Real Estate: Waiting for Upturn

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In recent years, property investors and developers have become much more international in their outlook. Property has effectively become part of the global marketplace, bringing obvious economical benefits but also significant risks. The booming real estate industry over the last few years, and the ready availability of financing, encouraged many new entrants to the real estate market, pushing up prices and causing investors and developers to enter new and riskier markets in the quest for greater returns.

The rush of investors and developers into the Central and Eastern Europe region, together with the reduced risk, particularly following the EU entry of the countries in the region, resulted in real estate yields falling to levels similar to those in long-established Western European countries.

However, the current global economic downturn has caused a dramatic decrease in the fortunes of markets around the world, and whilst several countries in Central and Eastern Europe are so far less badly affected than many other locations, the region certainly hasn't escaped the negative impact of the downturn. The longer the period until recovery, the greater the effect will be in this region.

As elsewhere, the volume of real estate transactions started to fall at the end of 2007 and subsequently few large transactions occurred. This area is not yet showing significant signs of recovery. Initially, many investors and developers were finding obtaining financing for new projects to be one of their biggest challenges. However, an additional problem is that the lack of transactions in the market makes it very difficult to assess a fair price for a property, and therefore the few investors and developers who are looking to buy or sell are finding it very difficult, if not impossible, to agree on a mutually acceptable price. Potential buyers do not want to risk investing before the market bottoms out, whilst potential sellers would prefer to hold on to their assets if they can, rather than risk selling for significantly less now than they might be able to obtain later.

Lenders continue to be very cautious about financing real estate projects, but at the same time they are reluctant to force repayment of existing loans as a result of the borrower's failure to meet some of its loan covenants (for example the loan-to-value ratio), provided that the loan is still being serviced. This makes sense, given that forcing a borrower to sell a property now could tip it into bankruptcy, leaving the bank with a significantly lower recovery on the loan than if it works with the borrower to reduce the risk of bankruptcy. This approach by the banks is one reason why the market has not seen many 'distressed assets' up for sale, an outcome some had predicted at the start of the downturn. However, more forced sales might start to occur if rental income from existing buildings falls significantly due to lessees scaling back their operations or going out of business, since this would negatively impact an investor's ability to service its loans.

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Managing costs, and cash flow, are critical for all businesses in the current economic environment, including those involved in real estate. Investors and developers need to maintain tight control over their cash flows, and act quickly if problems start to arise – for example if there are payment delays or defaults from tenants. Unpredictable movements in currencies in many of the countries in the Central and Eastern Europe region make life even tougher, although Slovakia's entry to the Eurozone has reduced exposure to ongoing currency risk for many entities investing in that country. On the positive side however, for those developers who are continuing to build, reductions in construction costs in response to reduced demand are proving beneficial, particularly as these costs had risen significantly over a relatively short period prior to the onset of the current downturn.

Poland, the Czech Republic, Hungary and Slovakia are the core locations in the Central and Eastern Europe region, and development of the real estate markets in these countries has generally benefited from positive changes in the local economic, tax and legal systems, although investors and developers need to be aware that there are some significant differences between these countries. For example, corporate tax, VAT and other tax rates vary significantly between the countries in the region, as do the types of taxes levied in connection with real estate, with some of the countries levying transfer taxes on real estate transactions whilst others, such as Slovakia, do not. Furthermore, the rules concerning the tax deductibility of financing costs for real estate projects are also far from uniform across the region. In addition, care must be taken in relation to the legal environment, since although there are many similarities between the countries in the region, there are also some differences that could potentially have serious impacts if they are not taken into account.

New measures to stimulate the economy, particularly in relation to employment, and to reduce the impact of the global economic crisis have been introduced in most countries in the region, and these should also benefit real estate investors and developers, at least indirectly.

Throughout the region, flexibility is a critical success factor for successfully structuring any real estate investment or development, and for deciding how to act during the current downturn. Comprehensive planning and due diligence prior to undertaking any transaction are vital. It is therefore important that professional advice is sought as early as possible, to ensure that the relevant issues are addressed at an appropriate stage.

Whilst many developers have postponed or adjusted their projects in response to the economic downturn, there is still a significant level of new stock coming onto the market in all sectors, and in the coming months it will be interesting to see what level of rental take-up such projects are able to achieve, and how rental rates develop. Much depends though on how the global economy develops in the coming months, and how soon a recovery is in sight.

In conclusion, despite the generally gloomy economic environment many analysts are seeing some signs of recovery both regionally and globally, and although the second half of 2009 is expected to remain very challenging, many predict 2010 to be the year when things will slowly start getting better.

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