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Commercial Real Estate Market

Table of content

Is This Thaw on the Commercial Real Estate Financing Market? Characteristics of the Main Conditions and Collaterals Required by the Banks

As a result of turbulences in world financial markets, deteriorating macroeconomic indicators and a slowdown on the commercial property leasing market in Poland, the vast majority of financial institutions decided to suspend their credit policy, even till the end of 2009. Fortunately, not all banks turned the tap with money. Since the beginning of the year we have had a chance to observe commercial real estate financing transactions, which can be a sign of slow stabilization of the market. The banks prefer existing developments generating income, while financing new projects to a small extent, the so-called speculative, without an appropriate level of leased area prior to the first drawdown of a credit. The question arises as to what chances do investors / developers have to obtain finance for the construction? What collaterals and conditions have to be fulfilled prior to the first tranche of a loan? In response to these questions it can be stated that the banks now require the involvement of equity at a minimum of 35% and signed lease agreements for a minimum of 50% of a building leasing area. In addition, before releasing the first tranche of a loan the borrower should obtain a positive opinion in the due diligence reports (legal, technical) and to establish certain collaterals for a financial institution.

<u>Transaction of Finance Raised by the Developers / Investors in Poland in the First Half of 2009</u>.

During the first half of this year we observed transactions of funds raised by experienced developers for large and medium-sized developments, a well-prepared and safe through the high level of pre-lease.

The most important transactions of obtaining loans from financial institutions are shown below:

PROJECT NAME	DEVELOPER / INVESTOR	AMOUNT OF LOAN	PURPOSE
Galeria Jastrzębie	Polimeni International	18 mln EUR	Construction Loan
Saski Crescent Europolis Park Błonie, Phase I	Europolis	80 mln EUR	Refinancing Loans
Platinium Business Park – Phase III	Globe Trade Center	20 mln EUR	Construction Loan
Park Postępu	Echo Investment	50 mln EUR	Refinancing Loan
Malta Office Park	Echo Investment	32 mln EUR	Refinancing and Construction Loan
Crown Square Katowice Business Point	Ghelamco	60 mln EUR	Construction Loans

Source: CPRF

<u>Financing Conditions</u>

Due to market changes some financial institutions have been providing loans for construction, however they are dependent on a fulfillment of more stringent criteria. Currently it is required equity at a minimum level of 35%, and thus the share of credit in the total cost of a development (called LTC index, Loan To Costs) may reach a level of no higher than 65%. It was also raised the minimum required level of pre-let and margin. In addition, due to the introduced by the banks rules of secured loan policy, it was increased the minimum required rate of a debt service index (called DSCR / ISCR, Debt Service Coverage Ratio, Interest Service Coverage Ratio), expressed as the ratio of a cash flow from a rental income to the installment of total amount of interest and principal or only interest.

A more detailed comparison of current conditions of the financing to the period of property market prosperity is show below:

	PROPERTY MARKET PROSPERITY TERM	PRESENT TIME	
LTC	up to 85%	up to 65%	↓
MARGIN	1,5% - 2,0%	3,75% - 5,0%	↑
PRE-LET	5% - 10%	50% - 60%	↑
DSCR / ISCR	1,15	1,25	↑

Source: CPRF

<u>Positive Opinion in Due Diligence Reports and Collaterals for the Financing Institutions.</u>

Before signing the loan agreement and meeting conditions required for the equity, debt coverage and the leased space the developer / investor is required to obtain a favorable opinion in due diligence reports. In the legal and technical report, which are prepared by independent third parties, there are verified issues, inter alia:

- Land purchase agreement and property titles;
- SPV structure with particular focus on management agreement concluded between SPV shareholders;
- Borrower Equity;
- Financial statements / information about borrower's financial situation and its shareholders;
- Shareholder loan agreement of and their subordination;
- Legal state of the property, issued decisions, permits;
- Property valuation prepared according to TEGoVA / RICS standards by independent property appraiser,
- Loan to property market value index (called LTV, loan to value);
- Loan to the total development costs index (called LTC, Loan To Costs);
- Debt service coverage index (DSCR, Debt Service Coverage Ratio);
- Total cost of the development reviewed by banking inspector;
- Agreements with general contractor and subcontractors;
- Financial statements and track records of general contractor and subcontractors;
- History and current status of borrower’s settlement with tax and social security offices;
- Environmental reports - if applicable;
- Signed lease agreements and lease agreement template;
- Financial situation of tenants leasing more than 20% of building leasing area or generating more than 20% of development’s revenue;
- Projected budget of property operating costs involving non-reconciled costs;
- Property management contract and property manager experience;
- Contracts relating to the SPV and other which the borrower is a party in.

