan installments to income, which are valid from October 2018, were a major breakthrough for the mortgage market. However, despite the CNB's new recommendations, in 2018 the mortgage market reached almost the same volume of mortgage loans as in the record year of 2017. However, due to strong regulations at the end of 2018, we expect a significantly weaker start to 2019. The market situation should stabilize in the second quarter of 2019, but there is likely to be a noticeable decline in the sale of new mortgages this year. Given the major changes in the CNB's recommendations over the past two years, we hope to maintain the current conditions throughout 2019, allowing the entire market to stabilize.

As far as real estate prices are concerned, we expect their rapid growth to slow down. The supply of free real estate in the market is still very low; on the other hand, real estate prices have increased to the extent that they have become inaccessible to a number of income groups. In Prague, new real estate prices have exceeded the magical threshold of 100,000 CZK/m^2. However, an improvement in the whole situation of the availability of new housing cannot be expected in the near future primarily due to lengthy building proceedings. Especially the first and second quarters will be decisive for real estate prices, showing whether real estate price growth will really slow down.

From the perspective of banks, 2019 should be calmer. The market should stabilize, allowing them to adapt to new conditions. Banks will continue to improve their services to attract new customers.

JIŘÍ FEIX
Hypoteční banka