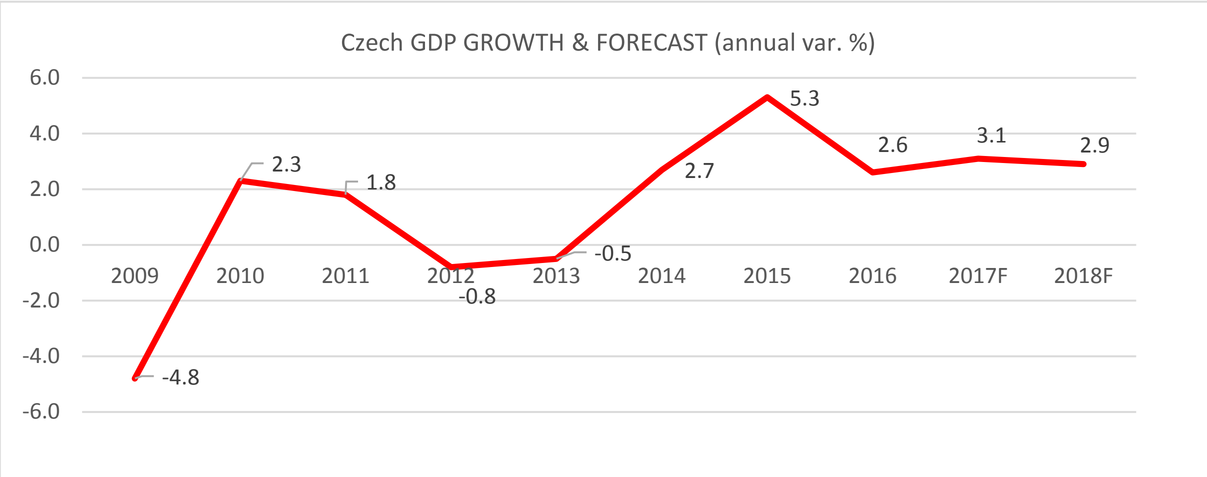
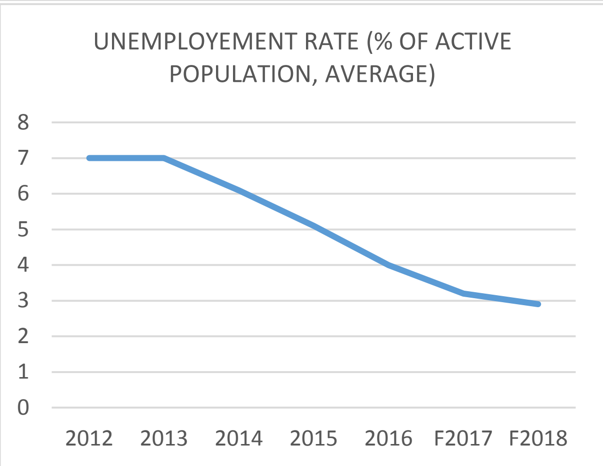
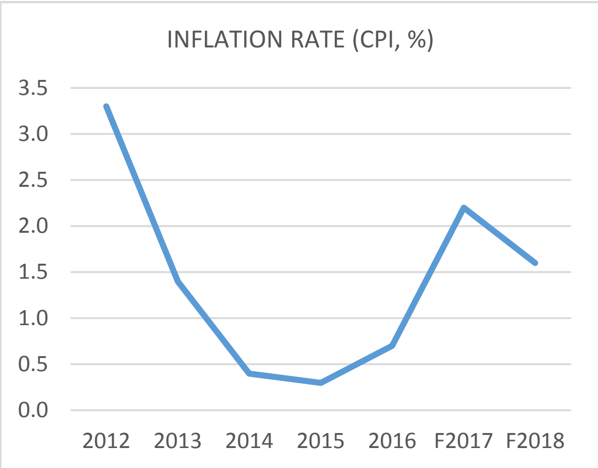
The Czech real estate market – strong and growing

The Czech Republic continues to maintain relatively low external and internal macroeconomic imbalances in addition to manageable levels of public debt and deficit. The Czech economy has been growing since 2014 and with its export-oriented focus has benefitted from the current economic upswing occurring in Europe and worldwide.