In addition, the financial institutions require from borrowers establishing, inter alia, the following collaterals:

- The first mortgage on the property (e.g. in the amount of twice of VAT credit and loan);
- The pledge over shares registered in the borrower SPV;

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- The pledge of bank accounts registered to the borrower (all accounts will be carried out in the bank of the lender);
- Transfer of receivables in respect of the lease agreements, management contracts as well as general contractor agreement, insurance, and any revenue generated by the property;
- Bank guarantee in the event of cost overruns amounting to 5% of the total cost of the development, in content and form acceptable to a lender;
- Bank guarantee servicing of interest (amounting to twice of annual interest handling). The guarantee will be released by providing - on the basis of a signed lease agreement - the DSCR of not less than for instance of 1.25;
- Lock on the borrower's bank accounts;
- Proxy to all bank accounts of the borrower;
- Subordination agreement concluded with shareholder of the borrower;
- A statement to submit to execution.

Conclusions

Due to the turbulence on the financial markets, banks have changed their financing policy substantially. Nowadays they require much higher level of equity and in case of construction loans, pre-lease at the level of 50% of the total leasing area. As a result of the introduction of more stringent criteria the commencement of a great number of commercial developments has been suspended. A significant number of the developments is likely to be redesigned and divided into more phases. In addition, due to the high cost of financing it is expected that a number of developments will be carried out by investors' equity and then refinanced during a building operation.

We believe that given the favorable macro-economic signals concerning Polish economy, among others increasing the GDP rate and a retail sale level, will make banks be more willing to loosening of their lending activity this and in subsequent years.

September 2009

RICS Commercial Property Valuation Information Alert

The RICS Valuation Group Board issued the "Valuation Information Alert" (VIA) regarding "Guidance to Lenders and Valuers when conducting Loan Security Valuation Reviews" at the end of May 2009. This gives guidance to both valuers and lenders on the advice that can be provided when conducting loan security valuation reviews of commercial property in circumstances when values are changing rapidly. It focuses on issues to be considered and reported upon in looking at the future prospects for a property. It is additional guidance when advice on a likely level of value is provided for the immediate period after the date of valuation. Lenders may request advice that not only focuses on the Market Value today, but also advice that looks forward into the immediate future. It is emphasised that Market Value is the starting point for the provision of good valuation advice and any forward looking view must always be provided in addition to an opinion of Market Value in certain strictly defined circumstances.

Valuers do not make forecasts. Therefore, among others in the VIA it is pointed that valuation reports for secured lending are likely to address the following issues:

1. <u>What is the anticipated period in which to achieve a sale</u>

- The valuer should comment upon any issues which are likely to influence the marketing period and saleability of the property.

- Whether the status of the tenant as perceived by the market may impact upon both saleability and marketing period

- How the supply of similar property in the vicinity or in the relevant sector may influence saleability.

- Will the asset achieve best price by a sale now; what would be the consequence of delaying a sale.

- What is the likely time period before a buyer is found and a sale is completed.

2. <u>The market for the asset and the best method of achieving a sale.</u>

- Will a disposal be readily achieved by private treaty, tender or auction.

- What are the prospects for achieving a sale and what sort of parties may be in the market for the asset, and how will they be motivated to buy.

- The ability or otherwise to secure loan finance. Comments on whether the there is a lending appetite for the particular asset type and whether the lot size may restrict the potential to secure a loan. Lenders and Valuers may want to state in the letter of engagement whether the Market Value will be based on a specific level of debt availability. This may take the form of a special assumption that the assumed debt is on favourable or unfavourable terms and whether it would be available to all purchasers in the market. Similarly, if the Market Value is to be based on a specific favourable level of debt being available, then the valuer should be asked to give an opinion of Market Value if debt is provided at a more normal level.

