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CEE Real Estate **Investment Compass 2017**

03	Introduction
04	CEE investment markets - flows and origins
06	Office sector
08	Retail sector
10	Industrial sector
13	Brexit effect?
14	W&I insurance - the lawyer's perspective
16	CEE key legal issues
20	Real estate deal financing
23	About us

Introduction

We welcome you to the joint Colliers International – CMS Investment Compass 2017 report on the CEE region. We stand at a particularly interesting juncture in the CEE Real Estate investment cycle as the risks that are present in the maturing Western European market cycle challenge what is clearly a firm domestic economic environment across the region. Clear premiums in commercial real estate yields compared to Western Europe and the CEE region's own funding rates should keep overall investment flows in 2017 at or above 2016's EUR 12.2bn, a level which is an indication of more liquid and mature marketplace. This maturity may help combat the key specific risk affecting Western Europe, that of "Brexit" and its reverberations, which will unfold further in 2017. Brexit's full consequences are not yet known and some might even end up as a positive for CEE. The spread of Warranty & Indemnity (W&I) insurance in the region is another sign of that maturity. As is the level of sophistication in the structuring of large real estate deals. We examine these topics in this report, as well as taking a closer look at the major fundamental trends in the CEE Office, Retail and Industrial arenas and the evolution of investment instruments, transaction costs and local differences in approach to real estate in each of the CEE countries.

The fundamentals

2016 saw higher flows into CEE Real Estate than at any point since the last cyclical peak in 2007. If last year's EUR 12.2bn in total flow is to be beaten in 2017, the fundamental outlook has to be in place. Underpinning all at present is robust GDP growth, with the CEE-6 economies seen expanding 2.3%-3.6% in 2017 and at broadly similar levels in 2018-19. Indicators suggest that consumer demand is contributing more to the economic dynamic in this cycle than previously. Importantly for indexed rents, Eurozone CPI looks set to overhaul 2% in 2017, perhaps rising to over 2.5% YoY. Thus the overall rent outlook is most likely robust, especially in the Retail/Traditional Shopping Centre (TSC) arena in the likes of Warsaw, Prague and Budapest. Historic wage competitiveness remains a plus factor for CEE in the Office and Industrial spheres, thus contributing to attractive rent levels for BPO/SSC operators and warehouse operators supplying both the region and Western Europe. But wage growth itself is eroding this advantage over time. We foresee wage growth of 10% in Hungary and Romania in 2017. For investors, some exposure to Retail hedges this risk, as higher wages drive tenant performance through retail sales.

We foresee firming rents in eleven out of the thirty key capital city data points (five categories: prime CBD Office, CBD Office, Logistics, Warehousing and TSC Retail) spread across CEE-6 in 2017. We predict decreasing rents in only three arenas. We see prime capital city rental yields falling in half of the three (Office, Industrial and TSC Retail) key categories present in the six countries this year.

Risks and opportunities in the changing investment market

Most of the risk factors facing investors into the CEE Real Estate arena are those confronting investors in Western Europe. The unfolding "Brexit", with its specific

disruptions to capital flows in and out of the UK (including the level of Sterling) is identified but not well-understood and will not be so for some time, as the process is due to take that time. What Brexit signifies is the wider political risks associated with the rise of "populism" in Europe which affects asset markets in terms of consideration of taxation and also more generally in terms of EU cohesion. Poland and Hungary in particular are also perceived to have their own brands of "populists" in government presently. Specific effects of "EU cohesion" and even the local presence of "populist governments" on the CEE-6 include the possible disruption of the inward flow of EU Structural Funds. Looking globally, the rise in bond yields accompanying the beginning of a tightening cycle by G10 Central Banks, the extreme degree of leverage present in key economies such as China (standing at over 270% of GDP) plus the uncertainties over future policy content and implementation by President Trump stand as risks to investment flows into the CEE-6.

As many of the CEE risks are common to G10, it is not a surprise to calculate that investment flows from the G10 arena have stayed in the EUR 3.4bn-EUR 6.6bn range since 2012, peaking in 2015, registering EUR 4.9bn in 2016. The majority of the fresh money entering the CEE space in 2016 came from South Africa (EUR 2.4bn), Asia (EUR 2.0bn) and domestic/CEE sources (EUR 2.6bn). 2017's flows from these sources are likely to be somewhat similar in size. The boost to liquidity from both the participation of Asian funds in portfolio-style deals and at the other end of the size scale, increased interest from locally-based players and investment funds is changing the dynamic of the CEE-6 investment scene.

CEE investment markets – flows and origins

Historical CEE investment volume (EUR bn)



Source: Real Capital Analytics, Colliers International

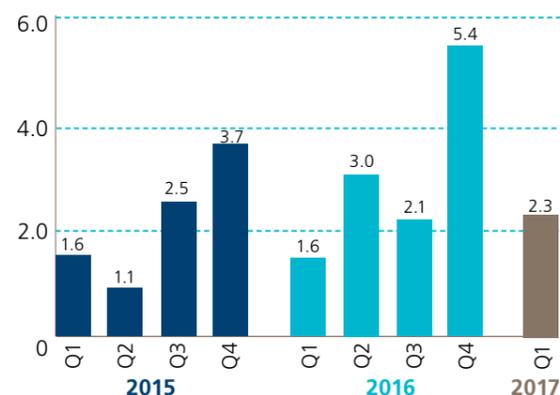
The CEE commercial real estate markets attracted the highest flows yet in this cycle in 2016. Investment was only higher at the last cyclical peak in 2007. CEE is presently defying the weakening EMEA investment cycle. Preliminary numbers into CEE-6 for the end of 1Q 2017 stand at EUR 2.30bn, according to Colliers International estimates. This represents a growth of 41% compared with Q1 2016 and 45% higher than Q1 2015. The region has started the year well.

Poland is still the largest recipient of flows but the other countries are growing faster, capturing share. Very noticeable amongst the estimated Q1 2017 figures is the high 62% share of the Czech Republic. The Industrial sector has seen the biggest incremental growth in the last 6 years, whilst Retail flows are yet to overhaul Office. Retail might well do so in 2017.

» Hungary and the Czech Republic's flows have grown fastest in the last 2 years.

A marked shift in the origin of flows is evident in 2016, compared to previous periods in this cycle. South Africa, Asia and flows from domestic/CEE sources are now larger than those from G10 countries. Preliminary indications from the first quarter of 2017 suggest continued significant local investor activity in Hungary and the Czech Republic and the entry of Thai investors into the latter and Poland.

Striking is the rise of domestic and CEE cross-border flows, up from EUR 1.1bn combined in 2011 to EUR 2.6bn in 2016. Within the region, Czech and Slovak domestic flows more than doubled in the period, whilst Hungary's mushroomed; The launch and development of



three large domestic open-ended retail /institutional funds in Budapest stimulated flow up to EUR 627m in 2016 from close to zero in 2011.

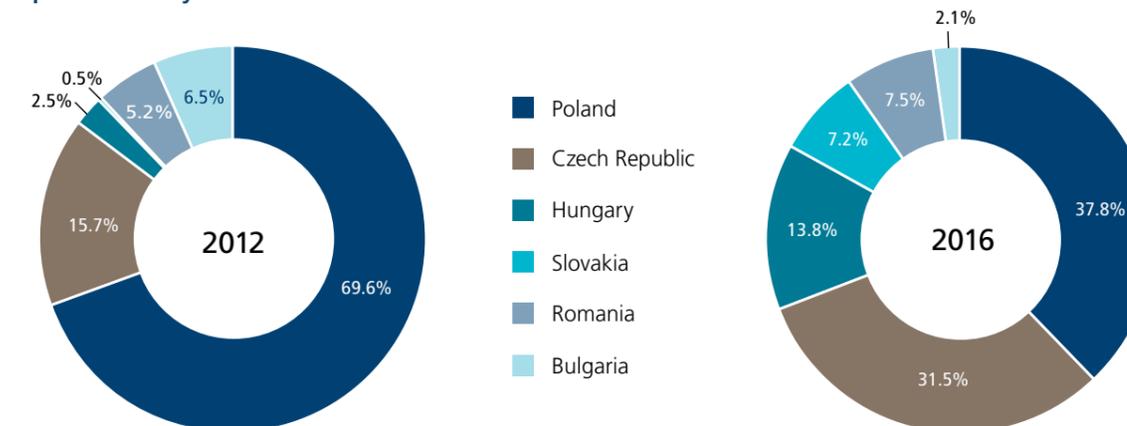
» The Slovak and Czech markets were both the largest origins and destinations of CEE cross-border flow in 2011-16.

Looking into 2017, the sources of flow into the CEE markets are likely to stay as diverse as seen in 2016, with Asian money at play looking to expand out of Western Europe. Large portfolio-type deals such as the sale of P3 to Singapore's GIC may become more common as the size of ticket from the Asian source dictates. South Africa's activity might not match that of 2016 in total but with over 10 of the domestic REITs committed to the CEE region either directly or indirectly through NEPI, Rockcastle or EPP, deals should continue to be executed. Falling commodity prices would probably trigger more money flow from South Africa whilst higher commodity prices would encourage investment from Russia, MENA and perhaps Turkey.

