

**CPRF Newsletter February 2009**  
**Commercial Real Estate Market**

**Table of content**

Title	Page
Banks Suspend Funding. What is the Key to Success in the Talks with the Lender?	2
Investment Market stood. First or Last Chance for Cheap Acquisition?	4
Is Poland in Danger of Zero GDP Growth, and the USA of Hyperinflation?	6
What is Essential in Lease Contract Regarding Office Space?	8

## Banks Suspend Funding. What is the Key to Success in the Talks with the Lender?

Global financial crisis began in the third quarter of 2008 had an impact in terms of financing on Polish commercial properties market. Nowadays, due to the difficulties in raising money in the interbank market, and while awaiting the financial results for the IV quarter of 2008 some financial institutions have announced that their credit activity will be unfrozen after the second quarter of 2009 in the earliest. Other financial institutions significantly exacerbated lending criteria. The question arises what changes this limited credit activity will bring on the commercial property market. Do investors/developers have the chance to secure financing for their developments from banks, now? What terms of financing are required by the banks? In response to these questions it can be stated that banks currently use a more selective approach to projects and borrowers. The process of obtaining financing may be extended up to about 6 months, and the key to success is buying an under-leased property or in case of developments, with a high level of so-called pre-let, so the level of leased area before the start of a construction process.

### Financing Terms – Prosperity Period vs Present Situation

urbulence in the financial markets have forced banks to tighten up lending criteria. At present, a higher level of equity is required, and thus a lower share of a loan in the total development costs (called LTC, Loan To Costs Index). It has also been raised the minimum required level of pre-let and margin, and reduced the maximum amortization period of the loan. In addition, due to the introduced by the banks rules of secured loan policy, it has also been increased the minimum required rate of debt service (called DSCR / ISCR, Debt Service Coverage Ratio, Interest Service Coverage Ratio), expressed as the ratio of cash flow from rental income to the installment of total amount of interest and principal or only interest. A more detailed comparison of current terms of the financing to those from prosperity period have been presented in the table below:

	<u>PROSPERITY</u>	<u>PRESENT</u>	
LTC	up to 85%	up to 65%	↓
MARGIN	1,5% - 2,0%	2,5% - 4,0%	↑
PRE-LET	5% - 10%	30% - 40%	↑
DSCR / ISCR	1,15	1,20 – 1,25	↑

Source: CPRF

### Developments Desirable by Banks

In 2009 banks will use a more selective approach to projects and avoid investors/developers with no experience. Which transactions will be preferred by banks? Banks will finance mainly projects:

- fulfilling a condition of maximum level of LTC up to 65%;
- well-located, preferably in the city center;
- developed and prepared by experienced investors;
- safe through the high level of pre-let before construction begins;
- existing, new or renovated properties which generate income (DSCR > 1.20), undervalued, however with a substantial potential of value increase by:

- possible growth of rental income in the future; and/or
- possibility of renegotiating the lease agreements; and/or
- potential possibility of tenants exchange for those generating and ensuring higher and stable rental income; and/or
- possibility of introducing to the lease agreements a clause on rents indexation and other lease terms increasing the stability of income in time; and/or
- possibility of reducing operating costs including the costs of ownership, maintenance and use of property or the introduction of the full reconciliation of above mentioned costs; and/or
- possibility of introduction other tools stabilizing rental income.

### Summary

In conclusion, the tightening of lending criteria will contribute significantly to changes in the real estate market in Poland. There will be probably observed, inter alia, the following trends:

- investors will alter the projects from residential schemes to office developments in short term;
- investors will postpone the commencement of projects;
- the emergence of new funds and real estate investors/developers debutants will be limited;
- the number of investment transactions will be reduced;
- the expansion of domestic and foreign companies will be limited, therefore the amount of potential tenants will be lower and prolonged decisions of companies as to the lease;

We are convinced that some financial institutions may limit the policy of credit up to the end of the first quarter of 2010. Fortunately, not all banks turned the tap with money. It should be noted that at the moment there are banks providing financing, although it is dependent on the fulfillment of more stringent criteria. We believe that banks will be forced in the near future to loosening of lending activity as it is their main source of income.