3. <u>The strength of the market as a whole.</u>

- How do the wider conditions in the property market impact on the foreseeable price.

- What are the perceived threats to price and prospects for movement in price? Distinction should be made between prospects for market movement which are property specific and those driven by market conditions.

- What type of purchasers may be in the market for the property?

4. Action that can be taken to improve the assets saleability.

5. Threats to Market Value price and saleability.

6. The consequence of local market factors.

7. The impact of current macroeconomic and property forecasts and sentiment.

8. The degree or severity of market movement expected in the foreseeable future.

• The key factors here are severity and degree of volatility of expected market change. This to be seen in the context of the general market prospects for the location and asset type.

There are times when markets can experience rapidly changing pricing of assets, with the consequence that a valuation can become out of date very rapidly. It is during periods such as this that a client, particularly a lender conducting a loan security review, may seek additional advice from the valuer. This is likely to be not only focus upon the Market Value today, but also what it might be in the near future. It is the valuer's role to observe the market and to look at trends and evidence. It is recognised that, in rapidly changing markets, the definition of Market Value would not deliver the same result if the marketing period started on the date of the valuation. In addition to providing an opinion of Market Value, a valuer can provide a view upon the potential market sale price with a marketing period commencing on the date of the valuation. The marketing period should be specified by the valuer. Any expression as to the potential price in the future must be provided in such a way so as to caution the client that it may include opinions which may be rapidly overtaken by events and should not be relied upon in isolation. According to the VIA any such view must always be provided in addition to an opinion of Market Value.

Note:

RICS is the world's leading professional body in land, property and construction with over 150,000 members in more than 146 countries practising in 17 specialisms. It operates under a Royal Charter, which means that, unlike a trade association, it is committed to giving a high priority to the public interest rather than simply advancing the interests of its members. To this end, it has developed and operates high standards of entry to the profession together with a continuing commitment to maintain and advance the highest technical, professional and regulatory standards.

RICS Survey and Warsaw Office Market

A couple of weeks ago Royal Institution of Chartered Surveyors (RICS), which is a global organisation associating real estate professionals, issued recently the next quarterly commercial market survey. The survey was focused on showing general trends at commercial propertied market, and presented individual respondents' opinion on main market indicators.

Global Trends

Demand – Availability – Rents

Tenant demand decreased almost all over the world in Q2 2009 – in comparison to Q1, and at the same time available space continued to grow. Both factors influenced other market indicators. Rents declined all over the world – excluding some African and Latin America countries. At the same time incentives offered by landlord to prospective tenants grew – to attract lessees.

Overall economic circumstances, commingled with situations on both financial and real estate markets effected in decrease in pipeline developments. Developers focus on leasing space in existing / under construction projects, and are rather reluctant to undertake new developments. This tendency is strengthened by rent predictions regarding near future – further downward trend in rent levels is predicted in almost all countries, which were surveyed.

Investment

The survey showed, which shall not be a surprise, negative trends all over the world. Investment activity in Q2 2009 in most countries dropped in comparison to Q1, although some countries in Africa, South-East Asia and Latin America noticed growth. In Europe, investment activity grew in the Netherlands, United Kingdom and France.

Due to lesser interests in real estate investments and difficulties in investment financing acquisition, yields continued to rise. Some exclusions from this trend were found in Asia, where government intervention influenced the market.

Regional Insight

Polish economy with 1,1 % economic growth performed outstanding recently, taking into account GDP decline in all except Poland EU members.

According to RICS survey and considering emerging markets in Central Europe, indicators describing Polish real estate market present rather modest negative changes. Rents as well as tenant demand continued to decline, which effected in higher tenant incentives and decreased number of pipeline developments. At the same time, despite modest slowdown in investment activity, yields in Poland slightly declined – contrary to global and regional trends.

Local Focus – Warsaw Office Market

Do Warsaw office market figures fit to RICS survey?