Domestic investors are becoming increasingly comfortable with market liquidity, with commercial real estate market capitalization estimated at between 55%-65% of GDP, except in Slovakia with over 100%. This may tempt local investors in Poland (only 2% of activity by volume in 2016) and Romania (only 4%) to become more active in the marketplace. Domestic activity is very well-established in Bulgaria (57% of activity in 2016) and Hungary (37%) whilst both local and cross-border investment are important in Slovakia and the Czech Republic.

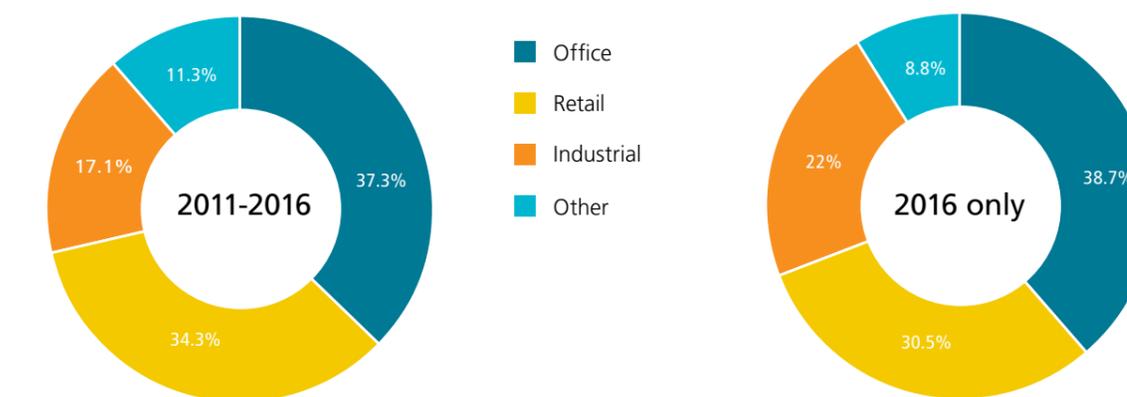
The chief risk to all this activity is a global economic slowdown, perhaps triggered by higher bond yields or China's debt pile.

Split of flows by destination 2012 vs 2016



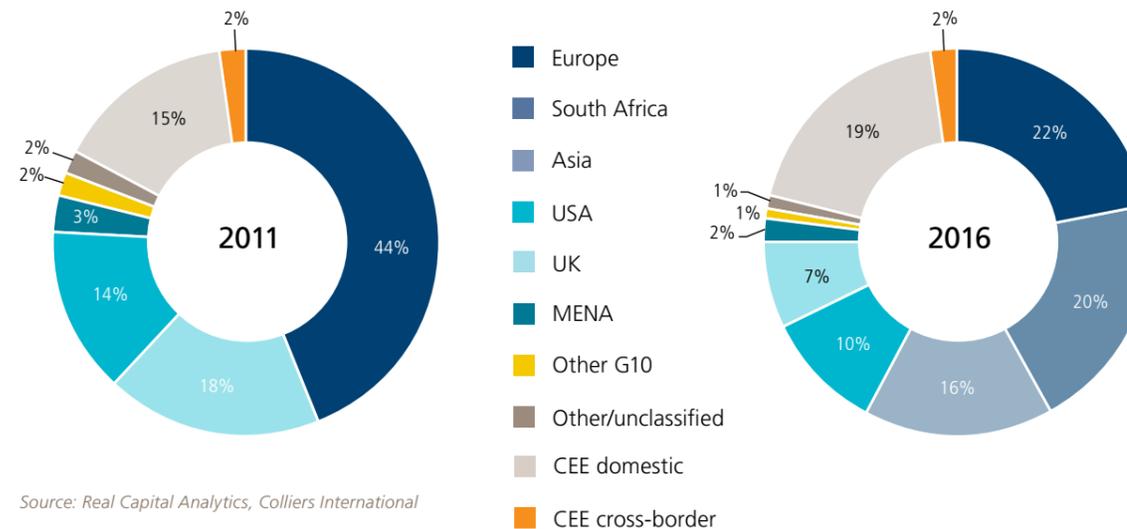
Source: Real Capital Analytics, Colliers International

Split of flows by sector totals 2011-2016



Source: Real Capital Analytics, Colliers International

Split of flows into CEE region by origin, 2011 and 2016



Source: Real Capital Analytics, Colliers International

Office sector

Persistent GDP growth in the CEE-6 countries underpins the demand for office space. With a relatively healthy German economy, this growth looks set to continue in the 2017E-19E period.

» **Poland and Hungary likely to see stronger GDP dynamics in 2017E.**

Whilst demand has expanded, along with GDP, in the CBDs of the key cities in CEE-6, supply has matched it, meaning that vacancy rates have been generally stable to rising in Polish cities and Bucharest in the past few years. Supply appears still robust in these arenas; we foresee rising vacancy rates in Warsaw, most Polish regional cities, Bucharest and Bratislava in 2017. The pattern is by no means universal with lower vacancy rates predicted in Budapest, Sofia (both continuing their recent trends), the Polish Tricity and Lodz.

How does this translate into rent dynamics? The recent GDP growth impulse has been sufficient to deliver sporadic rent increases in 2016 even in the face of higher vacancy rates in, for example, Bucharest. Sofia and Bratislava also saw moderate 3%-5% hikes, whilst prime rent dynamics remained soft in Prague and especially Warsaw. Prime rent levels in the capital city CBDs range up from EUR 13.5/sqm/month in Sofia up to EUR 22/sqm/month in Warsaw. Average rents range from EUR 11.5/sqm/month in Bratislava and Sofia up to EUR 18/sqm/month in Warsaw. We see rents as likely to rise in 2017 in Prague and Sofia. Average rents could fall in Warsaw, a possible consequence of the recently-rising vacancy rate there.

Prime rents in the Polish regional cities range from EUR 13/sqm/month in Lublin up to EUR 16.5/sqm/month in the Tricity. The competitive space offers from these regional cities and the likes of Brno in the Czech Republic (rent of EUR 13/sqm/month) and Plovdiv in Bulgaria (rent of EUR 8.5/sqm/month) are increasing in importance as the BPO/SSC dynamic continues to grow.

» **Business Process Outsourcing (BPO) / Shared Service Centre (SSC) activities are playing an ever-more important role in generating new demand for office space in CEE countries.**

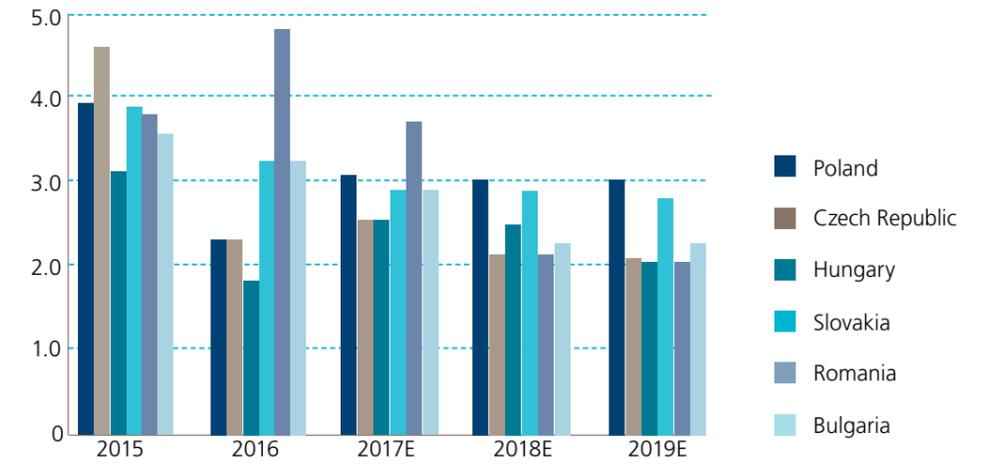
We are even seeing evidence of BPO/SSC penetration into cities outside of Poland's top 10 urban centres, with over 2,000 people employed in Olsztyn and nearly 4,000 in Rzeszow. A further 8 centres have up to 1,000 employees in Business Shared Services operations, according to a 2016 Colliers International study. Users of BPO/SSC services see relatively low wages, low taxation rates, good IT capacity and strong language and educational abilities as reasons to be confident in relocating operations within the CEE region.

The share of Office transactions in the CEE Investment pie has remained broadly steady around the 40% mark (39% in 2016), as the absolute value of transactions has of course grown. The most impressive increases seen in the last year were in the Czech (EUR 1.7bn in 2016 versus EUR 556m in 2015) and Hungarian (EUR 939m versus EUR 291m) marketplaces.