Household spending and corporate investments have also experienced growth. Based on preliminary GDP data for the first half of 2017, growth estimates have increased to 3.1%[1] [2] for 2017, and are above 2,9%[1] for 2018 and 2019. This growth has also contributed to improving the unemployment rate which is at the lowest levels in the European Union since 2016 and is estimated at 3.2%[1] for 2017 and 2.9%[1] for 2018. The shortage of labour is becoming a barrier to further extensive growth of output, although the situation differs from region to region (as an example, in the Ústí nad Labem region, unemployment is above the average at 6.33%[3]). At the turn of 2016, the year-on-year growth of consumer prices exceeded the Czech National Bank's inflation target (2%), and in future periods it is expected that the inflationary effects of increasing wages and a positive output gap are likely to be compensated by the anti-inflationary effects of the Czech currency appreciation. According to June figures, inflation in 2017 is expected at 2.2%[1], which is above the European Union average. The forecast for 2018 is 1.8%[1].







[1] Ministry of Finance of the Czech Republic - Macroeconomic Forecast - July 2017 published 31 July 2017

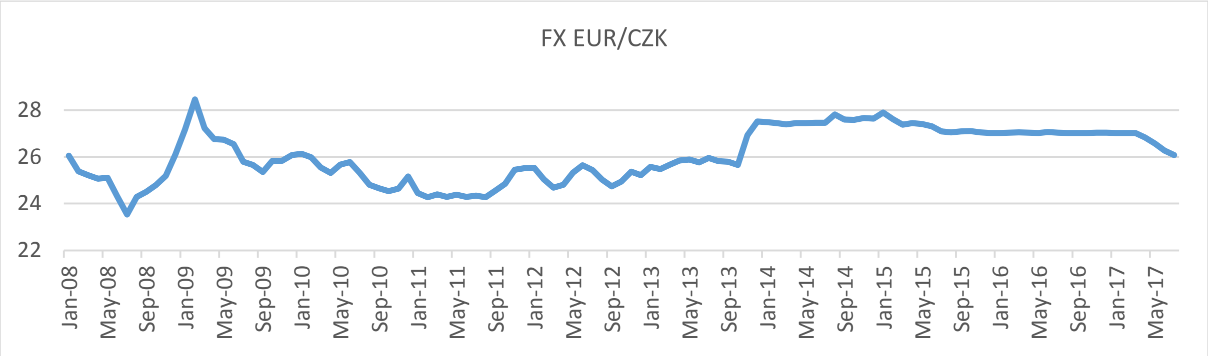
[2] Czech National Bank – Current forecast – published 3 August 2017 – Czech National Bank estimates GDP growth of 3.6% (2017), 3.2% (2018) and 3.1%(2019)

[3] Czech statistical office, data for July 2017

Source: Czech statistical office, Ministry of Finance of the Czech Republic Forecast for 2017 and 2018

The Czech crown (CZK) – end of the currency peg

In April 2017, the Czech National Bank removed the fixation of the CZK/EUR exchange rate, which was implemented in November 2013 to stimulate the Czech economy (exports) at a time of stagnation and to prevent further deflation. Maintaining the exchange rate of 27 CZK/EUR was costly as the Czech National Bank now holds the second largest foreign currency reserves in proportion to the GDP (Switzerland is the largest). Unlike the Swiss franc, which strengthened sharply (20%) after removing the currency peg in 2015, the Czech crown strengthened only mildly, as illustrated by the chart below. According to most experts, this trend of currency appreciation is expected to continue.