Quarter	Supply *(m^2)*	Take-up *(m^2)*	Vacancy *(%)*	Prime Rents *(€ / m^2 / month)*	Prime Yields *(%)*
1Q 2009	87 600	45 500	4,5	25 – 28	6,75
2Q 2009	86 400	63 500	5,7	23 – 24	6,75 – 7,00

Source: *CPRF and WRF*

Demand – Availability – Rents

According to above data we can notice a 40 % growth in a tenant demand in 2Q 2009 in comparison to 1Q. This is a significant increase, however take-up in 1Q 2009 was on a very low level. At the same time total take-up in 1H 2009 amounted to 55 % of total demand on the market in a corresponding period in 2008. We can notice the compliance with longer term global trend indicated by RICS survey, however quarter-to-quarter comparison shows a different short-run trend in Warsaw.

Vacancy / available space increased in Warsaw, placing the rate at the level of 5,7 %. The vacancy rate is partly increased by space offered for a sub-lease – approximately 50 000 m^2, which constitutes approximately 1,6 % of Warsaw modern office stock estimated at the level of 3,15 mln m^2. Vacancy grew significantly, as compared to 2,1 % at the end of 2Q 2008, and is a local confirmation of the global trend.

Supply of new space over 1Q and 2Q 2009 remained stable, and was 60 % higher than take-up during 1H 2009 – and more than 20 % higher than supply in a corresponding period of 2008. This may be seen as some discrepancy from the global trend, however it must be mentioned that a very low vacancy rate over recent quarters effected in almost fully pre-leased developments under construction. At the moment developers focus on leasing space in existing buildings and under construction developments, and are ready to start new constructions only on the basis of signed pre-leases, which complies with global trend indicated by RICS.

Increase in a vacancy influenced rents and tenant incentives. Prime rents noticed strong decrease – from the level of 30 – 33 € / m^2 / month at the end of 1H 2008 to 25 – 28 € / m^2 / month at the end of 1Q 2009 and 23 – 24 € / m^2 / month at the end of 1H 2009 – which confirmed global trends.

Investment

Prime yields remained at a comparable level – approximately 6,75 – 7,00 % during 1H 2009, and grew from 5,75 – 6,00 % in corresponding period of 2008. At the same time it is difficult to conclude on trends on the investment market – due to only three transactions, which took place in 1H 2009. Described situation is a confirmation of global trends indicated by RICS.

Future Outlook

Poland is the largest and at the same time the most advanced commercial real estate market in the Central and Eastern Europe region – treated as emerging Europe. With developing commercial real estate markets in Polish regional cities, large market in Warsaw and strongest in the region economy, Polish real estate market shall suffer from current economic circumstances less than countries in the CEE region.

RICS survey was focused on identifying global trends – therefore some indicators describing local markets may vary from indicators describing situation all over the globe. Warsaw office market proves both – global trends and some local exception.