» **Office yields likely to compress in 2017 in Prague, Budapest and Bucharest.**

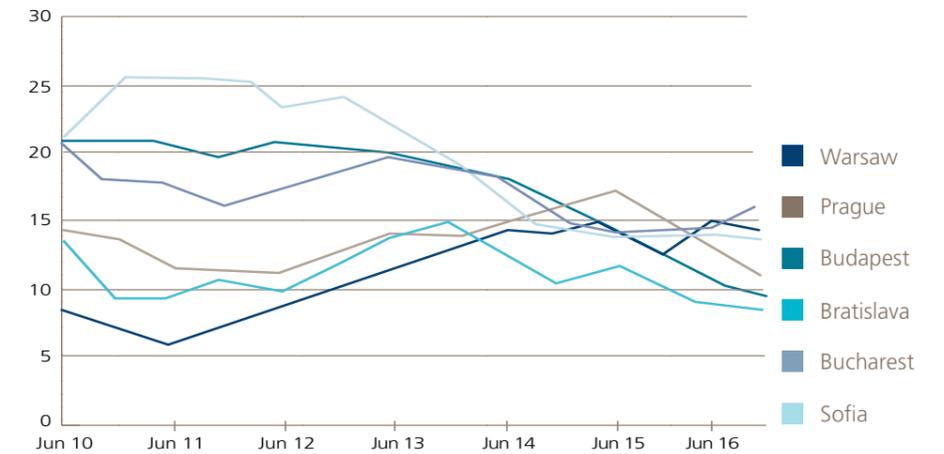
As the most liquid investment asset class, office yields have compressed along with funding rates in this cycle. We foresee some chance of further compression in prime Prague, Budapest and Bucharest given the investment demand and rent growth dynamics. We see the possibility of yields backing up in Warsaw, reflecting full pricing, a relatively full development pipeline and a narrower premium to funding rates than the comparisons with other capital cities in the region.

Recent and forecast GDP growth (yoy, %) in the CEE-6 countries



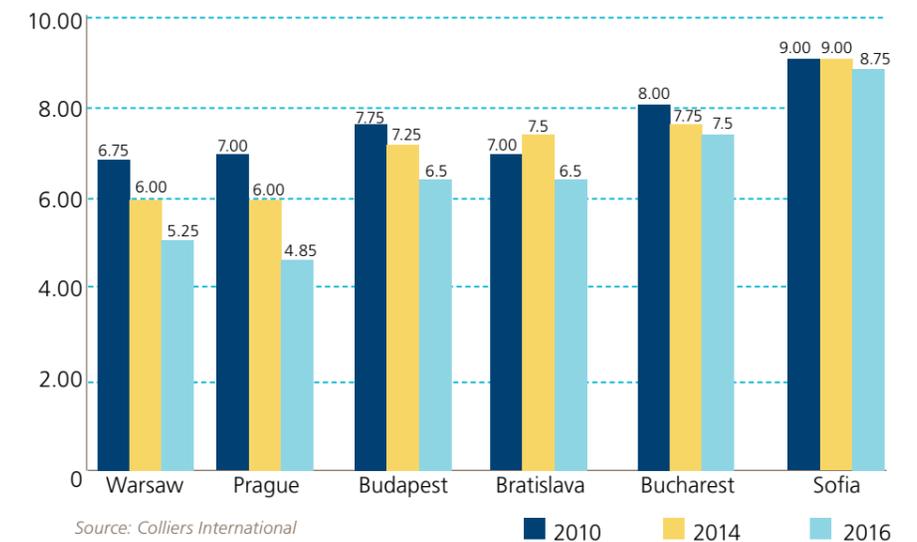
Source: Oxford Economics, Colliers International

Vacancy rates (%) in key CEE-6 cities



Source: Colliers International

Prime capital city office yields (%)



Source: Colliers International

Office forecast:

Vacancy rates 2017

- ▲ Warsaw
- = Prague
- ▼ Budapest
- ▲ Bratislava
- ▲ Bucharest
- ▼ Sofia

Prime rents 2017

- = Warsaw
- ▲ Prague
- = Budapest
- = Bratislava
- = Bucharest
- ▲ Sofia

Average rents 2017

- ▼ Warsaw
- ▲ Prague
- = Budapest
- = Bratislava
- ▼ Bucharest
- ▲ Sofia

Yields 2017

- ▲ Warsaw
- ▼ Prague
- ▼ Budapest
- = Bratislava
- ▼ Bucharest
- = Sofia

● Optimistic ● Pessimistic = Neutral

Retail sector

The Retail sector in CEE is a story of firming rental dynamics, especially in the Traditional Shopping Centre (TSC) segment. A firm escalator appears installed, with prime TSC rents in Warsaw for example rising steadily from EUR 90/sqm/month in 2013 to EUR 117/sqm/month at the end of Q4 2016. The pattern was the same from 2014 in Prague and Budapest. Occupancy in the key shopping centres in these cities is at or very close to 100%, with waiting lists of prospective tenants being reportedly drawn up. Fresh supply of new developments look relatively limited.

Why is the Retail sector so strong? Out of all the key Real Estate sectors, it has the clearest positive link to consumer demand and wage growth. Consumer demand is itself related to GDP (see the Office Sector section for GDP growth projections) but it is also very clear that in this economic cycle in CEE, the consumer is certainly playing a more prominent role than in the last major cycle that ended with the deep regional recession in 2008-09. Consumer sentiment, as measured by the European Commission's Economic Sentiment (ESI) data collected monthly, is stronger in this cycle compared to the last cycle. A comparison with the overall sentiment score when looking at the CEE-6 countries taken together illustrates the trend well.

» **Consumer sentiment and spending is now a more central keystone in CEE economies.**

The chance of these indicators climbing further is high, because wage growth is buoyant across the region. More money in the pockets of employed consumers, including many benefiting from significant hikes in the minimum wage in the likes of Hungary (30% over 2 years), Romania (16%) and the Czech Republic (11% in 2017), means higher spending on both staples and discretionary goods. As outlined in the key data table in the Industrial Sector section on page 10, overall wage growth is set to continue in 2017, in a range of between

Prime traditional shopping centre forecasts

Rents 2017

- ▲ Warsaw
- ▲ Prague
- ▲ Budapest
- = Bratislava
- = Bucharest
- = Sofia

Yields 2017

- = Warsaw
- = Prague
- ▼ Budapest
- = Bratislava
- ▼ Bucharest
- ▼ Sofia

● Optimistic ● Pessimistic = Neutral

4%-10% in CEE. In this environment, the chances of further rental growth in the likes of Prague, Warsaw and Budapest simply resulting from demand pressure are very high. These trends will also likely reflect nationwide in these countries, as the wealth effect ripples out. On top of that, benchmarking of tenant rents to Eurozone CPI, which we see as averaging 2.5% in 2017, will also add to the momentum. In the Czech Republic specifically, the probable appreciation of the Czech Koruna after the "currency cap" is removed would increase the purchasing power of Czech consumers further.

» **"The chances of further rental growth in the likes of Prague, Warsaw and Budapest simply resulting from demand pressure are very high"**

The wage dynamic by itself favours the Retail sector above others in the region, as labour costs are an input for Office (BPO/SSC) and Industrial (warehousing and manufacturing). Investors are recognizing this change as manifested in significantly lower yields. The minimum compression seen in the prime TSC arenas in the CEE capital cities between 2010 and 2016 was 125bps, ranging up to 200bps in Bucharest. Bratislava, Prague and Budapest saw 100bp drops in yields between 2014 and 2016. We believe that yields will continue to fall, perhaps significantly so, in Bucharest, Sofia and Budapest in 2017.

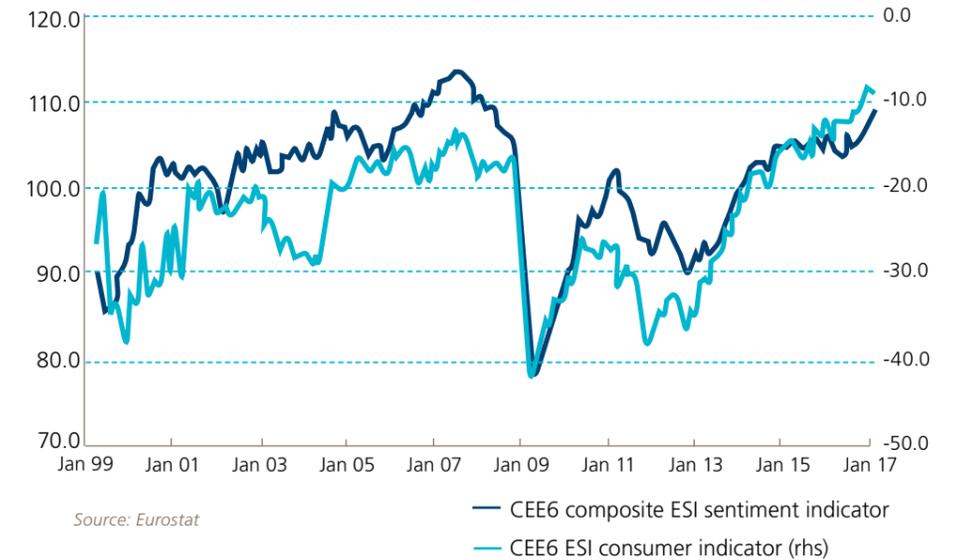
» **Investment yields in Retail could fall significantly in Bucharest, Sofia and Budapest this year.**

As might be expected, the volumes coming into the Retail sector in the CEE space have grown fast when compared to 2014 and prior years. The sector peaked at 42% of the region's investment volume in 2015, subsiding in relative terms to 30% (flat in absolute terms) of the much bigger pie in 2016. Indications from CMS suggests activity in the sector will be significant in H1 2017. The sector has been a favourite of the flood of money (20% of overall volume) entering CEE from South Africa.

