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PLANNING AND DEVELOPMENT COLLABORATIVE INTERNATIONAL, INC

Strengthening Small and Medium Enterprises in the Hungarian Real Estate Industry

Capacity-Building of Private Property Management Firms, Recommendations for Residential Housing Development and Developer Technical Assistance and Training, and Facilitating the Development of a Private Rental Market

Prepared for

United States Agency for International Development

Prepared by

PADCO, Inc
Washington, DC

Contract No EUR-0034-00-C-2032-00, TO 92
December 1996

PROVIDE GOVERNMENTS AND PRIVATE CLIENTS WITH SERVICES IN PLANNING, HOUSING, MANAGEMENT, FINANCE, ECONOMICS, ENVIRONMENT, GEOGRAPHIC AND OTHER INFORMATION SERVICES AND TRAINING

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Background

Small and medium enterprises have a great potential as a stimulus for growth in the Hungarian economy The housing sector has the potential for providing a healthy economic base for the country

The PADCO team visited Hungary during October 1996 in order to begin to develop technical assistance programs to increase the skills of property managers, promote participation in the residential real estate development by small developers, and strengthen the private rental sector

1 Capacity Building for Property Managers

In June and July 1996, Antonia Sanders of PADCO visited Hungary to interview principals of private property management firms and assess the sector's need for training Based on these interviews, it appeared that condominium owners and common representatives need training in the legal and financial aspects of managing their buildings Property management professionals could also benefit from training in business-related skills, such as business planning, marketing, financial forecasting, and market analysis

The purpose of the October trip was to explore the possibility of establishing a partnership with the Hungarian Trade Union of Asset and Property Managers for the development and institutionalization of a training program for property managers and to continue to determine specific training needs of private property management firms through additional interviews As a result of these efforts, the PADCO team was to develop a blueprint for a prospective training program

The team conducted numerous interviews to further assess the training needs of individual common representatives of condominiums as well as property management firms In addition, the team began to explore the possibility of creating an Association that would address the concerns of private property management companies to act as an advocacy body, disseminate information relevant to the sector to its membership, and serve as an institutional base for any proposed training program

2 Technical Assistance to Developers

The purpose of this trip was to preliminarily outline a technical assistance program that could strengthen small and medium-sized enterprises involved in residential housing development in Hungary These enterprises are currently experiencing substantial difficulty in the development of residential real estate due to numerous financial, legal, administrative, and market constraints The PADCO team's mission was to

- meet with developers and local government officials to identify current financial, legal, and administrative constraints to residential housing development,
- meet with financial institutions to assess the viability of current subsidies and resources available for residential housing development,

- determine the current status of previously identified public-private partnerships and the reasons for their success, failure, or inactivity,
- identify current economic and market constraints to residential housing development at both the national and local levels,
- discuss options for technical assistance and legislative reform that could be developed and implemented to improve the context of the existing environment at both the national and local levels,
- explore the potential for non-USAID assistance and new institutional frameworks that could assist the residential development sector,
- assess interest in the formation of an association of developers, educators, and financial institutions involved in residential housing development to improve the effectiveness of lobbying efforts, increase access to financial resources and market data, and heighten cooperative interaction within the residential housing sector, and
- develop a work plan for providing technical assistance and effecting reform in the residential housing sector with the aim of strengthening the viability of development efforts currently proposed by small and medium-sized developers

Ms Lowenthal, Mr Claggett, and Ms Sanders discussed the program with representatives of numerous local governments, financial institutions, private developers, and nongovernmental organizations (NGOs) located in a number of cities and Budapest districts These discussions led to the identification of several existing constraints and potential areas for reform in the residential housing sector A preliminary work plan was then outlined to address and overcome these obstacles and simultaneously increase the strength of small and medium-sized development enterprises

The PADCO team also met with Larry Birch of USAID/Budapest on October 15th to brief him on the purpose of their trip In addition, discussions were held with József Hegedus and Ivan Tosics at MRI on October 22nd to determine their preliminary opinion of the work plan, and to discuss their potential role in assisting in the data-gathering and implementation stages of the proposed program A final debriefing was held with Larry Birch at USAID/Budapest on October 22nd to discuss preliminary findings of the trip and the structure of the proposed work plan

3 Fostering Development of the Private Rental Market

The PADCO team's mission during October 1996 was to identify, interview, and work with private landlords to determine the breadth of the market and their needs for technical assistance in real estate and tenant-landlord law, tax requirements, and asset management In addition, they were to determine impediments to renting out flats and possible solutions through individual interviews and focus groups As a result of these efforts, the team was to initiate development of a training program for private landlords and to make preliminary recommendations for the development of a professional association for private landlords

Sandor Erdősi of MRI attempted to arrange for the team to meet with private landlords, but was unable to convince any landlords to speak with them Sándor was able to arrange a meeting with a real estate brokerage, Resideal, which arranges for the rental of luxury flats The company's primary activity, however, is arranging for the leasing or purchase of office space and industrial sites The company does not handle rentals of average- or lower-priced flats

The team also with met with the founder of an association of owners, property managers, and service providers that handles short-term vacation rentals

Both firms had the same opinion about the private rental market There is a market for higher-priced luxury flats, but not for middle- or lower-priced units It became apparent, however, that very little information exists about the extent of the sector, and, therefore, it is difficult to make any wholesale judgments about the private rental market as it currently exists in Hungary

Summary of Findings

1 Capacity Building for Property Managers

1 1 Training

Through interviews with four private property management firms and one individual common representative who manages several buildings, the PADCO team confirmed the assessment made by Antonia Sanders during her visit to Hungary in June/July that private property management firms could benefit from training Among the areas in which training would be useful are the financial and legal aspects of managing residential real estate In addition, training in generic business practices, such as preparation of business plans, small business management operations, problem-solving, and client relations, would be useful

Of the five individuals interviewed, all indicated that their firms did not have business plans, although some had thought about strategies for growth It was clear that of the five individuals, only one clearly understood conceptually the value of, if not the actual components of, a business plan Of the five, only two used advertising as a marketing tool (both firms advertise in the local District monthly newspapers and one firm distributes flyers) One firm is listed in the telephone Yellow Pages Three of the individuals said that their firms understood the value of good client relations and were concerned with their companies' responsiveness to the condominium associations Two of the firms demonstrated a lack of concern about client satisfaction

When asked if training would be useful for private property management firms, four of the five individuals answered affirmatively The fifth individual said that while he did not see a need for training, he thinks that some property managers have a knowledge gap that could be filled through a public information campaign consisting of radio and television "infomercials " Of the four, all said that training in the areas of the legal and financial aspects of managing condominiums would be very useful Two of the individuals said that property managers need training in client relations, and one acknowledged that training is needed in the area of basic management skills

Although the IREM training offered by Fúti appears to be of generally high quality, it is clear from a discussion with IREM trainer Ann Becher-Smead that, although the courses were somewhat adapted for East Europeans, the material has not yet been adapted to fit a specifically Hungarian context Kálmán Netkovszky of Fúti said that the organization generally revises and refines its materials over a period of time, but it appeared that no revisions had yet been made to the IREM materials In addition, one of the IREM East European courses, which focuses on subsidized housing in the United States, might be interesting, but may not be particularly useful to a Hungarian audience Also, despite Ms Becher-Smead's assertion that the IREM course fees have been decreased, Fúti charges 36,000 HUF for the three-day IREM 400 course on financial management to HAREM members, and 44,000 HUF to those who are not from HAREM member firms When asked what fees private property management firms might be able to pay for training courses, Mrs Karika of Zold-Karika Kft said approximately 3,000 HUF per day Thus, the IREM courses cost three to four times what at least some firms would be willing and able to pay

The IREM courses cover a variety of technical areas of property management, such as financial management, building operations, and commercial real estate management, but there are no IREM courses currently being delivered in Eastern Europe that focus on generic business practices management of a property management firm, business planning, etc

In addition to Fúti, the team visited another training institution, Coopinform, which offers training in areas of municipal management, such as management of municipal assets Coopinform does not offer any property management training as such, but provides logistical arrangements for training courses for which it is not involved in developing the curricula In addition, Coopinform is interested in joining with different organizations to offer training programs Its courses are quite expensive, however It charges fees similar to what Fúti charges for the IREM courses

1 2 Establishing an Association of Private Property Management Firms

Of the four private property management firms interviewed during Ms Sanders's visit to Hungary in June/July, the principals of three of these companies indicated that a professional association for private property management firms would be of benefit to the profession Individuals from two of the firms interviewed by the PADCO team during this trip also expressed support for the creation of an association that would serve to disseminate information to its members, act as an advocacy organization, and possibly provide or arrange for training in various areas

The PADCO team met for the second time with Mrs Hornyák, principal of the private management firm Otthon 2000 and president of the Hungarian Trade Union of Asset and Property Managers Ms Hornyák is a proponent of developing an association for private property management firms, but said that the Trade Union would not be an appropriate incubator for the new organization, as it is made up of employers of the former IKVs (former municipally owned firms) However, she suggested that the team meet with the Hungarian Chamber of Industry and Commerce to obtain its input on developing an association, and to explore the possibility of the Chamber's establishment of a property management sub-group She agreed to set up a meeting with the Chamber in December

2 Technical Assistance to Developers

As can be seen from the discussions outlined in Annex A, residential housing construction in Hungary is stymied by constraints and obstacles The recent changes in the national housing programs, insufficient housing subsidies, depressed local economies, spiraling inflation and construction loan interest rates, high collateral and pre-sale requirements of construction lenders, high VAT taxes on construction supplies, black market labor, unit prices not meeting market demand, ineffective marketing techniques, relatively few effective mortgage loan programs, and insufficient investment equity are just a few of the obstacles that must be overcome by residential housing developers

In attempting to address and overcome these constraints, the residential housing sector faces further obstacles due to the lack of accurate production figures, lending statistics, market data, and, most importantly, technical knowledge to assess development feasibility Few developers

actually pre-test the financial viability of a proposed development, and proforma projections are rarely prepared Moreover, if these projections are prepared, developers are reluctant to divulge this information Throughout the PADCO team's discussions, developers, local governments, and lending institutions were reluctant to reveal actual land values, construction costs, market pricing, or the sources of investment equity and construction financing This is due to a lack of actual knowledge as to where these numbers lie or to the old Soviet way of withholding information from competitors or some combination of both

Compounding the difficulties of the residential housing sector are the national and local governments Housing assistance programs are constantly pushed and pulled by the national ministries trying to juggle political interests, tight budgets, and spiraling deficits, and are too frequently amended or eliminated together Developers have a difficult enough time trying to figure out how to make new assistance programs work, let alone having to readjust their thinking every time the national government amends the programs Many developers have invested substantial equity in projects only to have an amendment in the housing programs pull the feasibility right out from under them Local governments complicate these woes by failing to understand the financial plight of the developer and imposing an added layer of politics and bureaucracy to the picture Very few local governments recognize that they are a vital link to bringing the programmatic difficulties involved in housing development to the national government's attention, and that they should be serving as an effective lobbyist on behalf of housing program reform