Source: Czech National Bank

The real estate market – another record year in the making

In addition to the positive outlook of the Czech economy, political stability is also attracting investors to the Czech market. According to CBRE, the volume of transactions was EUR 2.1 billion[4] for the first six months of 2017, making it the most successful first half of a year in history. The total volume of investments for the year is expected to exceed EUR 3 billion, which is a continuation of the record results of 2016. The Czech Republic, together with Poland, is among CEE leaders in terms of investment volumes. Other countries of the region, such as Hungary and Romania, lag behind despite sharp growth of investments in recent years. Investors are interested in all segments of the real estate market, with continuing interest in projects outside Prague. Prime yield rates remain unchanged for most property types and are still above the level of yields in countries such as Germany and Britain.

The composition of investors in the Czech real estate market continue to include a large proportion of local investors (30%), and a stable share of German investors, while there is notable growth in Asian investment. European and US investment continues as well.

According to Colliers[5], the vacancy rate for office premises in Prague was 8.6% in June 2017 – such a low figure was last achieved in Q3/2008. The low vacancy is partly due to a low number of newly constructed office premises in Prague for the last couple of years. This situation is changing with many 2018/2019 completion of office projects expected. Nonetheless, the vacancy rate is still expected to remain below 10% in the years to come.

[4] CBRE – Czech Republic Property Investment Q2 2017
[5] Colliers – Market overview Czech Republic Q2 2017

Shopping malls in the Czech Republic remain a highly sought-after real estate investment. In recent years the market has seen the expansion, modernisation, and remodelling of existing malls rather than the construction of new buildings. New constructions mostly involve smaller regional shopping malls.

The Czech Republic's location in the centre of Europe and in close proximity of the German market, together with economic and industrial growth (for all segments, not only automotive) has had a positive effect on the development of the industrial real estate market and the low vacancy rate in this segment. The challenges and experience resulting from the financial crisis are still evident as speculative development in the segment is minimal despite the current positive trends.

Bank financing - stability in real estate

According to the KPMG Property Lending Barometer[6], bank financing of real estate has been very stable in recent years, both in terms of the conditions of financing, and in terms of a low share of impaired real estate loans in the financing banks' portfolios. Czech banks have one of the lowest shares of impaired real estate loans of all countries surveyed, at a level comparable to Germany and Scandinavian countries. The results of the survey show that despite the competition between banks, interest rates do not substantially change. Larger banks are better able to work with lower margins; however, some smaller banks can match some offers under certain conditions. The low total interest expense makes borrowers less sensitive to interest rates, focusing rather on negotiating other conditions of the loans. The survey also confirmed that bankers still consider development projects risky and require higher interest margins for their financing than for completed and rented-out projects (income generating projects). Club financing of real estate is more popular in the Czech Republic than in any of the other countries surveyed. The same applies to providing loans in foreign currency (almost exclusively in EUR), under the condition that the revenue from the real estate is also in that currency. The Czech National Bank's removal of the CZK/EUR fixed exchange rate in April of 2017 had no effect on this.

According to the KPMG Property Lending Barometer[6] the banks generally request the following technical criteria for financing: loan to value at 70%[7] and debt service coverage ratio at 1.2[7]. The range of premiums (interest margin) requested by banks is for office 2,22–2,68%[8] (1,7–2,1%)[9], retail 2,26–2,6%[8] (1,7–2,1%)[9], Industrial/Logistics 2,4–2,73%[8] (1,8– 2,1 %)[9]

Permit procedures – continuing difficulties

The stable growth of the economy connected with an increase of household disposable income, low interest on mortgage loans, unprecedentedly low unemployment, few alternative investment opportunities (an estimated 30% of new apartments are bought as an investment) and demographic development are the main factors behind the growing demand for new apartments and projects. On the other hand, the supply by developers is limited. This situation is most noticeable in Prague, where 22%[10] of all dwellings in the Czech Republic are completed, resulting in growing prices of new apartments (+24%)[11] and the inaccessibility of owned housing for a large part of population. The situation in Prague is specific primarily due to the length of the approval process for new projects in