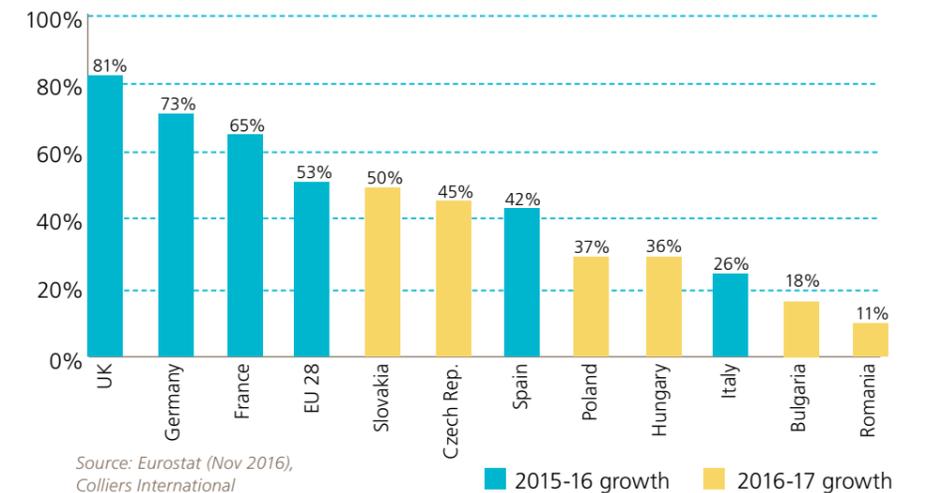
The main specific risk to this optimistic story, aside from finding sellers of the best assets, is the nascent growth of the disruptive e-commerce and online shopping phenomenon. Penetration levels in the region are still low, below 50% of the population. Growth rates of 10%-20% for e-commerce were reported in CEE in 2016 and are expected also for 2017 and may stymie high street and TSC demand. Other risks would include political instability from whatever source hitting consumer sentiment and funding rates (a proxy being sovereign bond yields) rising.



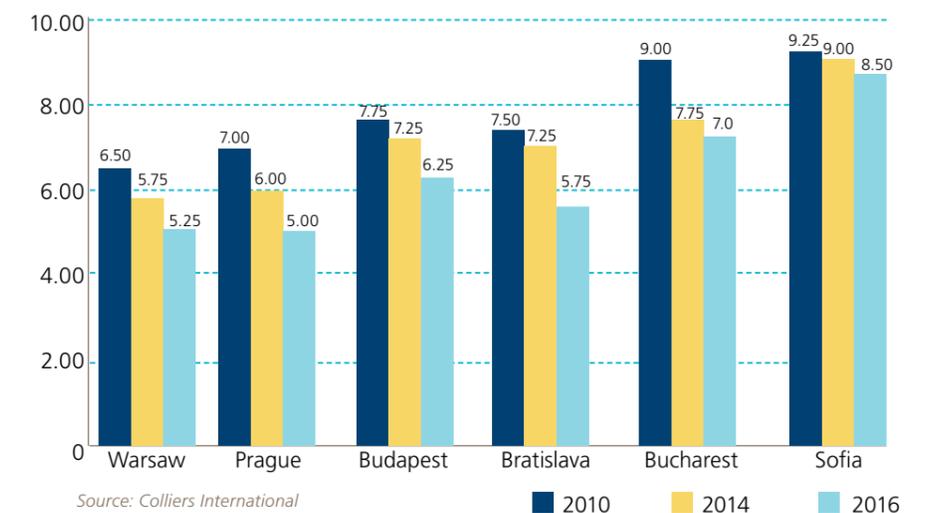
European Commission ESI monthly sentiment survey results



% of population transacting online in 2015



Prime capital city traditional shopping centre yields (%)



Industrial sector

The CEE Industrial sector is booming, with a bright start to 2017 already recorded in official economic figures. Prospects for Manufacturing space demand this and next year thus look promising. In the Logistics world, steady GDP growth in Europe and especially within CEE-6 plus infrastructure investment by governments and the EU should stimulate demand. Location, though is a trade-off between costs, especially wages, versus risk. Poland and Bulgaria appear to be the cheaper at present.

For both Manufacturing and Logistics, wage pressures are the main macro risk to consider in the near run. Wage pressures are clearly evident in Hungary, where we expect over 10% growth in 2017E. Data from the quarterly Industrial sentiment surveys collected by the European Commission suggest that over 75% of Hungarian companies see a shortage of labour as a constriction on expanding production. The ratio is also high in Bulgaria (35%) Poland (33%), the Czech Republic (also 33%) and Slovakia (22%) compared to the EU as a whole (12%).

Prime rents in both Industrial and Logistics arenas are firming, especially in Prague and Budapest. Vacancy rates remain low across CEE, although this indicator is less useful than in Office given the higher proportion of "built-to-suit" developments. Low vacancy applies also to key regional markets in Poland and the Czech Republic. Given the push into the region from e-commerce companies amongst others in the past 3 years, the dynamics outside of the capital cities will become increasingly important in the future.

» **Industrial yields are most likely to fall in Bucharest, Budapest and Prague of the capital cities in 2017.**

Industrial sector volumes made up 22% of the EUR 12.2bn CEE-6 investment total in 2016, up from an average of 16% in 2011-15, reflecting the unfolding positive story. And yields are reacting.

Yield compression multi-year is most evident in Warsaw and Prague and is now spreading southwards.

Key Industrial sector indicators across the CEE region

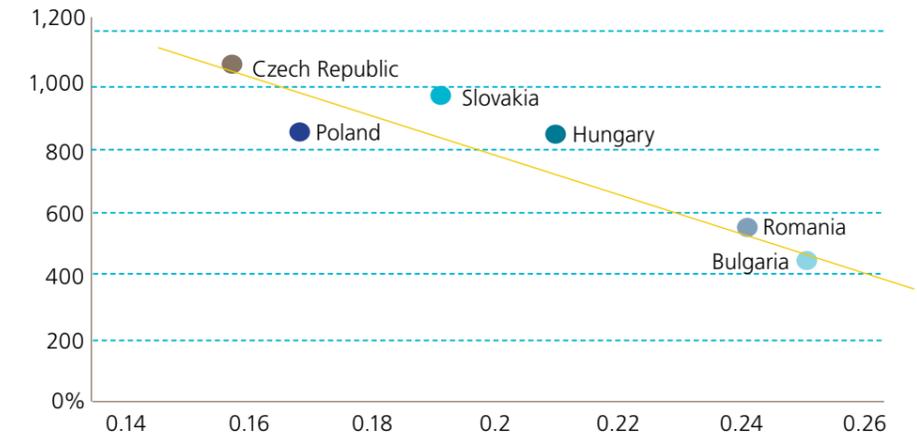
Industrial Indicator	Poland	Czech Rep.	Hungary	Slovakia	Romania	Bulgaria
GDP growth forecast (2017-19E ave)	3%	2.3%	2.4%	2.8%	2.6%	2.5%
Industrial production growth yoy (Jan 2017)	9.0%	9.6%	6.5%	7.6%	5.2%	-1.2%
Unemployment rate (%)	5.7%	4.0%	5%	9.4%	5.9%	7.5%
Wage growth 2017E	3%	5%	10%	4%	10%	8%
Manufacturing wage (EUR/month)	880	1080	852	978	586	440

Source: National Statistics agencies, Colliers International

Industrial forecasts

Vacancy rates 2017	Logistics rents 2017	Warehousing rents 2017	Yields 2017
= Warsaw	= Warsaw	= Warsaw	= Warsaw
= Prague	▲ Prague	▲ Prague	▼ Prague
▼ Budapest	▲ Budapest	▲ Budapest	▼ Budapest
▲ Bratislava	▼ Bratislava	= Bratislava	= Bratislava
= Bucharest	= Bucharest	= Bucharest	▼ Bucharest
= Sofia	= Sofia	= Sofia	= Sofia
● Optimistic ● Pessimistic = Neutral			