An example of how the problems listed above hinder housing development is evident in the public-private partnership effort undertaken in Szolnok, which began in 1993 Although the company Keviterv Akva signed a contract with the local government of Szolnok in January 1996, changes in the national housing programs, increased inflation, and a concomitant decrease in housing demand occurred during the 2½-year negotiation period, which had a large impact on the project's feasibility [1] In addition, during this period, the Deputy Mayor for housing was replaced and the city officials and staff associated with the project were not as committed to ensuring the project's success as was previously the case The municipality did not integrate the concept of partnerships into its modus operandi, it missed the fundamental point that in a partnership, both sides have to give something in order to receive mutual benefits

The project is currently stalled due to a variety of factors OTP is requiring 200 percent collateral for construction financing, and Keviterv Akva would have to form a joint venture corporation with his subcontractors to meet this requirement Because of inflation, the cost of developing the project has increased For the developer to have the project built, assuming it obtains the requisite financing, some financial concessions will have to be made on the part of the municipality Either the municipality will have to forgive the price of the land or assume ownership of some of the units as payment for the land

[1] For a detailed discussion of the public-private partnership project, please refer to Annex A under Technical Assistance to Developers summary of meetings held on October 18 1996

According to the city's Chief Architect, Keviterv Akva marketed the project inadequately Although the Chief Architect conceded the project's negotiations were protracted, the city does not seem to take any responsibility for the problems currently being experienced by the developer, nor does it seem that the city is willing to conciliate to ensure the success of the project

3 Fostering Development of the Private Rental Market

As mentioned earlier, it was not possible to arrange any meetings with individual private landlords The PADCO team met with a real estate brokerage firm and a vacation rental organization The vacation rental organization did not rent out flats on a long-term basis, as a rule The brokerage firm, Resideal handles very few residential rentals, and those in its portfolio are either luxury flats or residential housing

When told of the team's intention to facilitate the development of the private rental market and create an Association of Private Landlords, the principles of each firm said they thought it was unlikely that any private landlords would be willing to discuss their activities Because of the current tax structure, few landlords report all or any of their rent revenue to the taxation authorities Therefore, because of the gray market nature of the private rental market, landlords would be reluctant under most circumstances to come forward and reveal their practices and ideas about improving the market situation

Because the ratio of housing purchase prices to household incomes is so high in Hungary,[2] and because 90 percent of the housing stock is now privately owned,[3] it is important that the private rental sector is strengthened in order to increase mobility It is difficult for young families to purchase housing In an optimal market, these families could rent housing until they were able to afford to purchase their own home Because there is a dwindling supply of municipally owned rental housing, there is little transitional housing available The private rental market, under certain conditions, might be able to fill this gap

There is very little known about the depth and breadth of the private rental market No one knows the approximate number of residential dwellings on the rental market, who the landlords are (private individuals or companies), who the tenants are (Hungarians or foreigners), if there is a price differential for Hungarian vs foreign tenants, whether or not the landlord pays taxes on rent revenue, what kind of rental contracts, if any, are used etc According to most housing experts, the majority of rental dwellings are luxury accommodations that are let by private individuals to foreigners To develop a program of technical assistance to facilitate the developme t of a private rental market, it is essential to obtain information on the rental market, particularly answers to the questions outlined in this paragraph

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[2] The ratio has been quoted as low as 6 5 to 1, and as high as 14 to 1

[3] This percentage was obtained by Dr Mihaly Kopanyi of the World Bank

It also appears that the private rental market is not profitable, that return on investment from rental housing is lower than the interest one could earn on bank deposits Under what circumstances would investing in residential real estate be profitable? No one knows at this point As part of developing a technical assistance project, it is important to create a profitability model or financial feasibility analysis of rental housing in Hungary

Ms Sanders met with József Hegedus and Iván Tosics of Városkutatas Kft (Metropolitan Research Institute, or MRI) to determine ways in which to obtain information about the private rental market It became clear that because of the sensitive nature of this information, a survey methodology would have to be developed that would enable us to circumvent people's lack of willingness to provide this information A decision was made to develop a sample methodology, which will be tested in December, and to work with Hungarian legal and tax experts to obtain information on the legal and financial framework that affects the market

Recommendations and Next Steps

1 Capacity Building for Property Managers

It is clear from the interviews conducted by the PADCO team in June/July and October that there is a need for training in the technical aspects of condominium management for individual common representatives, and for training in generic management and business practices for private property management firms

The question is whether or not applicable management and business courses are currently offered or scheduled to be offered in Hungary through other USAID SME participants or by other Hungarian institutions Once this is determined, it will be necessary to examine the content of these courses to determine their relevance to the property management sector If they are relevant, then the PADCO team can explore the possibility of partnering with the institutions that are offering these courses and make them available to private property management firms If the courses are not completely relevant but may be adapted for the private property management sector, then the PADCO team can explore the possibility of working with the institutions to revise these courses If no courses currently exist in Hungary that would address the needs of the private property management sector, then the PADCO team may have to adapt similar existing materials developed with USAID funds for the property management sector in other countries, or develop new materials

In addition, the team should pursue the possibility of developing a professional association for private property management firms that would disseminate important information affecting the sector to its membership, act as an advocacy body, and perhaps be a vehicle for institutionalizing a training program

Recommended tasks for the team's December visit to Hungary are to

- meet with USAID SME officials to obtain information about other SME assistance providers that developed training programs in generic business practices,
- meet with various SME assistance providers to obtain information on available training programs and determine their relevance to the needs of the private property management sector,
- meet with the Hungarian Chamber of Industry and Commerce to determine the possibility of establishing a property management sub-group,
- work with Mrs Hornyak of the Hungarian Trade Union of Asset and Property Managers/ Otthon 2000 to determine the feasibility of establishing an Association of Private Property Management firms, and
- discuss the possibility of establishing an association with other property management firms

2 Technical Assistance to Developers

The most difficult task facing a program to overcome the constraints of small and medium-sized housing developers will be to obtain sufficient, accurate data to assess exactly why existing resources are failing to meet demand In addition, lending practices should be examined to see if there are areas where additional resources, insurance, or guaranty programs might relax collateral requirements If proformas and financial projections are prepared delineating the gaps in housing assistance, this may serve as the basis for lobbying the Housing Policy Committee, national ministries and banks for programmatic reform

In order to test potential legal and/or financial remedies, a demonstration project should be developed, which, if successful, could be duplicated for use throughout the country and serve as a basis for legislative or policy change The demonstration program should target a small section(s) of Budapest for development of a mixture of new construction and rehabilitation of the surrounding area The project could demonstrate how various reforms might enhance development feasibility Annex B gives a preliminary outline of a possible demonstration project

In addition, a Developer's Association should be formed to convey technical knowledge, serve as an institutional basis for a training program for banks and developers, and foster the replication of the demonstration developments

Recommended tasks for the team's next trip to Hungary in December are to

- meet with the Housing Policy Committee and/or Ministry of Finance at the national government level to assess their present direction in housing program reform,
- meet with representatives of the World Bank, the European Bank for Reconstruction and Development, ICMA, and USAID to discuss their efforts at programmatic reform, proposed new financing and technical assistance programs, and prospective interest in a demonstration development,
- work with MRI to identify other sources of accurate market and development cost data,
- meet with the established real estate associations, and those being formed, to identify whether any of them are appropriate bodies to foster the proliferation of information, technical assistance, and lobbying efforts of the housing development community,
- meet with the sponsors of the new university programs in real estate development to assess their interest in participating in an association and to identify whether anyone is currently researching or analyzing the constraints facing housing development, and
- obtain further information for development of a technical assistance program to be initiated in January 1997

3 Fostering Development of the Private Rental Market

As stated above in the Summary of Findings section, because so little is known about the private rental market, it is necessary to conduct research so the team can begin to determine the size and scope of the market Our product for this quarter will be a work plan for future research, which

will ultimately lead to the development of a technical assistance effort targeted to strengthening the private rental market

It is recommended that the following tasks to be undertaken by the team in Washington, D C in November and during its visit to Hungary in December

- Develop a model for use in determining the financial feasibility of a rental housing as an investment
- Along with MRI, develop a survey mechanism that will be used to quantitatively determine the extent of the private rental sector in Budapest, types of participants in the market (both from the supply and demand side), types of decisions involved in determining whether to participate in the private rental market, and impediments (legal, financial) to renting out flats
- Work with MRI to select a contractor to test the survey methodology
- Work with team of Hungarian lawyers and tax experts to determine current legal and regulatory framework that currently affects the private rental market
- Assist in the analysis of the results of the test
- Make recommendations regarding how to proceed whether to refine the existing instrument as part of a larger, empirical survey or to abandon the effort

with IREM to continue to develop courses for property managers However, if these conditions are not met, USAID should not work with IREM

10/8/96

Meeting with József Hegedus, Iván Tosics, Sándor Erdősi, and Andrea Iván of the Metropolitan Research Institute, and Katharine Mark of the Urban Institute, Budapest

Katie Mark and I discussed the outline for PADCO's work in housing in Hungary through December 31, 1996

With regard to the property management component, it was agreed that we must find out more about the private property management sector how many companies, the scope of their services, who their clients are, and what are their training needs József and Iván say that some of this information may be available in the recent panel survey they conducted on 1,000 flats in Budapest

10/9/96

Meeting with Mrs Karika of Zold-Karika Kft , IXth District, Budapest

Zold-Karika Kft is owned by five partners, each of whom is employed within the firm One of the owners is an accountant, another is a technical supervisor, and three have property management expertise obtained from working at the District IX IKV The company also contracts with two pensioners on a part-time basis

Zold-Karika Kft was established in January 1996 Prior to that time, Mrs Karika worked in the District IX joint stock company (previously an IKV) The five partners who opened the firm each invested 1 1 million HUF into the company They generated their first operating revenue in April 1996 The aim of the firm is to provide jobs for the five owners It will probably take two years for the firm to generate a profit and for the owners to begin to realize some return on their initial investment

Currently, Zold-Karika Kft engages solely in property management The company's charter, however, includes the provision of accounting services and real estate brokerage However, before the firm starts to engage in other activities, it aims to build up its property management business

The company currently manages 800 units They are located in the VIIIth and IXth Districts only, and the company wants its portfolio to be limited geographically For this reason, the company does not manage units outside of Budapest The owners of the firm devote substantial time to their duties, which are conducted in a highly professional manner Some of these duties are very time-consuming For instance, the company and a designated individual from the condominium association must approve and sign all receipts and vouchers Also, clients, particularly pensioners, like to be able to come to the office and talk to the staff about their problems, and sometimes simply to converse

The company advances petty cash for small expenses which it pays on behalf of the association and then receives reimbursement A condominium representative must countersign all bank drafts

Annex A
Summary of Meetings

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1 Property Management Capacity Building

10/7/96

Meeting with Katharine Mark of the Urban Institute and Sándor Erdősi of Metropolitan Research Institute, Budapest

I met with Katie Mark of the Urban Institute and Sándor Erdősi of the Metropolitan Research Institute to receive an update on what is happening in Hungary with respect to property management since my last trip at the beginning of July, and to discuss upcoming activities