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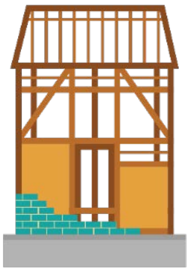
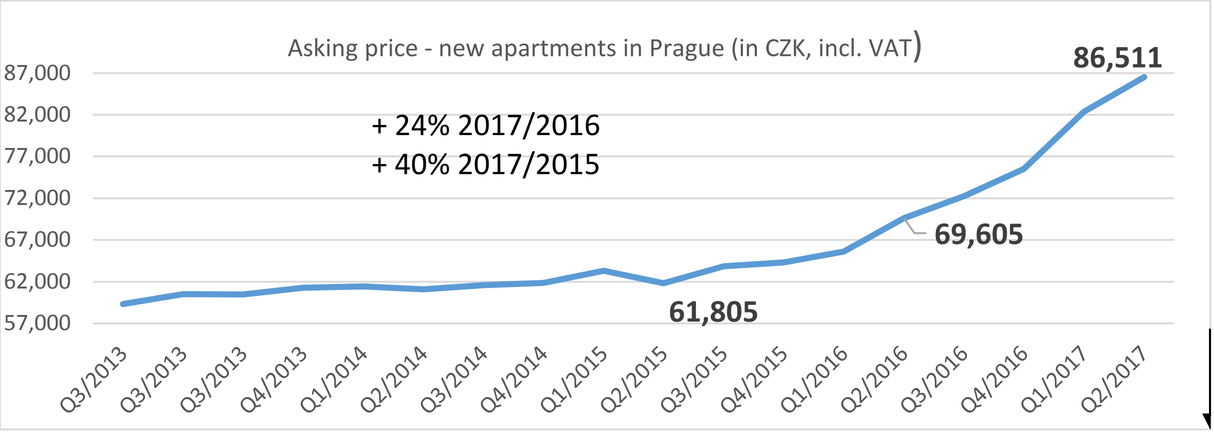
[6] KPMG Property Lending Barometer 2016, published October 2016, data collected in May-June 2016
[7] income generating properties
[8] Interest premium that banks would apply on a 3month EURIBOR basis on loans for high quality income generating properties
[9] Data only for the biggest banks operating at Czech market
[10] Czech statistical office, data for 2016, total new apartments completed in the Czech Republic –27 322 (including 6 092 in Prague)
[11] Trigema, Skanska, Central Group – Q2/2017 asking price for new apartments (incl. VAT)

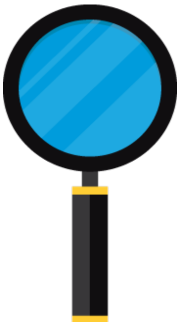
which developers are unable to flexibly respond to the growing demand for new apartments. As an example in Warsaw, public authorities issued permits for more than 22 thousand dwellings in 2016, which is a similar number of dwellings as in Prague, Munich and Budapest combined. In Budapest, authorities issued building permits for an additional 195% of dwellings compared to the previous year. In Prague the number of new dwellings approved for construction are falling year on year. In 2016 the number of completed dwellings exceed the issued building permits by 15%[12]. According to research by the World Bank[13], the time to obtain a permit for a small construction is 247 days in the Czech Republic, which is significantly longer than other European countries (for instance, Germany: 96 days; Poland: 153 days). In this respect, the Czech Republic ranked 127th out of the 189 countries surveyed. Notably, the figure has been determined based on a modelled situation where all administrative deadlines are met and no appeals or court reviews of the administrative decisions have taken place, which is rather unlikely for larger building projects in Prague. Hence, in reality the time it takes to obtain a permit is much longer than the modelled situation suggests. The excessive duration of the building permit procedure and its unpredictability are the challenges of all real estate projects – most notably for housing projects in Prague. Necessary changes to the permit process, related legislation, city and country planning (zoning), and building procedures are taking place at a slow pace, and the sector will have to continue to wait for any tangible results.





