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FINANCING COMMERCIAL PROPERTY IN POLAND AND THE UK

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A b s t r a c t

The following work is a comparison of real estate financing methods in Poland and Great Britain. A comparison of the data from both countries shows that the most popular method of real estate financing in both countries is through mortgages.

External financing of commercial real estates in Poland is accomplished by: universal and mortgage banks, leasing companies, investment funds-loan, private investors and through the issue of ownership or debt securities. Another method of financing commercial real estate is financing it through the establishment of a special, separate company designed to carry out the project, which is known as "project financing".

The availability of a variety of grants, preferential loans and time loans, is the strong point of the Polish system of financing commercial property purchases.

FINANSOWANIE NIERUCHOMOŚCI KOMERCYJNYCH W POLSCE I WIELKIEJ BRYTANII

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S ł o w a k l u c z o w e: finansowanie, nieruchomości, Polska, Wielka Brytania, kredyt.

A b s t r a k t

W pracy porównano sposoby finansowania nieruchomości komercyjnych w Polsce i Wielkiej Brytanii. Porównanie danych z obu krajów pokazuje, że najbardziej popularnym sposobem finansowania nieruchomości komercyjnych, zarówno w Polsce, jak i Wielkiej Brytanii, są kredyty hipoteczne.

Finansowanie zewnętrzne nieruchomości komercyjnych w Polsce jest realizowane przez: banki uniwersalne i hipoteczne, towarzystwa leasingowe, fundusze inwestycyjne i poręczeniowe, prywatnych inwestorów oraz emisję papierów wartościowych o właścicielskim lub dłużnym charakterze. Innym rodzajem finansowania projektów zakupu nieruchomości komercyjnych jest ich finansowanie przez założenie specjalnej spółki do przeprowadzenia danego projektu, zwanej spółką celową (z ang. *project finance*). Mocną stroną polskiego systemu finansowania zakupu obiektów komercyjnych jest dostęp do różnego rodzaju dotacji oraz kredytów preferencyjnych.

Introduction

Purchasing commercial real estate is a popular method of investment in Poland as well as in the UK.

The economic boom in the Polish market in 2007–2008 was related to a rising number of investments and the ability to obtain EU funds. The boom also strongly influenced the general demand for commercial real estate.

Investors seeking a source of funding for projects involving the commercial real estate sector have several major types of financial institutions (which offer so-called "external funding") to choose from. These include:

1. Universal banks; institutions that have no limitations in their banking activity. They have the broadest range of commercial banking services. That is why these banks can be classified as institutions which combine deposit and credit transactions with transactions in securities and assurances. They serve natural persons as well as economic entities and may operate in joint activity – which means combining both ways of serving their customers.

2. Mortgage banks; these banks specialize in issuing mortgage bonds, granting loans secured on real estate mortgages and buying the debts of other banks for mortgage secured loans.

3. Leasing companies; where a lessor transfers the rights to use a particular object to a lessee for a period of time contained in the leasing agreement; in which the lessor will receive payment in installments from the lessee.

Most important elements of a leasing agreement

– The leasing agreement must be in a written form under pain of nullity.
– The sum of installments which the Lessee is obliged to pay the Lessor must be at least equal to the price of the agreement subject.
– It is Lessee's obligation to pay for repairs, inspections and maintenance at his own cost and to cover taxes related to ownership of the subject.
– Upon signing the sales contract by Lessor with the Provider, all powers tied with the warranty are transferred to the Lessee. The ability to withdraw from the sales contract by the Lessor is an exception to this.
– It is the Lessee's obligation to pay installments regularly, according to a schedule he accepts. In case of delays in paying an installment, or lack of them, it is the Lessor's right to terminate the contract and regain the subject.
– Upon completion of the contract, ownership of the subject is usually transferred by Lessor to the Lessee, unless both sides agree upon another way to dispose of the subject after the contract is completed.

Given the number of sides taking part in a leasing transaction, two types of leasing are distinguished:
- **Direct leasing** (when the manufacturer signs a contract directly with the user)
- **Indirect leasing** (more than two sides take part; i.e. a specialized leasing company exists between the manufacturer and the user)

Operational leasing

The main features of an operational leasing contract are:
- If the real estate is amortized, the period of contract should be at least 10 years.
- The sum of the installments contained in the contract must be at least equal to the subject's price.
- Depreciation is done in the Lessor's accounting books.
- Leasing installments are the Lessee's cost of revenues.
- The Lessor may repurchase the subject upon the completion of the contract; the price of repurchase depends on the amount of depreciation for that particular subject or leasing period. The repurchase value is calculated as the beginning value reduced by depreciation calculated by taking factor 3 into account.

Financial leasing

The main features of a financial leasing contract are:
- The contract is signed for a period of time; in this type of leasing contract there are no limitations for a minimal or maximal period.
- The sum of installments contained in the contract must be at least equal to the subject's price.
- The contract states that depreciation is done by the Lessee during the contract's period.
- Leasing installments are made up from two shares: the capital share, making payments for the subject's value, and interest share, being the Lessor's salary.
- The customer's cost of generating revenues constitutes only the interest part of the leasing installment.