Katie had met with Al Van Huyck of the Eastern European Real Property Foundation (EERPF) regarding the joint IREM/HAREM training that is being offered in Hungary Apparently, the organization Fúti, a training institute, has a lock on the real estate brokerage training that is being delivered in Hungary, and which we thought has an exclusive right to offer the IREM training As I knew from my last trip, HAREM and Fúti are lobbying the government to pass a law that mandates that all property management firms, in order to obtain licensing, have at least one Certified Property Manager (CPM) on the staff This creates a ready-made market for Fúti It also works to prevent small firms from entering into or staying in the market, as the training, as far as we know, is very expensive The cost is 10,000 HUF per day and to receive/obtain a CPM designation requires at least 20 days of training Furthermore, the courses have still not been revised to fit the Hungarian context, they are virtually the same courses that are delivered by IREM in America Fúti and HAREM are splitting the fees They have no interest in widespread dissemination of the courses, but are pleased to have the prestige of having the exclusive right to market them

Another problem is that Fúti appears to be characterizing the program incorrectly It is intimating that by taking the courses, one automatically receives the CPM designation, while in reality the participant must take and pass certain exams and successfully prepare a management plan for a property

We decided to write a letter to AID advising against giving Fúti/HAREM a monopoly on offering the courses and having a law passed that makes it mandatory for staff to be CAMS in order for a property management firm to be licensed

Apparently IREM is offering five courses in Hungary at present 102 (government-assisted housing), 855 (condominium management), 302, 400, and 500

IREM courses in America are generally of high quality If its courses were adapted to fit the Hungarian context and inexpensive, if the instructors were well-trained and knowledgeable about the subject, and if the CPM designation were not mandatory, it would make sense for USAID to work

These financial checks and balances ensure the client's confidence in the company Obtaining client confidence is worth the extra time spent by the owners of the firm

Zold-Karika Kft advertises in the District IX newspaper, which is published on a monthly basis by the mayor's office [1] This advertisement costs 5,000 HUF Apparently, it has generated some inquiries that may lead to actual management contracts When asked if they advertise in any other publications, Mrs Karika explained that the company does not advertise in any citywide paper because it does not want to accept clients from outside of Districts VIII and IX

In March 1996, the firm distributed a one-page flyer that advertised its services Soon, they will create a half-page flyer that will be distributed to all of the mailboxes in District VIII

The principals of Zold-Karika Kft have not conducted any formal analysis of the market The company had ready-made clients Because Mrs Karika worked at the District IKV for 25 years, many people in the area know her Mrs Karika said that she has met with various foreign organizations and that business in Hungary is unique in that it is based on personal contacts

The firm does not have a formal business plan as such, however, it does have an informal strategy It aims to focus its business on the VIIIth and IXth Districts and to build its portfolio to 2,000 units in order to make a profit Mrs Karika is not certain whether or not the company has the capacity to satisfactorily manage more units than that

When asked what she thinks are the most substantial problems faced by the property management sector, Mrs Karika answered that one of the major problems is that prices for services are forced to be extremely low According to her calculations, Zold-Karika should charge management fees of 600 HUF per unit per month, but the firm's established prices for 1996 are 350 HUF per unit per month Prices that can reasonably be charged to condominiums vary by district In District II, which has a higher concentration of wealthy people, condominium fees are generally higher than they are in poorer Districts like VIII and IX

There has been a rapid and dramatic increase in the number of condominium buildings in District IX, from 21 buildings to 560 buildings in a relatively short period of time Owners in Budapest who were previously renters have been slow to assume the responsibilities of ownership In the poorer areas of the city, this situation was exacerbated by the fact that people were almost forced, due to economic uncertainty, into buying their flats without being adequately prepared, either financially or psychologically, to assume responsibility for maintaining the common elements of the buildings

Consequently, there is a great need in the new homeowner communities for individuals or firms with expertise in the fields of legal requirements, technical issues, accounting, tax regulations, and

[1] Each District in Budapest publishes a newspaper or newsletter on a monthly basis

social security withholding According to Mrs Karika, not many people in either District VIII or IX have this expertise

Another problem is that the buildings in these districts have a general lack of funds There are very few lawyers who will provide assistance to these condominiums because the fees they can charge to condominiums tend to be quite low

Common representatives are entrusted by the owners to become employers, in essence, and this responsibility includes an array of duties, some of which are very difficult Laws that are relevant to the operation of condominiums are continually changing, and common representatives must keep abreast of these changes, as, theoretically at least, they are liable for errors they may commit in tax reporting, etc

On the technical side, it is difficult to find reliable repair people for small jobs Most condominium associations are able to afford small repairs, but not renovation or capital improvements

Mrs Karika thinks that individuals from small property management firms would benefit from training by persons with expertise in a variety of fields, particularly on tax regulations (personal and company income tax), the social security regulations, the housing regulatory framework as a whole, and the Condominium Act, which is due to be introduced in a revised form by March 1997 [2] Owners need to learn what they have to gain by undertaking such actions as selling off attic space for the construction of additional units and other business-oriented strategies

Mrs Karika said that property managers could benefit from training on the particulars of the Accounting Act, and specifically on the accounting requirements for condominiums and how to apply and execute them

Another course she said would be useful has to do with the psychology of the relationship between service providers and clients In short, Property Managers need training on how to serve their clients in order to retain their business Zold-Karika Kft , for instance, has space in its office for clients to sit down and talk to company staff The clients, said Mrs Karika, want to feel as though representatives of the management company are concentrating on their needs

Mrs Karika thinks that many property management firms would participate in training on the topics described above She said that the Socialist Party approached her about taking the lead in organizing training, as it has organized a "club" for property managers in the IXth District, but it has no funds with which to organize training sessions or other activities [3]

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[2] Parliament has discussed the problem of the current Condominium Law which requires agreement by 100 percent of the owners of a building in order to change the Foundation Documents The problem of requiring a unanimous vote to make any sort of decision is obvious

[3] Apparently Mrs Karika has been approached by all of the major parties about participating in organizing party-sponsored training Mrs Karika declined to be involved however as she feels that property management training should not be guided by political aims

I explained to Mrs Karika about USAID's possible willingness to organize training courses on various topics relating to property management I asked about appropriate fee levels Mrs Karika said that a one-day briefing organized by the Social Security Administration costs from 8,000 to 10,000 HUF Small companies cannot afford such high fees, but could pay 3,000 HUF for a course

Ms Karika said to be aware that many property managers do not know what they do not know, and may be disinclined to participate in training courses Furthermore, some employees may not be interested in furthering their knowledge

Sándor Erdősi asked Mrs Karika why she thinks that prices are so low in District IX She answered that in 1991, when she worked for IKV, the organization undertook to manage condominium units on a market basis A cost analysis was not prepared prior to setting fees People did not care about the fees because they were not thinking in an entrepreneurial manner They were employed and got paid, regardless of the level of management fees charged to the condominiums Increases in service sector pricing were tied to the price increase index issued by the Central Statistical Office At the time, annual price increases were limited to 50 HUF per unit per month Private property management firms had to accept these terms as well In addition to this problem, most condominium owners in Budapest do not view property management as a profession that provides valuable services, nor do the owners have sufficient capital with which to pay higher fees

Sándor asked why the larger, formerly municipally owned firms still retain such a large share of the property management market Mrs Karika said that the larger firms continue to avoid calculating reasonable fees, but rather try to undercut the prices of smaller firms The larger firms make up for these low prices by charging higher prices for repair work Many property management firms offer repair services, which provide the bulk of their income and subsidize their property management activities Mrs Karika said that this is a conflict of interest She also said that these companies will not survive if they continue to engage in these pricing practices and do not begin to practice good customer relations

Meeting with Ann Becher of IREM and Katie Mark

Katie and I met with Ann to determine what types of courses are being offered by IREM in Hungary Ann is a Financial Specialist who teaches the IREM 400 and 500 courses in the United States

Today, Ann delivered IREM 855, a course on condominium management The course participants were primarily from small firms One couple was in attendance has a small firm with three employees The firm manages 1,000 units

The IREM 855 course is a one-day course that is delivered in two half-day sessions The IREM 300 course will be offered in December

Ann said that one of IREM's principal assets is that its instructors are all practitioners She would like to see Hungarian practitioners eventually offering IREM courses in Hungary She doesn't think, however, that anyone can teach anything, and that people should not deliver courses in areas outside of their expertise

Ann has been teaching in Poland as well as in Hungary She thinks that the institution with which IREM has a training partnership in Poland is better-organized than the groups with which they are working in Hungary

Ann thinks that the Hungarian courses are open to everyone who wishes to attend She is unclear about the extent of the market for these courses in Hungary She thinks that the prices were cut to 3,500 HUF per course, but is not aware how these funds are distributed between HAREM and Fúti She thinks that Fúti is well-organized but that HAREM would not be able to deliver the courses on its own

Currently, 43 participants are enrolled in the IREM 400 course, which will be delivered next week Katie said that it would be interesting to us to get information on the course participants Ann said that this information is requested on the back of the examination forms In 1996, 480 Hungarians participated in the IREM training courses

Three-page flyers regarding the courses are distributed to all HAREM members, and HAREM members receive a course fee discount IREM, however, does not have an exclusive arrangement with HAREM to offer its courses in Hungary IREM would be willing to become partners with other Hungarian institutions

IREM courses have been offered in Hungary for several years Many participants have taken the 102, 302, and 855 courses within the last two to three years Hopefully, by June of 1997, several Hungarians will become qualified CPMs Some of these individuals will be trained as trainers

Katie mentioned that Larry Birch of USAID suggested that the Budapest University of Economic Sciences and the Technical University might be conduits for training Ann said that IREM offers its 200 courses in universities, but university settings are generally counter cultural to IREM, which requires that its trainers be CPM practitioners Larry's theory is that some of the courses that the universities offer at the Master's level in Hungary may be available for practitioners

IREM is offering four courses in Hungary

102 and 855	(combined into a four-day module)
400	(financial management — three days)
500	(case study dealing with real estate)
302	(office and commercial management)

Participants must write a management plan for an actual property in order to qualify for CPM designation The management plan must include an Executive Summary, a description of the

region in which the property is located, a description of the neighborhood, a description of the property, a discussion of the property's problems, and recommendations

These courses do not exactly correspond with those courses that IREM offers in the U S The requirements are less stringent in Hungary, but the course content is not diluted Hungarian participants are required to pass exams at the completion of each course and write a satisfactory management plan prior to being qualified as a CPM [4] The 400 course is very difficult, so participants may retake the exam if they fail after the first attempt

IREM rewrote the courses for its Eastern European participants For instance, the 400 EE course is somewhat different from that offered in the U S The concepts are essentially the same, such as the time value of money, but some discussions are different, such as discounted cash flow, cash flow, and taxes The courses were rewritten by Franz Janicek and Bill Burke of IREM Franz has been delivering most of the East European courses

Although the courses have not been "Magyarized," Ann feels that the concepts they impart are relevant in Hungary IREM has brought in Hungarian attorneys to advise them on the Hungarian legal context