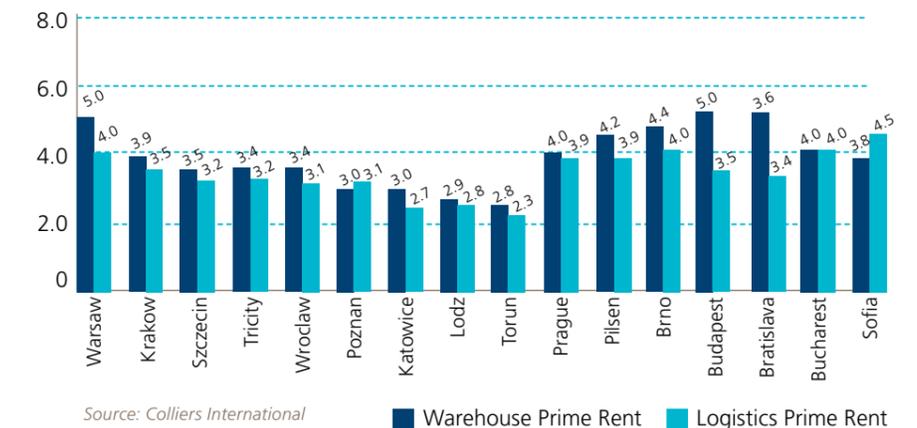
Manufacturing wage (EUR/month) versus blended risk indicator*



Source: National Statistical agencies, Colliers International

*Colliers International Industrial country blended risk indicator equally weighted average of country risk, ease of doing business rank and logistics performance index rank.

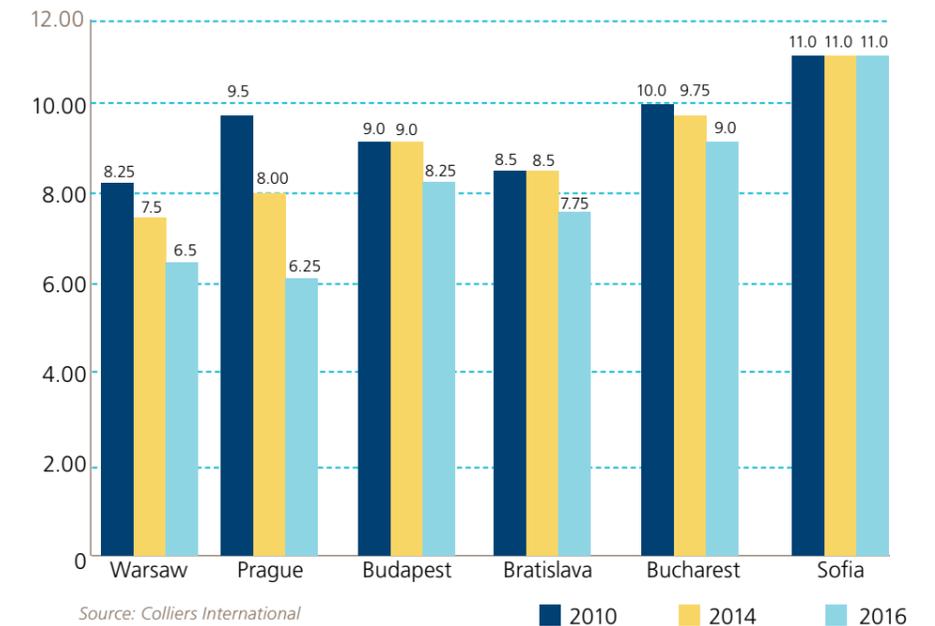
Prime rent levels (%)



Source: Colliers International

■ Warehouse Prime Rent ■ Logistics Prime Rent

Prime capital city industrial and logistics yields (%)



Source: Colliers International

■ 2010 ■ 2014 ■ 2016





Artur Mokrzycki
Head of Capital Markets Europe,
Panattoni Europe
E amokrzycki@panattoni.com

Investing in logistics real estate provides investors with a very unique diversification and truly international exposure. Historically, logistics assets have delivered high returns and outperformed other classes of assets like offices and retail, and we do not believe this trend is likely to change.

Future development of the logistics real estate market is driven by factors such as (i) macro and micro location (ii) proximity of the industrial and consumption bases and (iii) capacity to provide a cost-efficient environment with a sufficient supply of labour.

The countries, and more precisely the regions, having the capacity to utilise the above drivers may expect the highest increase of activity.

In the continental Europe we may face more diverse development trends between countries and regions. The regions spread across the Benelux, Germany and Central Europe are expected to continue enjoying healthy market growth given the centric position in Europe, significant industrial environment, and the ample and low cost labour supply in CEE.

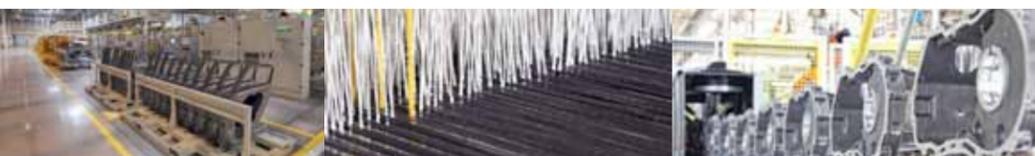
Global e-commerce development supported by modern technologies means that the location of the property has secondary meaning these days and it will remain a very powerful market booster. We will see relocation of the part of the retail activity from traditional brick and mortar shopping centres to modern warehouses, fulfilment and distribution centres. The current wave of market expansion in CEE is very spectacular due to several very large recent projects in Poland including Amazon, Zalando and H&M. At the same time the market conditions are very healthy with vacancy, land

and construction costs being at a historic low. Developers, investors and banks are maintaining good discipline and we have not observed any significant speculative developments.

Central Europe and specifically Poland, the Czech Republic and Slovakia, offers competitive industrial/logistics services and proximity to Germany and Western Europe. Romania is still at a very early development stage but will make significant progress due to the new road infrastructure under construction to be completed within the next 3 years. Germany will remain the largest logistics/industrial market with significant development and re-development activities supported by its strong economy, diversified industry, large consumer market and ability to subcontract part of the supply chain to CEE.

2017 is set to be another good year for the logistics sector in CEE and Poland specifically. Proximity to Germany and other Western European countries, integration into EU supply chains, improving road and rail infrastructure, good global economic performance, increasing national consumption, relocation of the supply chain from Western Europe to CEE facilitated by ample provision of a skilled, flexible and cost effective workforce are among the most important factors. The existing modern stock of logistics space per capita is still significantly lower than in Germany and even the Czech Republic.

We will continue to see very spectacular development of large 50 000-100 000 sqm e-distribution projects, as well as the modernisation and consolidation of industrial businesses moving from Western to Central Europe. In Poland, the market will gradually expand from the current TOP 5 cities to TOP 10 cities and regional markets where we will see a steady flow of new occupiers taking possession of the new logistics and light industrial space. Land prices and construction should remain low and stable which will help maintain competitive and predictable rental conditions. Inner city developments will take on a more important role to serve urban supply chains including "last mile" sectors. Old, substandard facilities will be replaced by modern industrial space. More and more local investors will enter the logistics market which will further improve the liquidity and diversity of the investment scene.



Brexit effect?



Mark Heighton
Partner
Head of the UK Real Estate, CMS
E mark.heighton@cms-cmck.com

» *My lawyer's heart would love to give readers clear guidance, but I am afraid we have a long way to go before the full implications of Brexit are properly understood.*

It is now almost a year since the EU referendum and there is still very little understanding about how Brexit will evolve. There is no precedent to Brexit on which investors can rely to plan ahead. Serving the Article 50 Notice does not bring any greater clarity.

The uncertainty has led some London-based companies to announce that they will consider alternative locations outside the UK for some parts of their operations. Our CEE colleagues have already reported several real estate players relocating to Poland. But it is likely the UK's transparent real estate market and stable political system will continue to prove an attraction to many.

Along with the likes of Paris, Frankfurt and Dublin, Warsaw is also competing to attract a share of the financial service sector activity, although in Warsaw's case the focus is on middle office functions such as risk management and IT. If Warsaw is successful in its bid, then we can expect increased demand for office space and thus increased construction or rising rents in Poland's capital.

Investors, developers, funders and occupiers will need to work out their strategies. Some have separated sterling and euro exposures into different funds, and as a result, any possible negative impact is likely to be contained within UK Funds. By holding sterling-denominated real estate assets and euro-denominated real estate assets in separate funds they can, to a large extent, protect themselves from big movements in currency values – the primary source of volatility in recent years across most investment asset classes. In addition, many investors have other policies in place, designed to offset currency exposures, such as hedging.

Possible Brexit impacts on CEE-6 markets

- Weaker sterling leading to lower flow of capital towards CEE from UK?
- Impact thus far: average deals per quarter down (4 since Q3 2016 vs. 4.8 before). But average transaction volume per quarter is unchanged.
- Yield "correction" and ending of real estate cycle in the UK hits EMEA investment sentiment: the "EMEA cycle" peaked in 2H 2015 already.
- Possible "disintegration" of EU into smaller regional sub-blocs, including "Visegrad-4". Political "populism" may continue its rise.
- Possible negative impact on growth prospects both in direct trade terms and after removal of UK's 9% contribution to the EU budget, to the eastward flow of structural funding.
- Labour market shift as lower remittances are sent from UK (reflecting weaker GBP and returnee emigration). Returnees could help solve tight labour markets.
- Shift in tenant allocation (banking sector?) sees CEE capture some share of middle/back office and BPO/SSC activities.