In conclusion, it should be stressed that the timing and process of finance raising for the time being is considerably prolonging, that is why we recommend an initiation of appropriate action at the stage of waiting for a building permit. In addition, a very important factor in the negotiations with the bank currently is, and will be a purchase of the undervalued property with a great potential for growth or high level of pre-let.

February 2009

## Investment Market stood. First or Last Chance for Cheap Acquisition?

2008 compared to 2007 was characterized by a significant slowdown in the commercial properties investment market. The main reason for a lower volume of transactions was a limited number of quality investment properties sale offers as well as difficulties in securing financing, which in turn was the result of a turbulence at financial markets in Europe and USA. It is worth mentioning that in November 2008 the difference between the capitalization rate for the highest quality office buildings in Warsaw, which is the rate of return on a property investment, and the reference interest rate fluctuated at the level of 0. This illustrates that it was more profitable for the investors to place the funds destined for a investment property purchase on a secured bank account and postpone the investment decision in 2008. It is highly likely that 2009 will be an anticipation period. Investors will show more selective approach and be only looking for cheap investment opportunities. Only an increase in a confidence on the interbank market and thus gradually unfrozen lending activity by banks, combined with falling interest rates and faster growth of capitalization rates will allow investors to achieve a reasonable rate of return on the commercial properties investment market.

### Investment Market In 2008

One of the factors that contributed significantly to the slowdown at the commercial properties investment market in 2008 were significant differences in expectations of buyers and sellers regarding the level of the capitalization rate. The potential buyers of commercial properties demanded taking into account in the capitalization rates the risk associated with the global financial crisis. Owners, in turn, due to the good form of commercial properties market were reluctant to accept higher yields.

#### Vendors' expectations

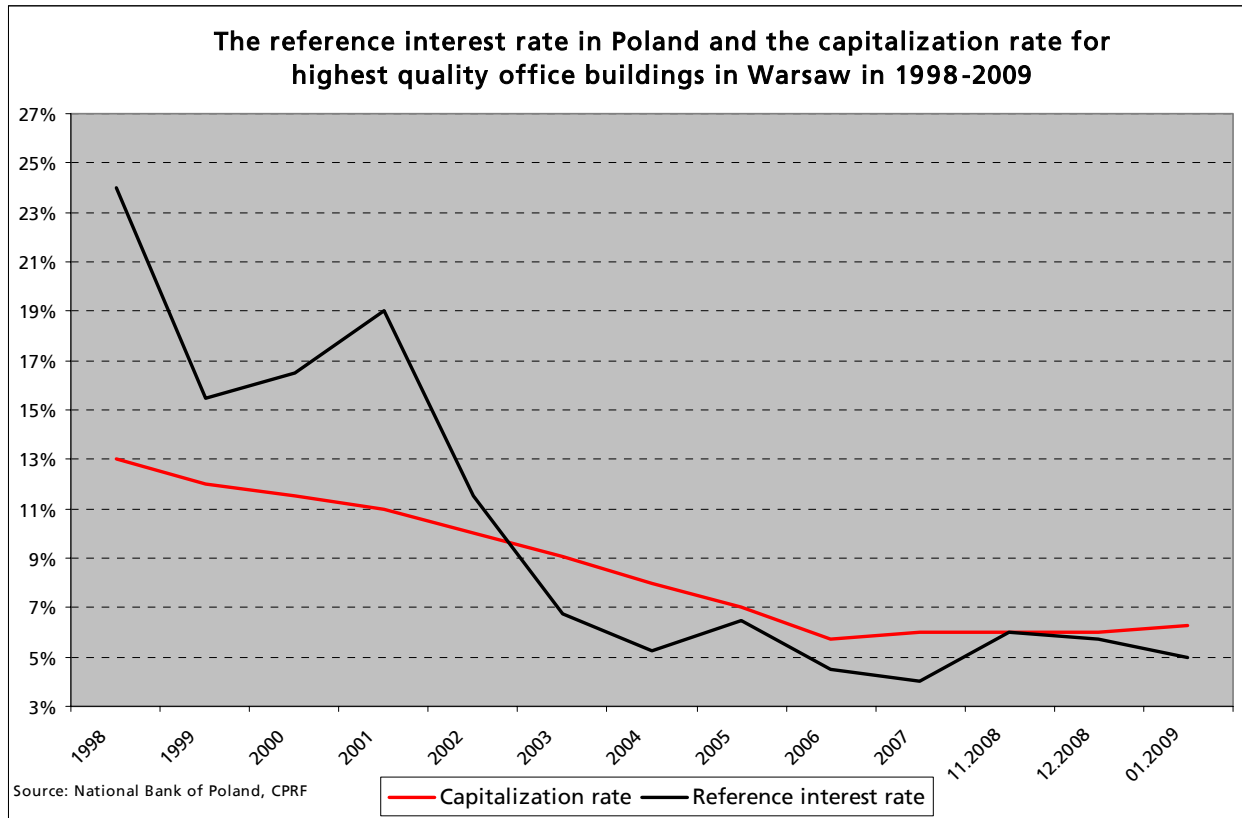
In 2008 in Poland, we had to do with a strong demand for commercial space for a lease, which resulted mainly from the growing Polish economy and a stable political climate backed by an increased foreign investment. The continuing high demand for commercial space for a lease has contributed to the fact that the property owners achieved more efficient rents by reducing rent free periods and their capital expenditures for tenant fit-outs, and hence higher incomes. The growing demand and insufficient supply has contributed to a rents increase and occupancy rate. It comes as no surprise that the property owners were not willing to sale developments at any price and accept the higher capitalization rates.