Ann does not think that all of the course participants will be CPM candidates, because some of them are only interested in specific courses She mentioned that one participant attended one of the courses because she had heard that the forms provided were good

I asked about the content of the 102 course Ann said that they were similar to the ARM course [5] Topics include communication techniques, managing maintenance staff and maintenance requests, tenant relations, evictions, financial reporting structures, tenant compliance with subsidy programs, tax credits, leasing requirements and lease documents, how to manage employees, how to decide whether or not to contract out for repairs and services, professional ethics, budgeting for capital improvements, and NOI (net operating income)

Although some of these topics are not particularly relevant in Hungary, such as tax credits and tenant compliance with subsidy programs, participants apparently are curious how certain aspects of property manager differ between the U S and Hungary

There is a problem inherent in preparing trainers to offer these courses although Ann can answer questions from experience, the trainers most likely would not be able to do so

I identified the need for courses on marketing and market analysis While IREM's 700 series includes marketing courses, these are not yet offered in Hungary Fúti is responsible for getting

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[4] To pass an exam participants must score at least 70 percent The exams are objective multiple-choice tests

[5] IREM offers an ARM (Accredited Resident Manager) designation to individuals who take a course and pass an exam on the basics of property operations

the IREM materials translated from English to Hungarian It also is responsible for advertising the courses From what Ann could tell, Fúti does not understate the requirements for the CPM designation

Ann said that participants are interested in obtaining books on property management She suggested that a library be started in Budapest, perhaps in connection with HAREM Katie said that EERPF, in partnership with the Hungarian Real Estate Association, received assistance in starting a library

10/10/96

Meeting with Mrs Hornyák of the private firm Otthon 2000, President of the Trade Union of Asset and Property Managers, and Sándor Erdosi

The Trade Union of Asset and Property Managers currently is comprised of 24 member unions throughout Hungary Of these member unions, 40 percent are located in Budapest, and 60 percent throughout the rest of Hungary Each of the 24 member unions have one representative on the board of the national organization There are roughly 4,000 members in all

The members of the organization are employees of the former IKVs The member organizations manage municipally owned housing and some condominiums Member organizations have at least 50 employees Mrs Hornyák said that for this reason the Union does not represent private property management firms, which are smaller and have different needs

The Union assists in the development of collective contracts for employees of the member organizations At the national level, it provides interest representation on behalf of the property management profession or employers in connection with changing legal regulations On the local level, the Union represents the social welfare interest of employees The board of 24 representatives of the local chapters meet quarterly to exchange information

With regard to the property management market, Mrs Hornyák said that there is a substantial amount of business available in Budapest, and many firms have emerged as a result Some of these firms will survive, and some will not

When asked how she would characterize the concerns of publicly owned vs private firms, she answered that the interests of the two firms are different Local government firms manage municipally owned stock, whereas private firms must compete for business in the management of condominiums Speaking as a practitioner, she said that private firms take much more responsibility with regard to the properties they manage, and are more interested in pleasing their clients

I asked Mrs Hornyák whether she thinks the firms in which the municipalities have an ownership interest will survive and be competitive over the long term She replied that they will survive, because they generally manage all of the local government's assets But if they are to retain property management business, particularly the management of condominiums, she said they will have to adopt a better attitude toward their clients

One area in which the former IKVs generally perform is payment of the building's utility bills They are very disciplined in paying these bills, whereas, according to Mrs Hornyak, small private firms are not However, the former IKVs generally do not provide maintenance services that are as good as those provided by the private firms

Mrs Hornyák said that the condominium owners do not recognize the rights and responsibilities of ownership They generally do not realize that they should supervise the common representatives of their condominium building When condominiums were first established in Hungary, many homeowners lost confidence in their common representatives because of the incidence of bad financial management They did not realize, however, that they had a role to play in the financial management of their buildings Unlike when they were tenants, and IKV took responsibility for all physical and financial operations of the buildings, owners now have responsibilities themselves, but are reluctant to assume them

Sándor asked if there is a trend for condominium management contracts to be given back to the former IKVs Mrs Hornyák said that this seems to be the case When 51 percent of the units in a building are under private ownership, usually the homeowners fire the former IKV and give the contract to a common representative However, after a few years, the management contract is handed back to the former IKV

Mrs Hornyák said that common representatives should have some financial liability with regard to their duties so that the homeowners have some security The homeowners generally end up being liable for unpaid bills of the condominium The homeowners can sue the common representative or the management company, but the legal process is time-consuming and expensive

In discussing how to strengthen small and medium-sized property management firms, I asked Mrs Hornyak what she thinks about the possibility of establishing an association of private property management firms She said that if it could be proved to the principals of small companies that their interests could be served by joining such an organization, then they might be willing to participate and incur the associated expenses She suggested that we speak to the Chamber of Industry and Commerce about starting a sub-group for property managers, which could be a conduit for information exchange It is mandatory in Hungary for all businesses to pay dues to the Chamber, and it is unclear what, if anything, the businesses receive in return

She also thinks that there is a demand for training of individuals from firms that do not employ accountants and/or lawyers The courses would have to be affordable She also thinks that business planning and marketing courses would be interesting, but is not sure whether or not there would be widespread interest in such courses

Meeting with Tamás Lakatos of Ésosz Bt , Budapest

Ésosz Bt is a private firm located in Budapest's District III The firm is owned by three partners, and employs four staff members on the average It has some part-time staff and some contract employees, such as superintendents and janitors

The firm manages 900 units, the majority of which are located in Budapest's District III Other than property management, the firm provides maintenance and repair services

Ésosz Bt was established in 1991 Mr Lakatos had been the director of the maintenance group attached to one of the district's IKV organizations When the IKVs started to lay off people in the early 90s, Mr Lakatos decided he should open his own firm rather than run the risk of losing his job

The firm does not advertise, and has obtained new business in the past by word-of-mouth Mr Lakatos is currently not concerned with obtaining new contracts He and the rest of the staff work very hard, and do not have time to adequately service additional units

Mr Lakatos said that Ésosz Bt has not done an analysis of the market, and that no firms in Budapest do this The firm has no formal business plan Small property management firms, he said, are not enterprises in the truest sense, and most of these firms have no funds available for organizational development

Mr Lakatos thinks that one of the biggest challenges faced by small property management firms is that the former IKVs still dominate the sector and charge lower management fees Condominium owners tend to consider price only, not quality of services when choosing a management company Condominium owners undervalue the work of professional property management firms

Small firms are generally undercapitalized and have to undertake more work than they can reasonably handle Esosz cannot pay its maintenance staff enough for the work that they do, and e condominium owners do not value the repair work anyway The condominium owners do not tr st their common representatives They require that any bank drafts, invoices, and receipts have one signature from the management company and one from the condominium association [6]

When asked if he thinks that any kind of training would be beneficial to the property management sector, Mr Lakatos said that he doesn't need any training, nor does anyone in his firm With regard to laws and regulations, Esosz hired an accountant who monitors changes and informs the partners He said that it is not difficult to learn about these regulations, as there are not very many that are applicable to the company Rather than offering training, he suggested that USAID fund a public information campaign to educate citizens about condominium laws and regulations, the responsibilities of the common representative, cost-benefit analyses with regard to management and maintenance services, etc He said that a television program or infomercial might be very effective

Mr Lakatos said that Esosz's income does not cover its salaries and operating expenses, such as rent, and that the firm owes money to the tax authorities and the social security administration He is very skeptical of any improvement in the situation in the near future He said that small

[6] It is interesting to note that as described earlier Mrs Karika of Zold-Karika Kft thinks it is a good idea for management and the condominium association to be co signatories, as this inspires trust

firms cannot compete with the former IKVs, because these larger firms are subsidized by the district governments and do not worry about profitability Condominium owners who employ these firms in essence pay for their services twice through management fees and through local taxes

10/14/96

Meeting with Gyula Varga of Pyramidon Kft , District III, Budapest

Pyramidon Ltd is a privately owned firm that has 12 full-time employees The firm was established in 1989 Mr Varga is an electrical engineer and used to work for a research firm Because of the change of the regime at the end of the 1980s, there have been profound changes in the economy Mr Varga attempted to find a market niche He felt that IKV did not provide good property management services and his firm is trying to find the right path in terms of providing good service at a reasonable price

Pyramidon Kft supervises approximately 100 janitors who are employees of the condominiums in which they work The company manages nearly 70 buildings, of 50 to 100 units each Total units managed are approximately 5,000 These units are located in Districts III and XI The firm entered into a contract with the District XI municipality to provide management services for some of the municipally owned stock in 1994

Other than property management services, the firm provides accounting services to small and medium enterprises With respect to property management, the firm provides accounting, legal, and technical services to each of the buildings it manages The firm employs accountants with mid-level education, and the rest of the staff are engineers

Pyramidon Ltd does not manage any units outside of Budapest Mr Varga feels that management is effective only when the management office is located no more than a 10- or 15-minute drive from the buildings Because the firm works consistently in these two areas, and staff are generally in close proximity to one another, it is easier to work with the homeowners on security issues and to represent them in front of the municipal governments

Pyramidon is listed in the telephone directory, in the white and yellow pages It does not advertise, however, and obtains clients by word of mouth Mr Varga said that Hungarians as a rule distrust firms with flashy advertisements When the firm was established, no market analysis as such was performed At the company's inception, it managed only a few buildings for the first one to two years During that time, Mr Varga concentrated on organizing the company and creating its infrastructure Once the company was duly organized, the firm did perform a market analysis of sorts The staff interviewed individuals from the lift maintenance and cable television companies, and learned about their competitors Mr Varga said that he learned a lot from mistakes made by his competitors

The firm does not have a formal business plan When asked about the reason for this, Mr Varga said that long-term planning cannot be done in Hungary right now, because laws and tax regulations change so quickly The firm's implicit plan is to not undertake the management of too

many more properties Mr Varga feels that Pyramidon currently has the right staff and the right number of staff to properly manage the buildings the firm now has under contract

Mr Varga said that Pyramidon has not had any problems obtaining clients When the firm is approached by new clients, it engages in a contract for a three-month trial period, to determine whether or not the professional relationship will work

I asked how Mr Varga defines "profitability " Mr Varga answered that property management is not like trading, in which one can potentially make fast profits Property management is only profitable for those who have a long-term plan and stay in business For those who do stay in business, they have the advantage of being able to calculate quite closely what their annual revenue will be Contractually, property management firms may raise their fees only once a year If property management firms stay in business for two to three years, then they will usually be able to survive In order to do so in today's market in Hungary, however, the firm has to be well-qualified and provide good service The firm should be well-equipped from a technical/ administrative standpoint, it should be fully computerized The firm should have a budget for itself and each of its buildings, and should be able to adhere to these budgets within reason

According to Mr Varga, the greatest problems facing the property management sector in Hungary today are the lack of financial resources for building renovation In view of the present wages and costs, condominium owners want to pay only the minimal costs for the building's immediate operating costs