Mark Robinson
CEE Research Specialist | Research
Colliers International
E mark.robinson@colliers.com

W&I insurance

- the lawyer's perspective

In the last two years Warranty & Indemnity Insurance (W&I Insurance) has been in high demand, particularly in real estate transactions. Almost every transaction on which the CMS CEE real estate team is currently working involves W&I insurance.

Warranties and indemnities have always been a focal point in transaction negotiations. W&I insurance provides comfort to the insured party in relation to unknown risks associated with a M&A transaction and can often be a bridge in what may otherwise be difficult negotiations.

Under a transaction agreement concluded between a buyer and a seller W&I Insurance provides insurance cover to either the buyer (buy-side policy) or the seller (sell-side policy) for loss (including defence costs) suffered by the buyer as a result of a breach of a warranty or a claim under an indemnity.

W&I insurance provides a solution for both seller and buyer. A sell-side policy, taken out by the seller, provides adequate coverage of warranty claims, and protects the seller when giving security or agreeing to price retention to secure warranty obligations. A buy-side policy, taken out by the buyer, allows for investment criteria to be met vis-à-vis the realities of the market, and provides a satisfactory level of recourse.

In CEE, most policies are buy-side policies, which provide direct cover for the buyer and which can operate to relieve the sellers of most warranty liabilities. Even in the case of buy-side policies, the costs are usually borne by the seller or factored into the purchase price. Sellers are, however, expected to maintain some limited liability for warranties. Because the seller has a stake in the game, insurers feel more comfortable about the seriousness of the disclosures and warranty statements.

The lawyer's role

For it to be effective, W&I Insurance requires proper legal support in risk assessment.

The role of the insurer's lawyer is something like a legal audit of the transaction and due diligence process. Insurers require their clients to have a detailed due diligence report prepared by their own advisors (legal, technical, financial and commercial), and to have agreed upon fair terms for warranties, indemnities and disclosures. The insurer's legal team focus on whether these reports adequately cover the matters that are being warranted. Lawyers are not expected to repeat

the buyer's due diligence. On the contrary, by reviewing the reports in terms of scope, limitations and quality, and reviewing data rooms in terms of the structure and sufficiency of data provided, a lawyer must determine whether the scope and quality of the legal work and the disclosures is sufficient or any issues have been missed. Insurers are not overly concerned about risks that have been adequately disclosed in the report, but are interested in any areas that the buyer's advisors failed to investigate or the seller may have failed to disclose.

Besides the review of the diligence, it is also the role of legal support to review and analyse the transaction documentation in which the warranties and indemnities are given. The insurers need to assess if warranties/indemnities are more strict and extensive than usual, if they are properly limited with disclosures, and if there are missing qualifications. Insurers need to be advised on the limits and thresholds of liability, and whether they are customary or if there are any warranties not covered by due diligence and disclosures. In order to satisfy the needs of an insurer, the lawyer needs to have deep knowledge and wide experience of the market, and must be able to provide comprehensive advice during the last phase of a transaction.

When taking out indemnity insurance, known risks with remote probability and high value are covered; these types of risks would not otherwise be the subject of standard insurance policies. Insurers may decide to cover these more probable indemnity liabilities on a case-by-case basis. It is the legal advisor's role to assess the likelihood and seriousness of these indemnity claims in order to help the insurer decide whether or not to include coverage for such indemnities, and at what cost.

The insurers will step into the position of the seller when satisfying warranty/indemnity claims. Hence it is necessary that adequate claim processes are included in transaction documents and that the insurers have control over the defence against such claims. It is the lawyer's task and responsibility to ensure that such mechanisms are included in the transaction documents, and that they are in line with the insurer's expectations as set out in the policy.



Gabor Czike
Partner
Head of Real Estate, CMS Hungary
E gabor.czike@cms-cmck.com



Mark Storrie
Senior Underwriter, AIG
Emerging Markets M&A
E mark.storrie@aig.com

The use of Warranty & Indemnity (W&I) insurance on CEE transactions, in particular real estate transactions, is now commonplace, with a large proportion of deals from the relatively small to those with an EV in excess of USD 1 billion being insured. The speed of this development is highlighted by the rapid rise in the number of CEE submissions that we have received in the last 5 years, increasing from just **7 submissions in 2013 to 91 in 2016**.

In common with other markets, as the market has grown there has been a steady shift away from sell-side policies to buy-side policies, with the seller now being insured in less than 10% of cases. This has been driven by a greater understanding of the strategic uses of W&I insurance by both buyers and sellers, highlighted by the introduction of seller to buyer "flips" (whereby sellers procure indicative pricing and coverage terms from insurers for a policy that will ultimately be taken out by the buyer). This enables a seller to resist attempts by the buyer to seek a

liability cap above the attachment point of the policy, thereby putting itself in a position to achieve a more certain valuation without needing to tie up proceeds in escrow. Buyers in competitive situations are also now regularly looking to obtain W&I insurance themselves to enable lower liability caps to be offered to the seller and to either differentiate their bids or obtain a better price.

Pricing and retention levels have steadily decreased as the insurance market has become more familiar with CEE transactions and in many cases are now broadly similar to that offered on deals in the UK and other European jurisdictions. This has led to a shift in focus from pricing to claims, and M&A insurers are now more likely to be asked for information regarding their specific M&A claims handling experience to provide comfort that that any policy will respond in a timely manner in the event of a valid claim. In response to such questions, AIG has released a global study of over 1,000 transactions that it has written between 2011 and 2014 with a combined value of more than USD 200 billion, which revealed that nearly 14% of the M&A insurance policies resulted in a claim. Data for an extended period to 2015 will be released later this year and will show that the proportion of policies resulting in a claim has increased further.

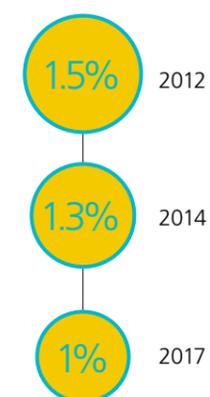


Rose Weedon
Vice President, Transactional Risks,
Global Professional & Financial Risks,
A Division of Lockton Companies LLP
E rose.weedon@uk.lockton.com

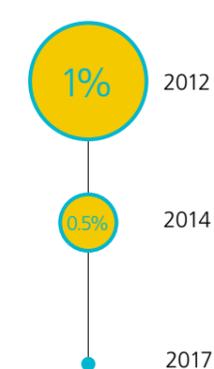
The appetite for W&I insurance in the CEE over the last five years has been ever expanding. The product has now become an established part of Real Estate M&A transactions and both Buyers and Sellers are increasingly aware and accepting of the process, pricing and comfort of a W&I insurance policy.

Both Warsaw and Prague have led the charge for use of the product but we increasingly see deals in Slovakia, Bulgaria, Romania and the rest of the CEE region using W&I policies to cover off unknown liabilities in transactions. Underwriters are particularly keen to take on risks in Real Estate deals due to the low claims ratio and hence this is by far the cheapest sector in terms of pricing. With e-commerce ever increasing in the region we see a large amount of deals in the logistics space and no sign of these deals slowing down.

Pricing on CEE RE transactions as a percentage of the limit purchased



Policy Excesses



CEE Deal enquiries



Source: Lockton

CEE key legal issues

Bulgaria

Investment instruments

- Real estate investment trusts (REITs), are an option for large scale real estate investments. Specific requirements apply to incorporation and operation, including having initial capital of BGN 500 000 (c. EUR 255 000), public company listed at the stock exchange, 30% of the capital must be subscribed by institutional investors, licensing from the Bulgarian Commission for Financial Supervision.
- Transactions with real estate assets are typically structured as share deals in respect of special purpose vehicles. In most cases, the reasons relate to lower transaction costs and taxes applicable and the flexibility in setting up an OpCo/PropCo structure (for e.g.).

Transaction costs, including taxes (share deal vs asset deal)

- There is no transfer tax on transfer of shares, whereas the transfer of real estate is subject to property transfer tax 0.1% to 3% of the higher of market/tax value of the property.
- Share transfers are VAT exempt (VAT applies to transfer of regulated land plots and new buildings, i.e. those entered into exploitation within 5 years).
- No real estate registration fee in case of a share transfer (notary fee applies to transfer of shares in limited liability companies, but capped at EUR 3,000), whereas if a real estate asset is transferred 0.1% registration fee on the value of the transaction is applied by the Property Register.
- Withholding capital gains tax from disposal of shares in a Bulgarian company may be exempt under the provisions of an applicable double tax treaty (more than 65 in force currently).
- Generally, distribution of dividends to an EU shareholder is exempt from Bulgarian withholding tax, as is the disposal of shares traded on an EU regulated stock exchange.
- Both capital gains from disposal of shares and real estate are included in the general taxable base of local companies and are subject to the general 10% corporate income tax when realised by local companies.