#### Purchasers' expectations

The difficulties in obtaining financing, as a result of the crises in the market of the U.S. subprime loans and the financial markets, have contributed to reducing buyers activity in the property investment market. In addition, the interest rates held by the Monetary Policy Council on a high level resulted in that the difference between the capitalization rate for the highest quality office buildings in Warsaw and the reference interest rate fluctuated virtually at the level of 0 (see [Chart 1](#)) until November 2008. It resulted in that it was more profitable for investors to place the investment funds on a secured bank account, and postpone investment decision.

The process of reducing the reference interest rate since November 2008 and an increase of capitalization rates as a result of declining activity of the buyers resulted in that from December 2008 to February 2009 the gap between these rates is becoming wider, which should soon translate into an increase of purchasers investment activity.

Chart 1:



### Summary

In 2009 we can expect a further capitalization rate growth and falling down reference interest rate. The increasing potential rate of return on property investments will encourage investors to return to this market, although they will look for opportunities in undervalued properties/developments. It can be also expected that negotiations of transaction terms and purchase of investment property will be extended as the due diligence process will be subject to more detailed analysis.

February 2009

## Is Poland in Danger of Zero GDP Growth, and the U.S. of Hyperinflation?

The chances of the emergence of hyperinflation in the U.S., that is, the monthly increase in prices by over 50%, appear to be relatively low, although the chances are pretty big on the price increase by about 10% -20% per year, such as in the seventies during the oil crisis. U.S. credit crunch adversely affected the economy of the European Union and will contribute to lower level of growth of Polish economy. Given the delay in the start of infrastructure investments by Poland, it is likely that the increase in Gross Domestic Product (GDP) in 2009 may amount to little more than 0%. What are the arguments for such a scenario?

### Economy in Poland

According to the latest assumptions of Polish government the GDP in Poland in 2009 will increase by 1.7%. It is highly probable that the presumption is heavily underestimated. By adopting the pessimistic assumption that due to the budgetary savings, the start of infrastructure investments will be delayed, GDP growth may reach a level of just over 0%.