Mr Varga has spent a great deal of time helping his firm evolve to its current state He receives numerous phone calls from condominium common representatives who have management-related questions for which they cannot obtain answers from the municipal governments Mr Varga said that the property management sector, particularly common representatives, have substantial training needs In his opinion, the areas in which training or assistance is needed are as follows

- acquisition of problem-solving skills,
- accounting for condominiums,
- budget preparation,
- preparation of management plans to address short- and long-term building needs,
- interpreting applicable laws, and
- general management skills (how to coordinate diverse tasks), and knowing what types of skills are needed to run a successful property management business

Mr Varga thinks that people would take courses such as those described above, although it might be difficult to market them He said that common representatives are eager to be trained in practical courses, from which they can learn skills that can be immediately put to use The training should be offered by practitioners rather than academics

Mr Varga stressed the importance of budget preparation He said that budget preparation is not only important from the technical point of view, but from a psychological aspect as well

Condominium owners often become upset when management exceeds the building's operating budget, particularly if they are not given notice or reasons why additional expenses have been incurred

Mr Varga does not belong to HAREM When asked about the value of professional associations, he said that it is not as though he doesn't believe in their value *per se*, but that he doesn't think that they can efficiently lobby for legislation and that they don't have any real influence over the government He said that associations do not provide services that the members cannot obtain in some other fashion He said that if his firm has a problem, the problem can be solved by his lawyers and/or engineers In other words, the problem can be solved much more efficiently independently than if an association were involved In addition, he thinks that lobbying by individual companies is much more effective than group advocacy efforts

I asked if Mr Varga thinks associations are beneficial from the standpoint of disseminating information that is of general interest to the professional community He said that some experts are not really experts, and that some sources may not necessarily disseminate information that is correct In the housing sector, he said, information is readily obtainable

With regard to the marketplace, Mr Varga said that the former IKVs had hoped to obtain management contracts for privatized condominiums automatically, based on their contacts in the community New condominiums usually contract with the former IKV initially, but after a year or two the former IKV is terminated The consciousness of condominium owners is slowly being raised, and they are beginning to understand what they may expect from management companies To the IKVs' credit, however, they are generally honest in their financial dealings with the owners

I asked Mr Varga about the impediments to small and medium firms that are emerging in the property management market He said that the former IKVs received capital, office space, and clients automatically when they were formed by the municipalities Private firms had to acquire these, and it takes them years to do so Many private entrepreneurs are unwilling to seek credit or take any kind of risk Furthermore, all service industries in Hungary are suffering at present, because people cannot afford to pay for these services The price of electricity and gas in Hungary is approaching western levels, while salaries are typically 1/6 to 1/10 of average western salaries

People living in condominiums generally prefer that one of the owners act as the common representative for the building, because the IKVs destroyed the reputation of property management as a profession The time of the jack-of-all-trades, however, is over, and one person cannot provide all of the services necessary for adequate operation of a building and condominium association Mr Varga thinks that eventually, condominiums will not employ individual common representatives The owners often accuse them of cheating or stealing, whether or not this is justifiable

Two-thirds of the municipal housing sector in Budapest has been privatized, but owners continue to retain the attitudes of tenants IKV did a poor job in maintaining the buildings Rising energy

prices cause a huge burden on residents who had been allocated their units years ago, and who have to deal with a growing amount of deferred maintenance

Mr Varga said that it is essential for property managers to have good relationships with the condominium owners He thinks that firms that treat their clients as IKV traditionally treated the tenants will eventually go bankrupt Only a few private property management firms have placed a priority on good client relations as part of their long-term strategies

Mr Varga considers his greatest professional achievement the continuity and consistent growth of Pyramidon The firm started as a small partnership or Bt , and is now a limited company, or Kft

10/17/96

Retreat for Participants at USAID's SME Program in Hungary, USAID Office Budapest

USAID held a meeting on its SME program in Hungary so that participants could share information about the activities in which they are involved Antonia Sanders and Olga Mendez attended the session briefly to meet the participants and determine which organizations might be involved in generic business training efforts The PADCO team intends to visit some of these organizations during its trip in December to determine if existing training programs would be relevant to private property management firms

Meeting with George Császár, Managing Director, and Ildikó Mészáros, Director of Training, Coopinform, District II, Budapest

Coopinform is an educational and advisory corporation that was established in October 1990 It used to be a computer technical company that developed software and did computer systems analysis After the change in the regime, when Hungary would import products such as IBM and Microsoft, the company was transformed into an educational organization

Originally, Coopinform targeted its training courses to top-level managers However, since the market for training is decreasing, the company is increasingly targeting its efforts toward training mid-level managers Its current training courses are at the post-graduate level, but Coopinform is trying to develop post-secondary school level courses

Currently, Coopinform's most popular classes are as follows crisis management, asset management, management of publicly held companies, the stock exchange, and computers In addition, some courses focus on harmonization of European businesses, the financial and banking sectors, cash flow management, and cash management Each course has two components general management information and marketing (how to communicate/negotiate)

Coopinform uses instructors who are among the best lecturers from the best Hungarian universities or practitioners who work with Hungarian or international companies

Coopinform uses interactive training methods and incorporates role-playing and case studies into its classes

The company receives no funds from donor sources, although the principals of the firm would like to receive some type of donor funding so that they can offer courses at a lower cost to participants The management of the training courses causes the fees to increase, and it would be helpful if these costs were covered through donor funding In 1992 or 1993, Coopinform applied to a foundation to sponsor training and received funds from PHARE Mr Császár feels that the training offered through PHARE and other foundations do not meet the current needs of target participants Coopinform revises its courses to meet the changing needs of its participants, while PHARE and foundations generally have a two-year lag time between the time an application for training funds is made and when the courses are actually offered By this time, the courses are no longer relevant Coopinform feels that there are not enough funds available from foundations to cover the number of companies applying for funds

Occasionally, Coopinform enters into joint ventures with corporations to offer training to members of the board of directors or supervisory staff The company has developed good relationships with professors of universities in Western Europe, America, and Japan Coopinform will also offer logistical assistance for training courses other than those it offers directly

The shortest courses offered by Coopinform are 2-3 days One-day conferences are also offered The Asset Management Course meets one day per week for 5-6 months Mr Császár feels that most companies will allow employees to miss one day per week to attend training In any event, Coopinform has no problem filling these courses People like the courses and are willing to pay for them

Mr Császár feels that the biggest problem in offering training is that not everyone can afford the fees, so prices must be reduced This results in a low profit for the company and a high profit for trainer/instructor

10/18/96

Meeting with Mrs Ildikó Traub Bézsenyi, Common Condominium Representative, District IX, Budapest

Mrs Bézsenyi is an individual entrepreneur who is the common condominium representative for approximately 400 condominium units in Budapest's District IX She began managing condominium units in 1990 She has no employees, but contracts with various technical service providers

Mrs Bézsenyi is a teacher by training, but could not take a job with fixed hours because she has a sick child Being a common representative works for her because she can work out of her home and the hours are flexible

Mrs Bézsenyi's duties consist of handling each condominium association's accounting functions, preparation of correspondence, monitoring lawsuits, serving as liaison with utility companies,

doing inspections, organizing assembly meetings,[7] and paying bills She signs all of the invoices along with a representative from the Executive Committee She never makes a decision about matters concerning the buildings, as the members must vote on these issues

Mrs Bezsenyi said that she generally works with five to seven people in each of the buildings she manages If there is not a core group of people who are actively involved in the condominium's operation, she will not work with that particular building

It is important that Mrs Bézsenyi keep abreast of all new regulations affecting the operation of condominiums She says that this is difficult but necessary, as it is her responsibility to prepare all of the buildings' tax and social security reports Currently, any profits earned by the association are taxed at a rate of 20 percent A revenue tax is paid in addition to the profit tax

Mrs Bézsenyi gives the unit owners a lot of individual attention and takes pride in this aspect of her job She does not want to add any clients at present as she feels she would not be able to provide additional clients with quality service

Mrs Bézsenyi thinks that condominium management is profitable, and she makes enough money as the common representative of several buildings to suit her needs She says she could even make more money if she accepted additional clients

Mrs Bézsenyi thinks that one of the greatest problems faced by the property management sector is the difficulty of finding competent, reliable, and honest technical service providers Also, most condominium buildings have no "operating instructions" that explain the building's systems and peculiarities She commented that when one purchases a radio, one receives more operating information than is accessible to condominium managers Another problem is that, under current law, concurrence of 100 percent of the homeowners in a given building is required to effect any decisions One person in a building can stonewall any potential decision on the part of the other homeowners to fund necessary repairs and/or capital improvements

The greatest problem facing property managers, according to Mrs Bézsenyi, is the lack of financial resources on the part of most condominium associations Despite the fact that there are operating standards for various building systems, often condominium associations cannot afford to pay for the work that needs to be done

In responding to a question about the private property management sector's need for training, Mrs Bézsenyi said that it is likely that the larger firms would not attend training courses, but common representatives need assistance in interpreting foundation deeds and other aspects of their jobs

[7] Each condominium association generally has two to three assembly meetings per year

Mrs Bezsenyi occasionally meets with other common representatives to exchange information She said that some associations exist, but they do not provide information that would be useful to her personally She said that an association of common representatives might be useful if it acted as an advocacy organization, but is not certain whether common representatives would have the time nor the financial resources to sustain such an organization

Meeting with Mrs István Buzási, Arbiter Bt , District XVII, Budapest

Arbiter Bt was established in 1992 The company employs 25 to 30 staff members and contracts with an additional 25 to 30 The principals of the firm used to work for the District XIV municipality in its efforts to privatize its housing stock The municipality established its own Kft to manage the newly privatized condominiums, but strategically undermined it by awarding management contracts to other businesses in exchange for bribes The municipally owned firm eventually went bankrupt in 1993

Besides property management, Arbiter Kft engages in some brokerage activities The staff lawyer handles real estate transactions

Arbiter Bt currently manages 18 buildings made up of 60-300 units Three of these buildings are located in District XVII, 12 are in District III, 1 is in District XIV, 1 in District XI, and 1 in District X In addition, the company is a subcontractor to the municipally owned management firm in District X and provides services to seven buildings The firm does not accept clients outside Budapest

Arbiter Bt occasionally advertises in the local government's newspaper, and also occasionally distributes leaflets to advertise its services It has obtained clients through word of mouth The firm never did a formal market analysis but knew that condominium buildings had a need for quality property management services

The company has no formal business plan, but its strategy includes centralizing activities According to Mrs Buzási, it would be more practical for the company to have more of its business located in District XVII, where the office is located Arbiter aims to manage three additional condominium buildings in District XVII Each building has a written management plan Mrs Buzási thinks that the economic situation in Hungary is too uncertain for companies to formulate business plans

In Mrs Buzasi's conception, the issue of whether or not the company is profitable is a "Catch-22 " To be really profitable, the company would have to hire more qualified staff, but would have to pay these individuals more than it pays its current employees This would necessitate an increase in management fees, which would cause the company to lose business To avoid increasing management fees, the company would have to accept many new clients and

compromise the quality of the service being provided [8] Arbiter Bt 's cash flow is at the break-even point, but the company has no capital reserves