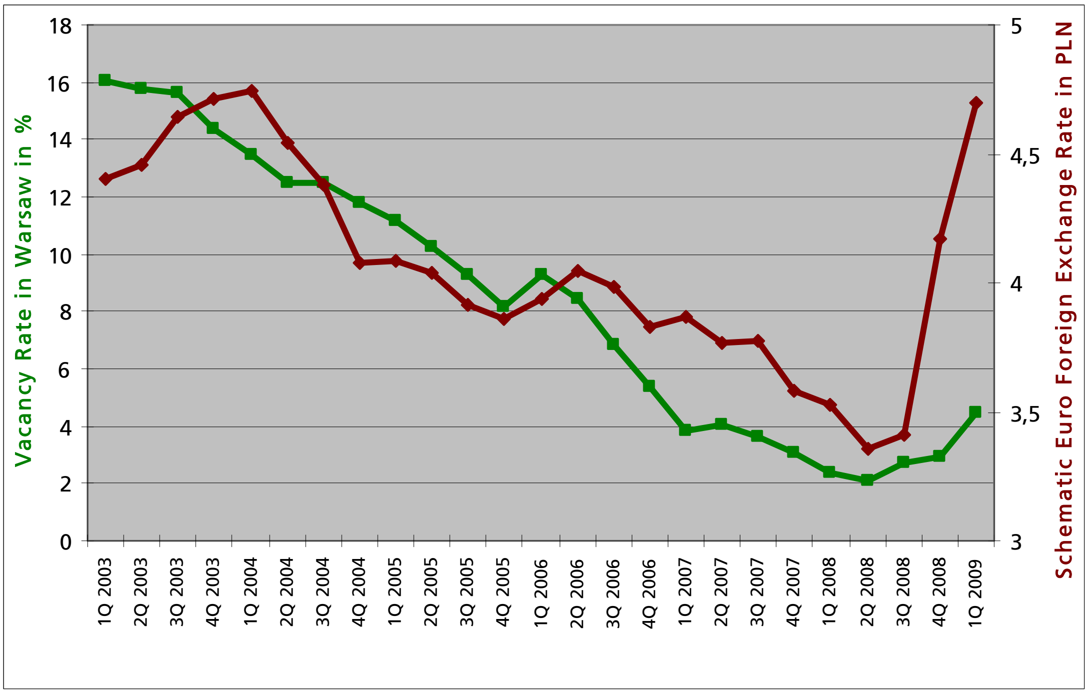
According to RICS survey, downward trend in a rent level may be expected in Q3 2009, as well as other negative trends on the market. Will Polish commercial real estate market follow global trends or copy Polish economy achievements?

August 2009

Can EURO foreign exchange rate indicate the state of the modern office space?

Financial and economic crises appearing recently in Poland are felt by everyone. We can view it through our country development rate that amounted to 4.8 % last year, whereas according to the Ministry of Finance this rate will amount to 0.9 % at the end of 2009. We can see the increasing unemployment that amounted to 10.8% in April 2009, the increasing inflation that amounted to 3.5 % in May 2009. Deteriorating macroeconomic coefficients indicate an existence of crisis that influances also commercial real estate market.

We decided to review trends on the modern office market through the prism of fluctuation of Euro foreign exchange rate. For this purposes we have compared a schematic Euro foreign exchange rate valid in the last day of the quarter with the vacancy rate existing in Warsaw in particular quarters, in the period from the first quarter of 2003 to the first quarter of 2009. Based on such an analysis we observed that when Euro foreign exchange rate decreases/increases, due to appearing correlations between the schematic Euro foreign average exchange rate and a rate of vacant space existing in Warsaw, appropriately decreases/increases also the vacancy rate.



Prepared by: CPRF, source CPRF, DTZ, NBP

Upon analysis of correlation coefficient between the schematic Euro foreign average exchange rate and a vacancy rate of modern office space in Warsaw, we obtained a coefficient at a level of 0.76. It means that these data are interrelated to the significant extent, up to 76 %.

The vacancy rate of modern office space constitutes one of the main indicators that determine form and general state of the office space market. It is a fusion of existing relations on the market between supply, demand and rents. Based on our analysis, we may come to a conclusion that a foreign exchange rate can be an indicator that allows viewing the office space market in the broader range. It allows determining strength of the market, its form and potential perspectives of the development. Observing mid-term and long term fluctuation trends of foreign exchange rate it can be concluded on the potential trend for a vacancy rate, and in result, relations can be analyzed between supplied/ planned new office space to be introduced to the market, a demand, and a rent for which this space can be leased.

Asymmetry of Information in Economy means a situation where one party has more of better information than the other, when not all market players have the same information about being purchased or sold goods. It refers usually to the situation when a seller is in a privileged information situation in a comparison with a purchaser, however an opposite situation is possible. One of the major features (defects) characterizing the real estate market is Asymmetry of Information. An access to the appropriate market data about properties and a market is very difficult and their collection and analysis is expensive and time consuming. Whereas, an access to information about a daily and historical Euro foreign exchange rate is immediate and very easy. In our opinion, an observation of the office market in Poland through the prism of mid-term and/or long-term trend fluctuation of Euro foreign exchange rate allows Principals change into Agents. Everybody can try!

September 2009

Explanations:

A party which is better informed is called an **Agent**. Whereas, a party worse informed, not owning entire information is called a **Principal.**