Denominated leasing, indexed to the exchange rates of EUR/USD/CHF

- The concept of denominated leasing, indexed to the exchange rates of EUR/USD/CHF is a contract of financial or operation leasing, where leasing installments are determined as equivalent in zlotys, given in foreign currencies (EUR/USD/CHF) (GETIN Leasing.pl, access 2011).

Methods for financing purchase of commercial real estates

The most popular method of financing commercial real estates is a loan. Banks holding large equity capital can fund expensive investment projects on their own, without a need to create a loan banking consortium.

Limitations in credit concentrations are comparatively high and the equity capital of universal banks is definitely higher than mortgage banks. They make use of different financing sources, which include:

- Deposits belonging to customers.
- Deposits belonging to other banks.

Additionally, universal banks do not have limitations to the loan value or the subject's value (the so-called LTV proportion – loan-to-value, which is a proportion of granted credit to the proportion of the real estate value) and in the range of their commercial activity (full range of bank services), contrary to mortgage banks. The majority of large universal banks possess an extended, bureaucratic process of decision-making concerning credit granting and on possible annexes to the credit agreement. It can happen that certain investment projects may be treated carelessly, without a thorough review of their specifications. The advantages of a mortgage bank over an universal bank may include narrower specialization, experience in financing various forms of commercial real estates, a shorter bureaucratic process and an individualized approach to customers.

Recently, the economic crisis in Great Britain was a period of both the largest and longest downturn since World War II and 2010 was filled with uncertainty about its outcome. In 2010, the British economy periodically achieved good growth values, nevertheless, it is not widely believed to be headed for a fast recovery to pre-crisis economic status.

The crisis in the commercial real estate market in Great Britain developed in accordance to particular phases. The crisis phases in the sub-prime loans market proceeded as follows: (*Financial Stability Report*, no 22, Park Communications Limited, London 2007):

- Growth of the sub-prime loan market in the United States of America.
- Losses and reduction of value on related property protection markets and other compound financial instruments.
- Uncertainty of values in the global property protection market.
- Widespread flight from risk on credit market as well as on other markets.
- Risks flow into bank balance sheets.
- Tightening credit requirements and reduced liquidity.
- Problems with financing activity in some banks.

According to KEN data, in June 2008 British banks issued mortgage loans totaling £23.6 billion, which was 4% less than in May 2008 and 32% less than in June 2007. (*Finansowanie nieruchomości przez banki w Polsce* 2008).

Financing commercial real estate in Poland is mainly based on bank credits and self-owned funds. According to an analysis from June 2009, the yearly growth rate for receivables from commercial real estate credits was 43% (whereas in April 2009 it was 5.9% in the Euro zone) which constituted one of the highest levels among all 27 EU countries. (*Finansowanie nieruchomości przez banki w Polsce* 2009).

A large number of credits for purchasing commercial real estate were given in foreign currencies, which has generated the persistence of a rather high risk level, resulting from the fact that credits were contracted for very long terms, reaching even up to 50 years. This may lead to the occurrence of a currency crisis, or larger and longer depreciation of the zloty in comparison to foreign currency. Such a depreciation may lead to a rapid debt crisis among developers who contracted credits in a foreign currency, resulting in a reduction in the credit capacities of particular banks and deteriorating their financial situations. Quality losses in particular foreign currency credits, along with a drop in the value of the zloty, may cause a need to create a comparatively larger amortization deduction, which in turn, will increasingly weigh on the financial results of banks. Recent years have shown that, together with the rise of receivables from credits contracted on residential properties, real estate prices have also risen. This situation stems from an insufficient supply of residential property on the real estate market and the continuing process of adjusting prices to other EU countries. This rise has slowed, and a downward trend was even observed in 2008 and 2009.

Financing the purchase of commercial real estate in Great Britain as well as in Poland mainly involves contracted credits. Lowering interest rates could have been a step toward increasing the availability of those credits, but on 10.01.2007 the Bank of England decided not to reduce interest rates and left them at the previous level of 5.5%. Concerns of an inflation increase in Great Britain were much stronger than a willingness to revive the Britain economy. Even in 2007, forecasts for 2008 mentioned 2% economic growth, which would have been the worst result for the British economy in over 16 years. In reality, those forecasts have proven to be optimistic. The Bank of England decision wasn't greeted well by some economists, and after the information about interest rates was revealed the main stock market index in London, the FTSE 100, fell by 0.4%, which showed that investors were be disappointed by this decision. It was some analysts' opinion that the following years would bring further cuts in interest rates, even to 5%. The decisions made by the Bank of England may be related to the fact that more and more developers were encountering difficulties in getting credits. Nevertheless, most British financial experts say that possible cuts in interest rates rather won't affect the situations of those companies which have already contracted mortgages.

Analysts explain that the interest rates established by Bank of England do not correspond directly with mortgage interest. If banks should start to give mortgages with quite attractive interest rates, they will also include very high preparatory fees to align this (MELUCH, WYDRA 2008).

"Buy-back" is a popular way to finance commercial real estate in Great Britain and other Western Europe countries. In Poland, this method is little-known.