What you need to be aware of

- Restrictions on the acquisition of agricultural land exist. Such land may be acquired by individuals who have resided in Bulgaria for more than five years prior to the intended acquisition; or legal entities that have been established and existing in Bulgaria for more than five years (or if the shareholders or members have resided in the country for more than five years.) Commercial companies directly or indirectly owned by companies registered in jurisdictions with tax havens ("preferential tax regimes", as specified in a list approved by the Minister of Finance) are prohibited from acquiring agricultural land.

Czech Republic

Investment instruments

- Limited liability companies (in Czech "společnost s ručením omezeným") and joint stock companies (in Czech "akciová společnost") are the most commonly used vehicles for commercial investments in real estate. The majority of institutional real estate transactions are carried out through share deals which are not subject to real estate transfer tax.
- Alternatively, open-ended real estate funds, which are to certain extent similar to REITs, can be used. The administrative burden connected with the funds is higher; however, the funds offer the advantage of lower corporate income tax compared to taxation of limited liability and joint stock companies.
- A new form of trusts (in Czech "svěřenské fondy") was introduced on 1 January 2014.

Transaction costs

- Real estate transfers carried out through asset deals are subject to 4% real estate transfer tax (RETT).
- No RETT applies to share deals.
- Corporate income tax of 19% applies; however investment funds are subject to preferential corporate income tax of 5%.
- Additional taxes, such as real estate tax, VAT or capital gains tax, also affect net returns on investment. In addition to taxes, usually there are transaction costs associated with agents' and counsels' fees.

Hungary

Investment vehicles

- Real estate funds are popular due to favourable taxation; however there are administrative burdens due to the need for a fund manager company and the involvement of a custodian bank.
- REITs exist and are exempt from corporate income tax and local business tax and a preferential property transfer tax rate applies; however, despite the simplification of the administrative burden regarding the establishment and operation of REITs in 2016 (initial capital of HUF 5 billion, public company listed on the stock exchange, 25% of shares can only be held by shareholders holding a maximum of 5% etc.), so far no REITs have been established on the Hungarian market.

Transaction costs

- Property transfer tax. Payable by the buyer on the purchase of a property; a 4% rate is applied up to a market value of HUF 1 billion and 2% for the excess with an overall cap of HUF 200 million per property (certain exceptions and lower beneficial rates are available). Funds are subject a preferential 2% flat rate transfer tax, but the cap does not apply to the properties they acquire. A direct or indirect acquisition of at least 75% of shares in a company that owns real estate is also subject to transfer tax.
- **The EU's lowest corporate income tax.** The new corporate income tax rate is 9%. The decrease from the previous rates (i.e. 10% on annual corporate profits below HUF 500 million and 19% on the excess) to a flat 9% rate may have the effect of increasing the volume of real estate transactions, as for decades real estate deals have been generally concluded as share deals and many investors faced the problem of latent corporate tax liability due to the low book value of real estates in the real estate holding company. The sharing of the burden of the latent tax liability was always a highly debated issue in the pricing of corporate transactions and the latent tax issue was a serious deterrent to sellers against asset deals. The lower corporate income tax rate may provide an advantageous exit opportunity for some investors making it easier for them to agree on the price with the buyers.

What you need to be aware of

- Land registry system. Hungary has a reliable land registry system with the presumption that the rights and encumbrances registered therein exist. The rights of parties relying in good faith on the land registry system are protected. A lawsuit for the cancellation of the title of a bona fide person who acquired a registered right by trusting in the validity of a previously registered person whose registration was based on an invalid document may only be initiated within three years of the date of registration of the predecessor's title on the basis of the invalid document.

Poland

Investment instruments

- The most common investment instrument in Poland is an SPV in the form of a limited liability company. Alternatively, it is possible to acquire property directly by a company incorporated in any country located within the European Economic Area.
- The methods of investing in the form of a Polish closed-end fund or by establishing a limited partnership do not currently offer any special tax benefits. Investors often prefer to set up a holding company in Luxembourg, which in turn establishes a Polish entity.
- Legislation concerning REITs is ongoing and the finalisation date is still unknown.

Transaction costs

- In line with a newly adopted interpretation of the law, the acquisition of income-producing real estate may be considered as the acquisition of an enterprise, which is subject to 2% civil transaction tax borne by the buyer. Until recently all commercial property deals in Poland were subject to 23% VAT, fully recoverable. The civil transaction tax is not recoverable, but increases the asset depreciation base.

What you need to be aware of

- In line with laws adopted in 2016 it is not possible for anyone other than individual farmers and the church to acquire agricultural land. The designation of land may be amended by adopting a local zoning plan. If a company holds agricultural land the sale of its shares is subject to pre-emptive rights in favour of State agencies. Furthermore there are several limitations to the acquisition of forests. This sometimes creates issues for investors as regards some logistics and retail parks which sometimes encompass agricultural or forested land. Further limitations also apply to other kinds of disposals of shares, which may impact restructuring of existing business structures.
- There is an ongoing discussion to close shops on Sundays in Poland, but the outcome of this debate is still to be known.



Adriana Andrzejewska

Senior Associate, CMS Poland

E adriana.andrzejewska@cms-cmck.com

Spotlight on hotel investments in Poland

Poland's hotel investment market is constantly growing. Potential investors and international hotel groups are watching the Polish market with interest and looking for the best locations for both business- and tourism-oriented investment opportunities.

There is no typical investment model for the Polish market. We advise on both the development and acquisition of hotels. Transactions vary from share deals to asset acquisitions and leases. A new model that is popular in other jurisdictions is lease of enterprise, which allows for the simplified transfer of assets and operations from the owner to investors interested in the long-term operation of a hotel. This structure also enables the automatic assignment of hotel personnel to the tenant. Lease of enterprise may also be used in leaseback transactions.

In Poland most administrative permits are not transferrable – in particular the following hotel operation permits: permit for the sale of alcohol, hotel permit (so-called categorisation decision), and the decision to register a hotel as a food and beverage sale point. All these permits are crucial for operating a hotel business as well as transferring a business,

especially if the hotel has already commenced operation or an international hotel brand has been contracted to manage it. International brands are particularly sensitive to problems in a hotel's day-to-day operations, as finances and reputation may be at risk. It is therefore crucial to structure a hotel transaction with great precision, especially regarding the time schedule and sequence of given actions.



Andrzej Pośniak

Partner

Head of Tax, CMS Poland

E andrzej.posniak@cms-cmck.com

Taxes

Polish VAT regulations are not clear on the taxation of real estate sales. As a result, taxpayers often have doubts about whether a transaction should be treated as a sale of separate assets (subject to VAT) or a sale of a going concern (not subject to VAT). In such cases, to be on the safe side, taxpayers usually apply to the Polish tax authorities for binding tax rulings.

As a rule, once issued, a tax ruling cannot be questioned after a transaction. However, recently the tax authorities have changed their approach and have started challenging such tax rulings by questioning the state of facts presented in applications for rulings. Such action is undertaken mainly in relation to sales of shopping malls, which constitute some of the most complex transactions.

Romania

Investment instruments

- The main types of investment vehicles in Romania are limited liability companies (SRLs) and joint-stock companies (SAs). Investors register new SPVs or buy existing "shelf companies".
- SRLs can be created with a minimum share capital of EUR 45 and provide the option of having a sole shareholder.
- SAs require a minimum of EUR 20,000 share capital and at least two shareholders.
- It is much easier and quicker to transfer shares in an SA than an SRL, as it only requires registration and a signature in the shareholders' registry, and subsequent publicity formalities before the Trade Registry.
- In SRLs, selling shares to a third party shareholder triggers an "opposition period" of 30 days, during which any interested party (including creditors and tax authorities) can file oppositions to the transfer of shares, thus potentially delaying the transfer until the oppositions are ruled out in Court, or even potentially cancelling the transfer.
- From the corporate governance perspective, SAs are better regulated and allow a two-tier management system, therefore increasing investors' control of directors.
- In SRLs directors generally enjoy full individual decision-making and representation powers.
- Foreign REITs are investing and functioning in Romania, but to date there is no Romanian-based REIT. The Romanian Financial Surveillance Authority is working on new legislation concerning REITs. The new law is expected to be enacted by the end of 2017.

Transaction costs

- Real estate transfers are done by notarial deed. Notary and registration fees are approximately 1% of the purchase price of the transferred asset. Transfers of shares in SPVs that own real estate, even as a core asset, are free from notarisation or transfer tax.