Mrs Buzasi said that one of the greatest problems facing the property management sector is the amount of deferred maintenance in many condominium buildings In addition, she said that there are many amateurs and swindlers in the property management market There is no regulatory framework to which private property management companies must adhere The high rate of unemployment in Hungary has resulted in a glut of dilettantes who attempt to enter the property management market without possessing the necessary skills There are apparently firms in the market that offer low fees and then undermine the condominium financially by submitting bogus bills According to Mrs Buzási, these firm s simply change their names when their reputations become tarnished

Another problem faced by the sector is that the municipal governments have retained the ownership of up to 90 percent of the commercial spaces in residential buildings If the building retained more of the revenue generated from these spaces, they would be better able to afford to address their deferred maintenance needs

The pre-fabricated concrete panel buildings are very expensive to operate because the utility costs tend to be very high in these buildings Mrs Buzási calculated that because of the high utility fees, it costs as much to operate a two-room unit in a concrete panel building as a detached house of 100 square meters This has a direct impact on the property management market, because the higher the operating costs are, the less condominium owners want to pay for management/ maintenance services

Ironically, utility costs are often higher than they should be due to overbilling on the part of the District heating companies Arbiter staff occasionally check the meters and have witnessed occasions when the District Heating has billed the condominium twice the amount of actual consumption The District heating company will refund the difference to the building if the overcharge is brought to its attention, but the refund process can take up to six months Often two to three buildings share one meter, which adds to the confusion about cost allocation, but individual metering is expensive In some cases, the District heating companies discourage buildings from installing individual meters

Since 1995, there has been a 500 percent price hike fo garbage collection The task of allocating the increase among households in each condominium building fell to the Common Representatives It is difficult to allocate garbage removal costs based on the number of household members, and this caused a lot of dissatisfaction among homeowners

In response to a question about property manager's training needs, Mrs Buzasi said that the more people that are trained, the greater the competition would be in the property management market

[8] Mrs Buzasi calls this the IKV syndrome IKV traditionally managed almost all of the housing stock and provided little or no service to the majority of the buildings

She has seen advertisements for training initiatives, but thinks that the courses do not provide all of the training that is promised She thinks that property management cannot be taught in an academic setting She does think that individuals from small property management firms could benefit from practical courses To be a qualified Common Representative, for instance, requires knowledge in three areas construction engineering, finance and accounting, and legal knowledge If a firm has employees, the principals need to know about labor law

According to Mrs Buzási, there is a lot of competition in the market and this is handled differently in each district in Budapest In District XVII, for example, the individual companies have agreed not to fight one another In District III, there is an unwritten law that if there is a municipal tender for a property management contract and the contract is not awarded to a District III property management firm, these firms recommend Arbiter to the General Assembly

Arbiter Bt has not been involved in any buildings in which municipal governments have funded renovation projects Arbiter Bt has applied for grants on behalf of individual condominium buildings, but has been refused in each instance She thinks the competition is "wired," and that those buildings in which municipal officials reside receive renovation funds from the municipality

10/24/96

Meeting with Mr Baksa of Intercisa Kft and the Association of Unit Operators (LESZ), Dunaújváros

LESZ is an association of property managers Mr Baksa is a representative of Intercisa, a housing cooperative organization, which is a member of LESZ Mr Toth, who is the President of LESZ, is the president of Intercisa [9] LESZ is an advocacy organization in the classical sense The members do not feel that politicians represent their interests The members of the organization would ultimately like to see NGOs represented in civilian parliament, as exists in Székesfehervar, which would advocate the causes special interest groups, such as pensioners, senior citizens, the unemployed, and people with large families

Currently, LESZ is negotiating contracts with the public utility companies and is supervising these contracts An example of this is that UTI, an American firm, is supplying telephone hook-ups in Dunaújvaros The contract between UTI and the consumer refers to a set of conditions that are not stated in the contract, so the consumers do not really know the conditions to which they are agreeing when they sign the contract

LESZ tries to provide interest representation to its members It has compiled a list of service providers who provide services at a fair price to condominium and cooperative owners LESZ arranged a forum to request that the local government give a certain percentage of its privatization revenues to condominiums in the form of grants or low-interest loans for renovation This is because when the municipality privatized the units, there was a substantial amount of deferred maintenance

[9] Unfortunately Mr Toth was in the hospital when we visited Dunaujvaros

The association is nonprofit, it receives funds from the municipality and membership, the latter covering the cost of mailings and miscellaneous expenses Twelve individual members also pay 50 HUF per year, and two honorary members pay what they wish LESZ's main revenue comes from the dues provided by the 4,500 units represented by Intercisa LESZ is currently trying to increase the number of units in its membership

Condominium representatives do not have basic knowledge or information about accounting, applicable laws, or technical fields to do their job effectively LESZ is trying to fill that void If a condominium, for example, is trying to renovate a building, it can request assistance from LESZ in finding contractors

The present condominium law makes it virtually impossible for a condominium to obtain a bank loan, since one person in the condominium can veto the idea LESZ was able to get 1 5 million HUF for a building, but could not convince the condominium to take the grant and apply for a loan from the bank for the balance of funds required The funds were to be used to renovate the building's heating system The heating company agreed to give 600 HUF per unit per month back to the condominium if this renovation was carried out The money from the heating company would have been 70 HUF per unit per month more than the monthly loan payment Out of the 28 members of the condominium association, one would not agree to apply for the loan, so the decision was nullified

Condominiums do not pay many taxes and as a result receive little supervision from the municipality This is advantageous, since the common representatives know little about the legal and tax requirements of condominium management In addition, the Executive Boards in most condominiums do not supervise the managers adequately The managers, therefore, often take advantage of their position and cheat the condominium associations

The Intercisa housing cooperative oversees 4,500 units Another LESZ member oversees 3,200 units and a third oversees 1,000 units The housing cooperatives comprise approximately 50 percent of the city's housing stock There are approximately 200 individual common representatives that are not members of any association

LESZ would like to train condominium representatives and have the trained representatives take over management of additional condominiums LESZ holds a monthly forum for common representatives and addresses different issues in each session (e g , accounting) The problem is that common representatives do not pay membership dues to LESZ, and the municipality does not cover the cost of providing information to common representatives Therefore, LESZ cannot afford to provide condominium training

It is a benefit to the municipality that the condominium representatives are untrained, otherwise they might try to exert more authority For instance, in mixed-ownership buildings, the municipality generally retains ownership of a larger proportion of the common areas than that to which they are entitled For a building to be designated as a condominium, 51 percent of the units have to be privatized The municipality retained ownership of the other 49 percent Common areas

were divided accordingly, however, as more units were privatized, the share of the common areas held by the municipality has not decreased Municipalities are now trying to sell their share of the common areas for outrageous prices to the condominium associations, to which the space rightfully belongs in the first place

Generally, the same 40 or 50 people attend association meetings LESZ and Intercisa would like to train and rely on these individuals to take on more responsibility

LESZ was established before the last municipal election, yet has succeeded in getting two people elected to the 26-member General Assembly The socialist party is the majority party in the Assembly, so capturing votes for Association members is difficult Instead, it may be more appropriate to increase the base of the association

Intercisa has agreed with another 3,200-unit cooperative to jointly represent its constituents in front of the municipality and utility companies LESZ will have a general meeting in March and would like to see the other cooperative become an active member

The problems that LESZ encounters are due to the fact it is not yet a powerful advocacy organization Their input is not requested in creating the laws that affect its existence, such as the condominium law and the association act Furthermore, LESZ cannot settle management problems, such as nonpayment of fees, until it has a legal means to deal with the problem

Dunaújváros is a young city that was built in the 1950s It was built according to socialist philosophy that a 50-sq -meter flat was sufficient for a family The housing stock consists mostly of two-bedroom flats of 50 sq meters Some mobility became possible after privatization and many people now want studio or three-bedroom apartments It is a status symbol to own an apartment A barrier to mobility is many senior citizens on small pensions who cannot afford to maintain their flats are unwilling to move to smaller flats Construction of prefabricated concrete panel buildings became prevalent in the 1970s, and almost no new housing construction has occurred in Dunaujvaros in last 10 years There is a system to allocate municipal apartments to those in need but the waiting lists are incredibly long Only 700 out of the city's 8,000 flats are municipally owned

Meeting with Kálmán Netkovszky, Fúti Omega Kiadványozási és Oktatatsi Kft , Budapest

Fúti is a private training institution that offers courses in various areas connected to real estate The organization is currently working in conjunction with HAREM to offer IREM courses in Hungary Other than the IREM courses, Fúti offers a series of courses on real estate brokerage, as well as courses on land law and property acquisitions The only course Fúti offers that is not directly related to real estate is accounting The company publishes its training materials as well

There is a Hungarian law on education that regulates training programs Exams are regulated through ministerial decrees There are three types of training in Hungary

- academic training (courses offered by schools),

- certified training delivered outside of an academic setting, and
- training delivered outside of an academic setting that has not been certified

One ministry is responsible for regulating training programs in each discipline For instance, the real estate sector is regulated by the Ministry of the Interior Training that is tied to a certification program is obviously more desirable than training that does not lead to certification Futi is attempting to lobby the ministry to certify the brokerage training and IREM training courses [10] Official recognition of these courses would lend them a certain cachet and increase their popularity No courses for which the materials were originate in a foreign country have ever been officially recognized

Fúti has identified a market for its brokerage courses and the IREM CPM courses Mr Netkovszky did not mention whether or not any formal market analysis was undertaken by the company

Fúti is supposed to modify the IREM training materials so that they reflect the property management environment in Hungary These modifications have not yet been made The organization is designing a course that will be offered in parallel with the IREM CPM courses Some textbooks for these new courses have been written, and others are currently being prepared This series of courses, which Fúti calls its "H" series, will overlap with the brokerage series by approximately 25 to 30 percent

The IREM 400 course on financial management is a three-day course Futi charges 36,000 HUF for participants who are HAREM members, and 44,000 for non-HAREM members [11] The course fees include the cost of textbooks, coffee breaks, and lunch There are no small private property management firms that are members of HAREM, and a cost of 44,000 HUF would most likely inhibit participation by a majority of these firms

The fees charged cover all of the logistical costs of offering the courses, such as the room at the Buda Penta Hotel, at which the courses are currently being offered Other expenses covered by the fees include textbook production, course preparation and marketing, and costs incurred in administering exams At present, the courses have been taught by IREM instructors, who are paid by USAID Mr Netkovszky said that, at present, USAID covers about 25 percent of the total cost of offering the courses

In Hungary, 5,800 people have taken the real estate brokerage course Of these 5,800, 86 percent attended the Fúti course Fúti was the first institution to obtain a license to offer this course in 1990 There are four other companies licensed to offer this course the Technical University, a

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[10] Mr Netkovszky said that he is currently spending two to three days per month discussing the possibility of obtaining ministerial certification of these courses with a Ministry official

[11] This is in contrast to the figures provided by Ann Becher, as mentioned earlier in this report

firm in Debrecen, a firm in Békescsaba, and a company called Kultrade Kultrade is Fúti's main competitor and has a 25 percent market share