The buy-back method of purchasing commercial real-estates allows funding the project and acts as a warrantor for repayment of financial funds on the basis of an agreement concluded with the producer and manufacturer of the project. This warrantor gains future tenants and buyers for a period of credit repayment.

In this way, he limits the risk for a subject carrying out a purchase project. Additionally, during the credit repayment period he will collect rent and an appropriate salary (KUCHARSKA-STASIAK 2006).

Another method of financing commercial real estate projects is financing them through establishing a special company separate from the project, which is called "project finance". Project finance created for this purpose should become the owner or administrator of a financed property, which would be the only area of this company's activity. This company also controls employment and salary budgets. In the "project finance" formula, it becomes a party to the contracts accompanying the project. In this type of financing, a ready cash surplus (derived from leasing, renting, or sale contracts) is a source of credit repayment. The choice of business partners, agreements and methods of managing the project should, as far as possible, increase the viability of the project and achievement of financial plans (Spółka celowa czyli project finance BRE Hipoteczny).

The method of financing projects realized in the commercial real estate sector through "project finance" (as described above) is widespread, especially by banks with foreign capital.

Most banks prefer "project finance" to be of a joint-stock, limited liability form. Beyond protection in the form of a mortgage on the credited property, banks also usually require legal security for credit repayment in the form of a pledge registered in shares. Bank can seize such a pledge in an extrajudicial way, which is equivalent to seizing the whole project. Other common legal securities are cessions of incomes from renting contracts, cessions of rights to insurance policies and rights to contractual warranties. The rights of contractual warranties are ceded by banks, if the bank funds the construction. If the renting contracts terminate or if the tenants violate their contracts, banks may also submit reserves destined for debt payment – a form of a special deposit, from which the credit is serviced if the property ceases to generate sufficient financial income.

According to the majority of analysts, even though for the first time since 2007 an increased tendency in financing purchases of commercial real estates has been observed, there will not be any visible acceleration in the commercial real estate market until 2012.

"Respondents expect further limitations in trade in Poland and Great Britain, primarily because of difficult access to capital. The upcoming year 2012 may bring a lack of access to traditional sources of debt capital for refinancing secondary real estates, although new funding sources will appear in the form of government-owned financial funds and insurance companies" – states John Forbes, a partner in PwC.

An increased availability of capital funding sources is expected in 2011 due to the growing number of investors from Asia and Pacific countries, insurance companies and private equity funds. However, financing appearing with new creditors on the market will only partially solve problems with the supply of capital.

Conclusion

The development of the Polish commercial real estate market will depend on lending opportunities offered by banks active in our country. Their condition is definitely better than their competitors and shareholders in Western Europe.

The situation in the commercial real estate market in Poland has never had the same influence on economic trends and economic expansion as in developed countries. The simple reason for this is that this sector's share of the national GDP is far lower in Poland. While it reaches 25 to 27% of Britain's GDP, in Poland it is merely 3.4%. (CYBURT 2010).

Various grants and preferential loans are used to fund the purchase of commercial property in Poland. Governments or other organizations partially fund the interest, making credits more available. This is an advantage of the Polish banking system.

The strengths of the British system lie in modern methods of financing. One of them is the popular buy-back method, allowing investors without sufficient creditworthiness a chance to buy real estate.

€1.112 billion was put solely into commercial real estate in Poland – estimates Jones Lang LaSalle in his August analysis. Warsaw Mokotów Gallery, Wars-Sawa-Junior and Promenada changed owners as commercial properties enjoyed the most attention – as many as seven were sold. The total amount of these deals was €611 million, making them more popular than office buildings (four transactions with a total amount of 501 million zlotys) and storehouses – logistics centers (two transactions with a total amount of €79 million).

According to the Royal Institution of Chartered Surveyors (RICS), Poland is one of the rising stars, next to countries like Russia, Malaysia and Brazil, where rates of return may be the highest. However, the organization also noted that the European market is becoming increasingly diversified due to financial problems in countries like Greece, Portugal and Ireland. (PolskieRadio.pl, access 2011).

Lack of access to ready cash is definitely a problem in the Polish and British commercial real estate sectors. Each company that wants to start construction must reckon with the increased cost of acquiring money. Higher margins are one of the causes. Before the crisis, an investor could attempt to undertake an investment with a contribution of only over a dozen percent. Now, after the recession brought the downfall of numerous financial institutions, more than 50–60 percent is required. It has led some developers to focus on one project at a time instead of doing several simultaneously. The unstable economic situation and increased risk has led to a situation on the financial market where there are practically no banks willing to fund land purchases or developer activity in commercial real estate construction.

The banks which survived the crisis have definitely tightened up the procedures for granting credits and – unfavorably for borrowers – changed the requirements for credits designed to purchase commercial real estate.

Because of the current situation in the market for financing commercial real estate, only the best credit applications have a chance to receive funding by banks. Most experts agree that it will cause the disappearance of weak applications from the market, and – in turn – lead to further bankruptcies since many banks are only interested in financing applications from reliable companies. Due to the increased attention to a developer's know-how and his experience in the commercial real estate market, the developer's brand is now becoming a key aspect in the loan-approval process.

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