Moreover, the argument in favor of the low level of GDP growth in Poland in 2009 may be a high level of interest rates, which was held by the Monetary Policy Council (MPC) for too long. It is understood that the impact of interest rates on the economy is seen in approximately 18 months and the MPC has completed series of increases of interest rates in June 2008, which means that a significant deterioration in expectations and financial performance of companies in Poland will take place in the near future, and their improvement can be expected in the second half of 2010.

Worse financial results of companies mean that we will witness the economic slowdown. Companies want to survive in the market during the slowdown/recession, they will seek to maintain liquidity and cut costs in the short term. Therefore, during this year it can be expected a progressive increase in the unemployment rate and reduced growth of wages. Fear of an employment loss and frozen wages can result in that Poles will not be willing to go for a shopping anymore, and this will translate into a lower GDP growth.

In conclusion, it should be recalled the old maxim, that the stock exchange forecasts the future trend in the economy. The main stock exchange index in Poland, WIG, fell down over 2008 by more than 50%. The decrease has been still continuing since the beginning of 2009, and in February this year, it was broken on the main index WI, the long-term upward trend launched in mid 1993 (*see Chart 1*). It should be noted that the percentage decrease of the level of the main stock exchange index in 2008 (-50%) is greater than that during the Russian crisis in 1998 (-28%) or in the previous bear market in 2000/2001 (-35%), which was characterized by a strong economic slowdown. If GDP growth was at around 3.5% in 1998 while in the years 2000/2001 at 1.5%, what level of GDP growth can be expected in 2009? Referring to the theory that share prices of listed companies, inter alia, are affected by the generated profits it can be concluded that in the future profits of companies are likely to fall down very much, and this in turn means that it will be a strong slowdown/recession. There is therefore a strong likelihood of GDP growth in Poland in 2009 at just over 0%.

Graph 1: The Breakout of the Long-Term Upward Trend for the WIG Index in February 2009.



Source: Bossa.pl

### Hyperinflation in the U.S.

Falling down prices of commodities, including liquid fuels, and food mean that now we see a decrease of inflation in the world. Lower prices caused that the United States decreased the interest rates to a historic low level of 0.0-0.25%, and all the time are injecting to the market hundreds of billions of dollars to rescue the financial system. Federal Reserve Bank is eager to print generally empty money in order to save the world before the financial crisis. Is the American economy threatened by hyperinflation? Referring to the definition, hyperinflation is caused by the total collapse of the financial system of the country and a huge budget deficit covered by the uncontrolled debt issuance and printing of empty money. Although, economists differ on what constitutes of inflation and hyperinflation, for a notional limit of hyperinflation is often assumed the increase in prices of at least 50% within one month.

The current economic slowdown in the U.S. will contribute significantly to the wave of job losses and bankruptcies and the collapse of many companies, and thus to lower state revenue from taxes. Their decline is likely to be covered from the issuance of debt, i.e. issue of bonds and treasury bills by the U.S. government, which, combined with the printing of money without the cover in order to rescue the financial system will affect the magnification of the already huge deficit. Taking into account the "Obama Plan" and the Chinese authorities, according to which the economy will be stimulated, inter alia, by the construction of infrastructure it can be concluded that the inflation impulse will be again generated in the form growing prices of commodities. The chances of the emergence of hyperinflation appear to be relatively low, because the U.S. is the country developed and rapidly adjusting to changes and will not be likely to collapse the financial system, but chances are pretty big for an annual 10-20% increase in prices, such as in the seventies.

February 2009

## What is Essential in Lease Agreements Regarding Office Space

Companies planning to lease office space, while selecting the most advantageous market offer, tend to concentrate mainly on financial lease terms proposed by developer, building location and its standard. Although, the key element in an office space lease process is a lease agreement – a document which legally regulates relations between a landlord and a tenant. It is essential to focus on many details of the agreement to avoid doubts in a future.

## What is Essential in Lease Agreements Regarding Office Space

Companies planning to lease office space, while selecting the most advantageous market offer, tend to concentrate mainly on financial lease terms proposed by developer, building location and its standard. Although, the key element in an office space lease process is a lease agreement – a document which legally regulates relations between a landlord and a tenant. It is essential to focus on many details of the agreement to avoid doubts in a future.