In the brokerage course, brokers learn how to use facts and statistics to buy and sell apartments The material is revised and improved annually Fúti uses a franchise system to offer its courses, and has 19 partners nationwide Fúti provides these partners with the published course materials

2 Technical Assistance to Developers

10/7/96

Meeting with Katharine Mark of the Urban Institute and Sándor Erdosi of Metropolitan Research Institute, Budapest

The National Association of Home Builders (NAHB) is going to be working with the Urban Institute to develop an association of developers They will begin work on this component in Hungary in November

Bill Claggett, who worked on the public-private partnership in Szolnok, will be in Hungary as of Monday, October 14 He and Sharon Lowenthal, together with Sándor Erdősi, will visit Szolnok to obtain a status report on the project Bill and Sándor will write an updated, expanded version on the methodology and results of the Szolnok project

In the meantime, USAID wants to focus more effort on training of developers rather than undertaking a new public-private partnership project at this time

Katie suggested that we speak to Ilona Beharka, a developer who has built small numbers of flats, to discuss impediments to the development of residential real estate

Sándor suggested that we review the current situation of construction loans and the construction subsidy

10/8/96

Meeting with József Hegedus, Iván Tosics, Sándor Erdősi and Andrea Iván of Metropolitan Research Institute, and Katharine Mark of the Urban Institute

Jozsef said that in order for developers to participate in training courses, the courses would have to be tied to a concrete project that would be of economic interest to them For instance, if a local government issued an RFP for developers to engage in a renovation project, a developer might attend a training course in how to prepare proposals and design specs

Otherwise, inexpensive, short practical courses might be useful to developers, on topics such as estimating project costs

As is the case with private landlords, the tax issue is a major problem for developers The lack of construction finance is perhaps the biggest impediment to the development of residential real estate

A possible output for this project, then, is how to address the major issues that are impediments to developers

10/15/96

Meeting with Pál Baross, Kolpron Consultants, Budapest

Mr Baross is involved in the preparation of feasibility studies for residential and commercial developments His clients are predominantly foreign development companies and institutions from the Netherlands, Germany, and Israel proposing residential, commercial, or industrial developments in Hungary Kolpron also works with local governments in Hungary Kolpron is one of the few firms in Hungary preparing feasibility studies, and his firm has little competition The majority of Kolpron's studies consist of gathering market data, identifying potential financial risks, assessing whether purchase prices or acquisition offers are reasonable, and concluding whether a development should be pursued further Overall, approximately 70 percent of these feasibility studies have negative conclusions, i e , that a development is not feasible and should not be pursued further Thirty percent receive positive feasibility conclusions Kolpron has a subsidiary company, PROPLAN, which offers other professional services, such as engineering, architectural, and financial packaging to developers who subsequently take their proposed developments into the planning stages

To date, Kolpron has not been successful in penetrating Hungarian banks that hold property OTP Bank uses its own internal resources, its development branch, and does not contract out for pre-development and development assistance

It is difficult for Kolpron to obtain accurate data for its feasibility studies, and to assess which banks are active in the residential housing sector Hungarian banks are tough to penetrate and are unwilling to provide information on their lending activities and development costs OTP Bank will provide rough statistics on their annual loan activity expressed in square meters developed Kolpron must then work backward from these statistics to determine the development costs or market pricing

Mr Baross was involved in the preparation of a study for Block 2 in District VIII in Budapest, which assisted the local government in procuring subsidies for a residential housing development The development was stalled, however, when a conflict arose with the chief architect The local government could not be convinced to lower its land price to a level that would allow for development feasibility given the available subsidies Mr Baross feels that this is a common problem in Hungary when a developer tries to build residential housing on land controlled by the local governments The local governments are shortsighted and do not understand that a concession in the acquisition price for the first development parcel is often necessary to assure feasibility, and might have a stimulatory effect on surrounding land values targeted for future development

Local governments are not reacting appropriately to proposed real estate developments, and are reluctant to alter current zoning plans to encourage development In addition, many of the existing plans are irrelevant given the rapidly changing local markets Mr Baross estimates that in the 20 or so major cities of Hungary (with population > 50,000) very little development is taking place and that the problems of the residential housing sector are becoming acute Local governments need to create new master plans in conjunction with the local development community He feels that the two university programs in development management that were started this year (Technical University's British and Economic University's French-sponsored program) will help improve the capabilities and raise the professional standards of planning and real estate development consultants in Hungary Mr Baross also mentioned that a Canadian organization, the Canadian Urban Institute, has a four-year contract to offer technical assistance to developers through the Association of Urbanists Kolpron itself was involved in a training program in District VIII and offers training courses to municipal asset management firms

Mr Baross further felt that the formation of a national association of developers would take 4-5 years, and would have a slower, more self-evolving effect on real estate development Local developers deal with very different issues and obstacles, depending on the politics of the localities in which they are operating and the economics of the local real estate markets Mr Baross felt it would be difficult to develop common interests and that incentives would be necessary to get developers to join and become actively involved in an association He would like to see such an association focus primarily on providing accurate market data and technical updates on financial resources and assistance programs Predevelopment planning and investment analysis are areas where developers need the most assistance Developers need to understand why and how some developments work and others don't Secondarily, an association should provide professional licensing standards, lobbying assistance for legal reforms, conferences, and a library Housing cooperatives that were state-sponsored and now individually owned should also be encouraged to join the association, as they have a pool of knowledge and experience in the development, marketing, sale, and management of residential real estate that has remained relatively untapped

Other concerns raised by Mr Baross were the lack of strong domestic investors in residential real estate throughout Hungary Most domestic investors choose to invest in high-earning national bonds or the stock market, and perhaps incentives could be developed to bring them into the residential housing sector Most Hungarian investors in residential real estate are institutional, predominantly insurance companies (AB Aegon, Postabank/PostInvest, Dom, Questor, Globex, OTP Nortland) In addition, there are very few private developers or construction companies in Hungary that can manage a residential housing development of more than 10 to 15 units because of the banks' collateral and pre-sale requirements [12] Mortgage banking reforms are needed, and developers need assistance in locating potential purchasers for their units More stringent government measures need to be taken to stem the hiring of labor and the purchasing of supplies from the black market

[12] Firms also cannot organize construction activities quickly enough

Meeting with Larry Birch, USAID, Budapest

In this meeting, it was emphasized that the primary focus of the work plan should not be housing *per se*, but the strengthening of the small and medium-sized enterprises involved in the development of residential real estate

According to Mr Birch, there is a need to understand why certain residential housing developments have been successful while others have failed For example, the success of the French-sponsored joint venture in District IX-SEM IX — where many older units were demolished to permit the construction of new residential units Since the completion of the development, it appears as if the surrounding area is benefiting from a synergistic improvement in the local economy Several small stores and restaurants have been opened Was the development profit making? Did the local government put in an inordinate amount of funds to make it work? Did the French bank provide the financing?

Mr Birch further expressed an interest in understanding the current effect of the local and national economies on the residential housing sector Sixty percent of ICA's requests for assistance are in the area of local/regional economic development The local governments are realizing that it is more important to plan and attract investment than it is to own and control development However, loss of industry, high unemployment, loss of municipally owned real estate, lack of potential buyers, rising energy costs, and increasing delinquency rates on OTP mortgages are all economic forces negatively affecting the residential housing sector In addition, the elimination of the VAT exclusion on construction purchases has slowed development activity drastically Though there appears to be enough available funding sources, including the new Housing Guaranty and contract savings programs, these sources do not appear to be providing sufficient fuel to spark activity in the residential sector

The Economist stated that $12 billion in foreign investment has been made in Hungary this year to date, including proceeds from the privatization of banks and energy companies The Budapest stock exchange is up over 100 percent Commercial properties are being built faster than brokers can find people to fill them Yet this activity has failed to kick off a stimulus to the housing sector of the economy Mr Birch feels that it is important to understand why, and where this money is flowing Could incentives be developed to encourage institutions and pension funds to move their investments from the safer national treasuries and bonds to mortgage pools or investment trusts that would benefit the housing market?

In addition to identifying and understanding the obstacles to residential development, Mr Birch saw a need for the formation of an incubator organization that could technically assist small and medium-sized enterprises in the development of residential housing The incubator would act as a non-profit support system for developers, assisting them in structuring viable developments given existing financial resources and subsidies These developments would then serve as prototypes that could be replicated nationwide by other developers and local governments The incubator would also provide training and technical assistance, lobby for necessary legislative reform, and identify potential sources of additional financial assistance

10/16/96

Meeting with Ms Ildikó Bohos, Local Government, Nyíregyháza

Two public-private partnerships were attempted in Nyíregyháza, a city of about 120,000 people RFPs on both municipally owned sites were sent out to local developers, and the local government requested the construction of a minimum of 40 residential housing units on each site Approximately 8-10 developers responded to the RFP All 10 bidders were local developers and most of them were formerly state owned enterprises All 10 developers proposed to construct their developments as well, only hiring subcontractors for smaller tasks Selection criteria included the proposed acquisition price for the land, the percentage of units to be retained by the city as socially assisted rental housing, the percentage of joint venture ownership offered to the city, and the amount of municipal assistance requested A development proforma was not required by the local government as part of the RFP submission City officials stated that they were not interested in reviewing financial projections They knew that the developers would only make a 5-10 percent profit per unit according to their calculations

Mr Jeno Horváth was selected as the developer of the Moszkva Street site with a proposal for the construction of 80 units in two phases The first phase is under construction and the second phase will commence construction in April 1997 The local government will retain 60 percent of the buyers' old units as socially assisted rental housing Mr Imre Szatmári was selected as the developer of the Szamovár Street site with a proposal for the construction of 108 units Due to recent government reductions in the subsidy assistance levels to home buyers, the proposed units at the Szamovár Street site could not be pre-sold The local government anticipates using the site to construct socially assisted rental housing The national government recently enacted a bill that requires the local government to utilize the sale proceeds it received from the privatization of residential housing to build socially assisted rental housing The construction of these units at Szamovár Street will avoid an audit of the city's use of these privatization proceeds

Local officials at Nyíregyháza stated that they had negotiated with both developers concerning the acquisition prices of the land The cost of connecting to public utilities, the government reduction in housing assistance, and the percentage of buyers' old units to be retained by the local government as socially assisted rental housing were all reflected in reduced land prices Unfortunately, no reduction in the land prices could compensate for the national government's elimination of the social policy allowance program, which had liberal maximums and was available to families with or without children The newly implemented buy down subsidy, where the government pays 4 percent of the loan balance in the first five years, 3 percent in the next five years, and 1 percent in the following five years, has a maximum eligible loan amount of 1 5 million HUF for families with children, and 600,000 HUF for households without children These new loan maximums and subsidy limitations are precluding many home buyers from purchasing newly constructed units