Source: Triigema (2012-2016), Trigema, Skanska Reality, Central Group (2017)

Brownfields - rediscovered



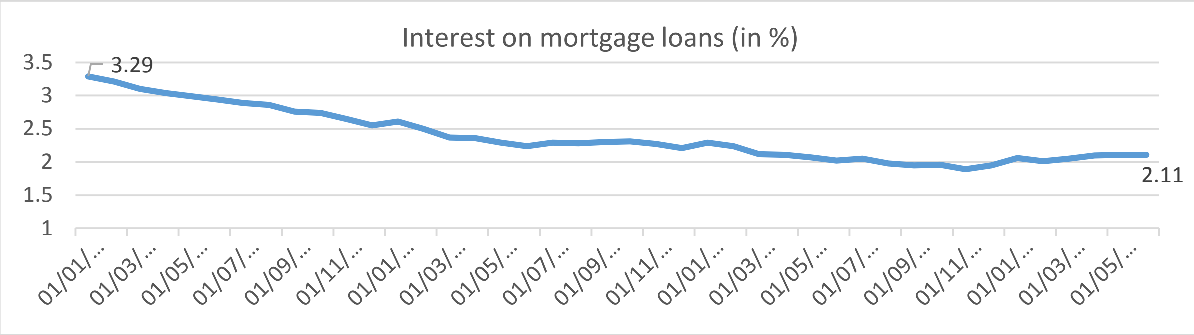
The current market situation has rekindled developers' interest in brownfields – unused land of former industrial sites, of which there are approximately 950 hectares in the wider city centre of Prague alone, and 1 400 hectares[14] in the entire territory of the metropolis. According to a survey of developers by CEEC Research[15] and KPMG a brownfield conversion increases the cost of the project by approximately 17 per cent, among other reasons due to the need to decontaminate. Notably, the conversion of brownfields connected to the existing city infrastructure is one of the development priorities of Prague. Compared to other cities, Prague with its 2 577 inhabitants[16] per km^2 has one of the lowest levels of population density[13] (ie. Munich

[12] Czech statistical office, new apartments completed in Prague 6 092, new building permits issued 5 147
[13] World bank Group –Doing business survey – dealing with construction permits, data collected in Jun 2016, http://www.doingbusiness.org/data/exploretopics/dealing-with-construction-permits
[14] Prague Institute of Planning and development, 2016
[15] www.ceec.eu, data collected in May 2017
[16] Statistical offices 2015/2016 and KPMG calculation

4 977 / km², Vienna 4 503 / km², Warsaw 3 391 / km²) and the city's growth within its existing borders seems to be the obvious option as it is financially advantageous for the city with no need to build and finance additional infrastructure.

Interest on mortgage loans - the lowest in the region, despite mild growth

Growing prices of residential real estate have led the Czech National Bank to issue a recommendation on granting mortgage loans (setting also a maximum loan-to-value ratio); therefore, obtaining a loan for 100% of the property value is a bygone. Unlike Poles or Hungarians, Czechs did not elect for mortgage loans in foreign currencies (CHF, EUR), meaning that the share of foreign currency mortgage loans is marginal. Despite mild growth, interest rates on mortgage loans have been among the lowest in the region in the past years.



Source: Czech National Bank

Rental housing - outlook

The growth in the prices of apartments has also had an effect on the growth of rents. In the Czech Republic, approximately 22%[17] of the population live in rental apartments (33%[18] in Prague), which is, for historical reasons, significantly less than for instance in Germany (48%)[12] or Austria (44%)[12]. The largest owner of rental apartments in Prague is the City of Prague itself, with more than 35 thousand apartments[19], while the ownership of the remaining rental apartments is divided between a large number of individuals owning from one to several apartments.

Prague, being an attractive tourist destination, is also affected by the phenomenon of short-term shared accommodation, with Airbnb alone currently offering more than 11 500[20] apartments in Prague. This is another factor influencing the residential market in the metropolis.

[17] EUROSTAT, data 2015
[18] Czech statistical office, 2013
[19] KPMG Survey 2016
[20] Czech News Agency, publlished on 6 August 2017

Why the Czech Republic

A positive economic outlook together with a political stability, higher yields than Western European countries, and access to bank financing continue to drive significant investor interest in the Czech real estate market.

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