### Subject of Lease

It is important to determine a subject of a lease in details. Lease area includes not only office area with internal communication area, social and sanitary rooms, terraces for a tenant sole use – net office area, but also a proportional share in common areas of the building and parking places as well. Common areas of the building are areas, which are used by all tenants in the building, for example: main lobby in the building, lift lobby, some sanitary rooms, halls. To calculate a total monthly rent add-on factor, constituting equivalent of a tenant share in common areas, is added to net office area.

The lease area may be measured according to different norms, which may lead to significant differences in an office unit lease area. For example Polish Norm PN-70/B02365 dated June 30<sup>th</sup>, 1970 assumes a core and shell measurement not including plaster, but PN-ISO 9836-197 dated October 27<sup>th</sup>, 1997 assumes a measurement including plaster. More examples of such discrepancies may be listed. In our opinion it is important to clearly define a method of lease area measurement in the lease agreement.

Lease agreement shall include among others: a detailed description of unit a subject of a lease, detailed information regarding location of the unit in the building, number of land and mortgage register, plot of land number, site plan of the building and floor plan with marked unit a subject of a lease.

### Lease Term

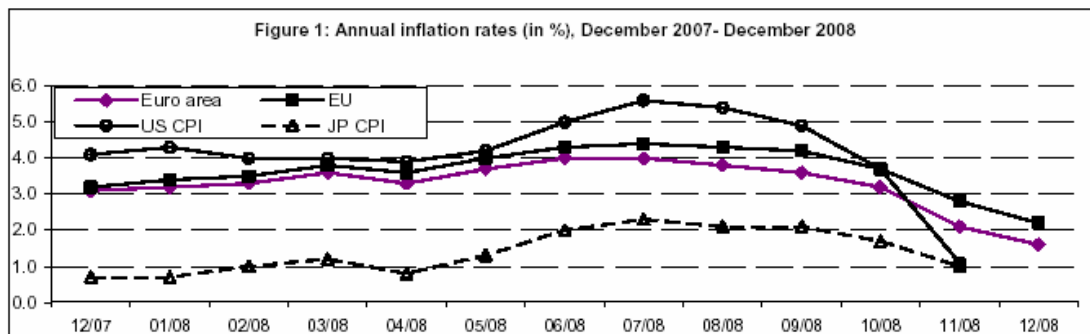
Lease agreements in Poland may be signed for a limited or unlimited period of time. Class B and A office buildings accept usually minimum between 3 and 5 years lease term respectively. Beginning since 1 January 2009 companies may enter up to 30 years lease, which is a significant increase of a limited lease agreement term, comparing to earlier regulations. Recent regulations are convenient for tenants, who due to very specific expectations and needs towards a standard of space have to adapt premises to their requirements on their own cost.

### Rent and Indexation

The tenant is obliged under the lease agreement to pay the rent to the landlord. Rents in modern office buildings are usually quoted in EUR but tenants are obliged to pay an equivalent of agreed rent in PLN. To calculate the equivalent, it is a common practice on the market to use average exchange rate EUR / PLN quoted by National Bank of Poland on the day accordingly defined in the lease agreement – usually it is the day of issue of the invoice or the day preceding issue of the invoice.

The rent is usually indexed annually by the agreed in the lease agreement price index. The most common indices are Harmonized Indices of Consumer Prices (HICPs), which are harmonized

consumer prices indices for member countries of European Union. When HICP is equal to 0 or less, rent usually remains on the same level and is not indexed. HICPs are used for international comparisons of inflation and are published on the monthly basis by Eurostat. In December 2008 the inflation rate in European Union was equal to 2,2 %, while in European Monetary Union countries was equal to 1,6 %.