What you need to be aware of

- The government wants to cut VAT for new houses worth up to EUR 100,000 acquired by individuals, in an attempt to support the residential sector. As of March 2017 the draft law is under public consultation.
- Starting in 2016, registered VAT payers can apply the reverse-charge mechanism for the supply of buildings, parts of buildings and land.
- The *datio in solutum* law was enacted in 2016 to enable real estate mortgagees to give their mortgaged real estate to the banks and be liberated from all liabilities arising from the related facility agreements.
- Improved zoning and building legislation provides for shorter terms for obtaining various endorsements, and construction permits. The registration tax has been cut for the first registration of agricultural land in the Land Register.
- Lease agreements are writs of execution in terms of payment of rent and eviction from premises, provided that they are registered with the local tax authorities. While such registration is compulsory for individuals, it is only recommended for companies due to the above-mentioned advantages.
- As Bucharest and various university cities in Romania are becoming IT hubs, IT companies continue to lease large office premises to accommodate the increasing number of workers in the industry, stimulated by significant labour tax incentives.

Real Estate deal financing

» **Participants in the CEE real estate market (from investors to lenders) are becoming increasingly sophisticated in structuring large real estate finance deals.**

Internationally recognised and experienced funds such as Blackstone, TPG, GIC and others have entered the market in the last two to three years, looking to structure and complete multi-jurisdictional portfolio transactions on standards applied and accepted in Western jurisdictions. This means law firms in CEE must be prepared to accommodate such structures and tailor them to CEE. Such transactions require intensive transaction management and coordination at international standards, as well as local know-how and expertise. It is therefore increasingly important for lenders and investors alike to find counsel with experience in these types of transactions in CEE, has offices in all jurisdictions involved and offers the local expertise needed to navigate the legal systems in the region.

We highlight below some of the aspects of a typical multi-jurisdictional transaction in CEE which should be considered early on in the process, when structuring the deal and seeking to obtain financing. Finding a workable solution for these issues will have a significant impact on successfully closing a transaction in a timely and cost efficient manner.

Governing law of underlying credit

documentation. English law continues to prevail as the governing law of the loan documentation in large cross-border and multi-jurisdiction transactions, offering liquidity of the loan in the secondary market, being perceived as more flexible, based on standard form agreements made and offering legal certainty with respect to interpretation of legal concepts which are usually derived from English law. Austrian lenders may sometimes choose to lend under Austrian law, in particular where there are no international syndication aspirations. Finally, when dealing with a bilateral loan, or a loan which will only be syndicated on a single market, certain CEE lenders which have in-depth experience in the region may choose to lend under one of the laws of a CEE jurisdiction.

Warranty and indemnity insurance (W&I) has become increasingly popular in UK and Western European transactions and is also growing as a tool in CEE. The seller should consider from the get-go whether it is preferable to make the deal on the basis of W&I insurance and offer it as a package. The buyer must

then consider whether it is willing to acquire the properties on such basis. The legal due diligence process may also reveal that title insurance is necessary, and the parties should consider whether the same insurer can offer both at a discounted price.

Change of control and other disposal restrictions.

If the properties are subject to financing the seller should approach (and the buyer should enquire if the seller has approached) the financing banks early in the negotiations process with the buyer to ensure that it will be able to satisfy the lender's KYC, exposure limits and business integrity provisions requirements. Failure to satisfy such requirements could mean either a mandatory prepayment or an event of default under the facility. Consider if there are other disposal restrictions in the facility agreement which should be addressed.

Legal and tax implications of structuring an acquisition as a share deal versus an asset deal – consider:

- the pros and cons of acquiring the asset without acquiring the liabilities of the seller vehicle;
- any taxes payable as a result of an asset transfer versus a share transfer;
- implications on any potential financing where the lender wishes to obtain security over the assets acquired and where the buyer is taking over assets which are already leveraged and subject to security; and
- documentary and regulatory transfer restrictions and requirements (such as competition authorities approval, change of control closes, contractual restrictions on transfer, mandatory prepayment requirements).

The answers to these questions vary from CEE jurisdiction to jurisdiction and you may often see multi-jurisdiction transactions including both asset and share transfers.

Closing mechanics. The closing mechanics can be complicated and time-consuming, and should be discussed early in the negotiation process with all parties involved, including all existing and incoming banks. A typical closing structure in CEE involves pay-off arrangements and second-ranking security, and banks who do business in CEE usually recognise this as an acceptable closing mechanism. However, this type of structure can be complicated by the type of sale

(whether shares or assets) and specific local requirements for taking and releasing security. Sometimes escrow agreements are required, but when dealing with several players, escrow agreements can become very complicated and time-consuming to negotiate. Sophisticated parties are now turning to solicitor's undertakings to replace an escrow mechanism, which is the tool typically used on the UK market, but which can also be used in CEE (it is not linked to the location of the assets), provided that one

of the seller's or the buyer's legal advisors has an office in England and agrees to provide the solicitor's undertaking. The buyer should discuss a closing strategy with its legal advisers and present it to its financing bank as part of early discussions, and ensure that the bank has obtained internal approval for such closing mechanism (the lenders' approval process can take time and may slow down the process. It should therefore be factored in to the structure and dealt with early on).

A buyer looking to finance the acquisition of assets must understand from the get-go the requirements of the financing lender(s) in respect of legal and financial due diligence, security and insurance:

- a. Consider whether the deal is structured on a corporate financing basis (where due diligence and security over the assets acquired is less important), or on a real estate financing basis (where the assets acquired provide the bulk of the security for the incoming bank);
- b. When the acquisition is financed on a real estate financing basis, understand and discuss with the financing bank(s):
 - its requirements as to legal and financial due diligence over the assets;
 - whether it will ask for access to, and reliance upon due diligence reports prepared for the buyer, or whether separate reports, prepared by the bank's advisors will be required;

- its requirements as to R&I and title insurance – the bank will most likely start by asking to be named co-insured on the relevant policies. Lenders' policies are more expensive, and a common alternative is to name the bank first loss payee on the insurance policy and allow it to take a legal assignment over the buyer's rights, title and benefit in the relevant insurance. When taking out insurance locally in a CEE jurisdiction, it is important to understand the legal effects of a lender being named as co-insured or first loss payee under the laws of that jurisdiction. The laws of a particular jurisdiction may give the lender much less comfort than in common law jurisdictions, and therefore lenders' requirements in that respect may vary from jurisdiction to jurisdiction.
- timing and costs of granting, registering and perfecting security in each relevant jurisdiction;
- the structure for taking and registering security in the relevant jurisdictions, as this may turn out to have cost implications during the lifetime of the transaction in particular where syndication is expected following financial close.



Simona Marin
Partner,
Banking and International Finance, CMS
E simona.marin@cms-cmck.com



Konrad Werner
Senior Associate,
Banking and International Finance,
CMS Poland
E konrad.werner@cms-cmck.com

**Richard Wilkinson**

Head of Group Commercial Real Estate,
Erste Group Bank AG
E Richard.Wilkinson@immorent.com

Real estate financing in Central and Eastern Europe has the same driving force as in Western Europe, namely the quality of projects. Real estate investors in CEE generally don't approach the region as a single market, but instead recognize the particularities and advantages that each individual CEE country retains.

Large international investors require large liquid markets to invest, so their focus tends to be on Poland, the Czech Republic, Hungary, Romania and, of course, Austria. Countries like Croatia, Slovakia, Slovenia or Serbia attract a much smaller band of investors. Nevertheless, what most of these countries have in common is that they are members of the EU, which provides a high level of confidence in their legal environment. Investor interest in CEE also extends across business sectors, ranging from the currently "hot" logistics sphere to the comparatively underinvested hotel and tourism sector, where Croatia in particular offers great potential.

In 2016, Erste Group underwrote close to EUR 2.5 billion of new commercial real estate - excluding Austrian residential real estate - and this new business was executed across all countries in CEE. However, given the current high levels of asset pricing, we don't expect markets in 2017 to be quite so active and, indeed, the region's markets have had a slower start during the first few months of this year.

**Michał Sternicki**

General Manager
Aareal Bank AG, Poland
E Michael.Sternicki@Aareal-Bank.com

The CEE market is relatively young in comparison to other parts of Europe, and is still evolving and finding its place, so really one notable difference is that you need to track the development of the markets a little more than you would in Western Europe, as one location today might not be the ideal location tomorrow, for any number of reasons.

Generally our clients view CEE as one market, but would view Hungary, Slovakia, the Czech Republic and Poland as more mature than other parts of the region. Having said that, it's all about liquidity, and in this regard Poland is the largest market – and you could argue the most visibly liquid market – followed by the Czech Republic.

Banks have increased their exposure to CEE real estate in recent years, and I feel this trend will continue. Competition has increased but is still below the levels of Western Europe, which is both good and bad: good in the sense that banks can make money; bad in the sense that debt liquidity is not at the levels of say Paris or London, which restricts the market somewhat. The more avenues to spread risk are open, the better for the marketplace overall.



Key contacts

**Mark Robinson**

CEE Research Specialist | Research
Colliers International
E mark.robinson@colliers.com

**Wojciech Koczara**

CEE Head of Real Estate, CMS
E wojciech.koczara@cms-cmck.com

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