Sources: Eurostat, US Bureau of Labor Statistics, and Statistics Bureau of Japan

Eurostat publishes also following indices:

- EICP (European Index of Consumer Prices for EU-15), which is an indicator of consumer prices for 15 member countries of European Union (EU-15). EICP is a weighted average of HICP indices for each of considered countries. The index had been basically calculated for 15 member countries up to April 2004 – this is the reason for naming the index EICP for EU-15. Beginning from May 2004, after European Union extension, the index is calculated basing on HICPs of 25 countries – this is the reason for naming the index EICP for EU-25;
- EEAICP (European Economic Area index for EEA), which is the consumer price index for European Economic Area;
- approximately 100 sub-indices for each member country and Norway and Iceland, with corresponding weights and weighted averages;
- Special Aggregates, which are special categories indices, for example: goods, services, energy.

### Operating Expenses

Operating expenses include costs covered by the landlord related to possession, maintenance and operating of an office building. Operating expenses in modern office buildings shall include among others:

- costs of maintenance of external / green areas, facade and roof of the building;
- fire protection and fire detection systems;
- lift maintenance;
- cleaning of common areas;
- security;
- main lobby reception services;
- waste disposal;
- water, heat and electricity supply to the building;

- insurance policies covered by landlord;
- property taxes;
- property administration and management, technical services;
- costs of maintenance, operational, renovations and repairs.

Operating expenses shall be covered by a tenant on an 'open book' basis – considering real costs covered by a landlord, for example media consumption measured by metres, or on the basis of invoices issued by sub-contractors.

The tenant is obliged under the lease agreement in modern office buildings to pay monthly pro rata payments regarding operating expenses. Reconciliation of covered by a landlord operating expenses takes place annually after end of each calendar year – usually a landlord presents to a tenant a statement regarding landlord's expenditures during reconciled year.

In case of real costs of operating expenses proves to be higher than already paid advance payments during the year, the tenant is obliged to pay a remaining sum to the landlord. In case of overpayment landlord is obliged to credit overpaid amount against future payments, or pay back overpaid amount.

### **Lease Security**

The tenant is obliged under the lease to deliver to the landlord security deposit or bank guarantee. The most common practice regarding the amount of a security is equivalent of three months payments of rent, including car parking places rent, operating expenses and VAT.

From tenant point of view, possibilities and rules of making use of the security by the landlord must be strictly regulated. In case of modern office buildings landlords expect the tenants to deliver a bank guarantee issued by a reputable bank acceptable by a landlord.

Security shall be valid over the whole lease term. A most common practice is to extend a validity of the security by an additional period of time up to three months after a lease expiry date. This practice is applied due to the fact that a landlord receives invoices for services included into operating expenses in different terms and is not able to reconcile with a tenant the costs of operating expenses at the day of lease expiry date. In case of a bank guarantee is valid for a shorter term than a lease term, the guarantee shall be regularly renewed according to payments due at the day of a guarantee extension.

The landlord is entitled to make use of the security when a tenant breaks his obligations under the lease agreement – for example: tenant does not pay the rent and / or operating expenses, tenant does not cover the costs of repairs of damages caused by him, his employees or guests, tenant does not pay contractual penalties in case of not keeping the date of return the premises to the landlord. If the landlord makes use of the security before the termination of the lease, the tenant is obliged to restore the security to the agreed amount in the lease agreement.

### **Insurance**

Both landlord and tenant shall be secured with a proper insurance coverage. The landlord shall be secured against following:

- third party insurance;
- insurance against loss and damage;
- insurance against loss of profits.

The tenant shall be secured against a loss and damage of his equipment, as well as should have a third party insurance.

### **Summary**

Above mentioned aspects of a lease agreement are basic and extremely important to take care of in order to properly regulate relations between a landlord and a tenant. We have presented some of important regulations which should be considered before a signature of a lease agreement. At the same time different standards of lease agreements may be met, depending on a building class and landlord experience. In case of modern office buildings lease agreements are most complex and regulate many aspects concerning a lease of space, which requires wide and detailed experience field. That is why using experienced external real estate advisors / consultants may benefit with reducing tenant risks during a space lease process.