Nyíregyhaza has seen 600-800 private homes constructed in the city this year These homes were commissioned by individuals who hired their own developers/contractors Approximately 80 percent of the city's housing stock is single-family detached homes No publicly assisted housing is currently being constructed, other than the Moszkva Street development The local government has a 1,600-person waiting list for socially assisted rental units This has remained

a fairly constant number over the past few years In addition, disabled and elderly housing units are needed If such housing were built, it would free up the socially assisted rental units for young families currently living with their parents Unfortunately, many of the 2,500 units of socially assisted rental housing owned by the local government are in substandard condition The rental income does not cover the maintenance costs, and many families do not pay their portion of the rent Nyíregyháza has 6,000 registered unemployed, with another 5,000 unregistered and incapable or unwilling to work, bringing the unemployment rate to 8-10 percent

The local government does not own many more land parcels that are suitable for residential housing construction and easily serviced by public utilities There are some parcels of land that they would like to sell, but there is no buyer interest due to the lack of the market demand for housing units Nyíregyháza has seen an increase in the renovation and new construction of commercial and retail space, and there is actually a slight oversupply Two large supermarkets have been constructed in the city in the past year The local government was and is willing to alter its zoning plan to accommodate new developments As a result of the new commercial development, land values are growing faster than the actual inflation rate It was estimated that land appropriate for the new construction of a home in the downtown area would cost 30-40,000 HUF, as opposed to 10-15,000 HUF in the suburbs Most newly constructed flats are 50-60 square meters and are selling at a market price of 100,000 HUF per square meter

Meeting with Mr Jenő Horváth, Nyírkomplett Ltd , Nyíregyháza

Mr Jenő Horváth was selected as the developer of the Moszkva Street site with a proposal for the construction of 80 units in two phases The first phase is under construction and the second phase will commence construction in April 1997 He paid the local government 2 5 million HUF for the land without public utilities, which amounted to 6,500 HUF per square meter He estimates that the market value of the land with public utilities would be 20 million HUF He received a construction loan from the National Trade & Credit Bank (OKB) after posting 150 percent collateral The bank is treating the development as an entrepreneurial venture, and he was not required to pre-sell any of the housing units If no one comes forward to buy the units, he will have to find renters or sell them to the local government as socially assisted rental units The local government has been monitoring both his construction and marketing progress

According to Mr Horváth, there is currently no demand for residential housing given the recent changes in the government's assistance programs He cited both the termination of the social policy allowance program and the elimination of the VAT exclusion on the purchase of construction materials as contributing factors In addition, since August 1996, the national government no longer allows the market value of more than one housing unit owned by the home buyer to be credited against the purchase price of the new unit This has severely decreased the pool of potential buyers, as families were trading in multiple units to afford the price of one newly constructed unit The old units are usually purchased and sold by the municipality, or retained (if the land price had been reduced accordingly) and rented to socially assisted tenants

Mr Horvath employs 100 laborers in his construction company, and an additional 13 employees in a subsidiary company that manufactures windows and doors He was a manager of a formerly

state-owned construction company, and has relied on this old network to provide the necessary contacts, technical assistance, and access to capital He is also constructing another development of 30 housing units in a neighboring town, a secondary school with 10 classrooms, an industrial plant, and a church, as well as renovating several private homes and flats He describes himself as a fully insured contractor, which means he carries all risk property and worker's injury insurance

Meeting with Mr Imre Szatmári, Mrs Miskei, Nyírber Kft , Nyíregyháza

Mr Imre Szatmari was selected as the developer of the Szamovar Street site with a proposal for the construction of 108 units Due to recent government reductions in the subsidy assistance levels to home buyers, the proposed units at the Samovar Street site could not be pre-sold The change in the old flat rule also affected the market demand for the housing units In addition, Mr Szatmári's company was too small to post the 150 percent collateral necessary to procure a construction loan He tried to organize a group of investors for the development, but could not show a 10-15 percent profit margin due to the reduced subsidies and increased 32 percent construction loan interest rate He located one Belgian investor, with whom he is joint venturing on another commercial development, but the investor required a 30 percent return on investment Mr Szatmari has tried to organize a lobbying effort to reverse some of the national government's recent changes in the housing programs The Mayor of Nyíregyháza is the leader of the lobbying group, but Mr Szatmári does not feel that they will be successful until the national government is faced with statistics that show that no new housing is being produced

Mr Szatmári's company is a true development company, as it does not have a construction arm It has worked with several contractors in the city on the construction of both municipal developments and private homes Nyírber Kft is a formerly state owned enterprise, which is now owned by the employees as a result of privatization It has financed construction in the past by either pre-selling the housing units, or utilizing the construction loan interest subsidy program and selling the units after construction completion However, the market is not currently strong enough to pre-sell units and the construction loan subsidy program does not reduce the interest rate to a level that assures an adequate profit margin In addition, the construction loan subsidy program prohibits pre-sale of the units

According to Mr Szatmári, an association of residential housing developers is desperately needed Legislative reform is necessary and market data should be made more readily available It would also be helpful to have a ready pool of investment capital available to qualified developers to assist them in meeting the banks' collateral requirements He feels that he had a good relationship with the local government in Nyíregyháza during the negotiations surrounding the Samovar Street site, but felt that they should have been of greater assistance in locating collateral investors, or posted the required collateral themselves The local governments should be an equal partner in these ventures, and the developer should not be expected to post the entire collateral himself

10/17/96

Meeting with Mr Gábor Aczél, SEM IX, Budapest

SEM IX is a company owned by a French bank, the Caisse des Dépôts et Consignations (CDC) CDC is a public sector lending institution created in 1816 by Napoleon Though it serves a primary market maker and dealer in French government securities and bonds of French public sector entities, it also finances France's public housing and is the country's largest owner of social housing In 1995, CDC financed the construction or acquisition of 90,000 rental housing units and the renovation of 200,000 existing units CDC also has 500 special purpose, semi-public subsidiary corporations called SEMs located throughout Europe CDC provides these SEMs with both construction financing and equity capital for residential housing developments In addition, it provides property management services and support

In Hungary, SEM IX has a staff of five and a capital base of 70 million HUF Last year, SEM IX had a profit of 6 million HUF, which will be used as equity capital for new developments At the current time, SEM IX is predominantly involved in the reconstruction of a 12 block area of District IX in Budapest SEM IX just completed its first 13 unit residential housing development with ground floor retail space The units sold at approximately 100,000 HUF per square meter In addition, SEM IX has completed a day-care center for 125 children and a convent They are currently in the feasibility stage of another housing development in District IX and an incubator building for industrial enterprises on a 120 hectare, former slaughterhouse site

The French supervisory committee recently authorized SEM IX to perform work in other districts in Budapest and in other municipalities in Hungary They have completed feasibility studies for District XXI on a proposed housing renovation project and in District VIII on the Futó utca site targeted for new housing construction SEM IX is optimistic that its work during the feasibility phase will lead to a role as co-developer of the sites If SEM IX becomes involved in the development of these sites, a separate joint venture partnership will be formed for each site and 51 percent will be owned by the local municipality, 24 5 percent by the French bank CDC, and 24 5 percent by OTP Bank (not OTP Ingatlan Rt , the real estate subsidiary)

Though CDC will provide construction financing, SEM IX is currently exploring alternative sources for construction financing, such as the European Bank for Development and Reconstruction, the MBFB (Hungarian Investment and Development Bank), and the Budapest Enterprise Development Corporation SEM IX has also explored the possibility of substituting MBFB as a future shareholder in its joint venture partnerships, in place of OTP However, MBFB is primarily a commercial bank, not accustomed to thinking about making money through the long-term investment of capital in real estate MBFB has regional branches that would be helpful in the financing of developments outside of Budapest

SEM IX expressed similar frustrations with the recent national government changes in the housing programs, and feels that these changes have restricted any new housing construction activity and essentially killed market demand for new housing units

Meeting with Mrs Ilona Szabó Beharka, Developer, Budapest

Mrs Beharka is the owner of a development and construction company called Beharka Építesi Vallalkozas, which has 26 employees and approximately the same number of subcontractors She is a former construction manager for a state-owned enterprise She formed her own company in 1991 and at that time employed 12 people About three years ago, she stopped constructing developments for companies and began concentrating on the construction of market rate single-family houses for private individuals She has found that private individuals are more reliable when it comes to paying on time, and has had very few developments stop construction due to non-payment since switching her clientele Her clients are primarily wealthy individuals, including foreigners Individuals pay her company in installments This effectively decreases the amount her company must invest in the project

Beharka Építési Vállalkozás constructs approximately three houses per year with a total production of 15-20 houses over the past five years Her houses range in size from 300-1,000 square meters and have sold at prices up to 100 million HUF Since it is difficult for development companies to receive development or construction loans, financing is the responsibility of the owner Development companies generally have a 20-25 percent profit margin, while interest rates are at 34 percent, which makes construction loans unaffordable The company's profit margin is 20-25 percent, and her final costs are usually within 10 percent of her pre-construction estimates She works from a full set of architectural plans and specifications and does a complete trade item breakdown prior to construction commencement Most of her construction materials are Hungarian, except for some imported finish materials and appliances The cost of infrastructure improvements and public utility connections are usually paid by her, and only in one case was she able to get the municipality to pay for such costs The company also was responsible for the renovation of the Budapest Bank

Mrs Beharka's clients usually find sites through advertisements However, her company will find a site for a buyer via real estate brokers if she knows in which areas the buyer is interested

The company is currently constructing its first multi-family development, which consists of 13 market rate housing units located in a suburb outside of Budapest All of the units were pre-sold, and down payments of one third of the unit price were required prior to construction commencement, with the balance of the unit price being pre-paid during construction Mrs Beharka has never borrowed construction financing from a bank as the interest rates and collateral requirements are too high She also does not carry insurance as it is too expensive, but hires a night watchman to protect the property and has fortunately never had an accident involving injury to a worker Her biggest competition comes from companies that employ black market labor, which allows them to underprice her company She would like to see the government crack down harder on companies that employ black market workers

Mrs Beharka does not consider training a priority and feels that most developers are not interested in it

She said that housing is not being built or renovated for the middle class Developers are open to working with middle-class clients if they have enough capital to finance the project When asked if she thought there were other solutions outside state subsidies or municipal subsidies to build housing for the average Hungarian, Mrs Beharka confirmed it was nearly impossible for an average Hungarian family with children to save enough money to buy a flat They could only afford to do so if they had access to subsidies or low-interest mortgage loans

10/18/96

Meeting with Mr Béla Kis-Csontos, Keviterv Akva, Szolnok

Mr Kis-Csontos' company was designated developer of a municipally owned site and signed a contract with the Szolnok local government in January 1996, as part of a USAID-sponsored project to foster public-private partnerships During the long 2½-year negotiation period, many changes were made in the national housing programs that decreased the market for potential buyers of the 24 proposed housing units In addition, in 1995, Szolnok had the second or third worst economy in Hungary and had the lowest level of housing production Many young residents are moving to Budapest to find employment Fortunately, Mr Kis-Csontos has been able to keep his company active and retain his 46 employees with the construction of two water distribution systems for the local government Keviterv Akva's main focus to date has been the design, supervision, and construction of water channels for the municipality The water channels are paid for by the municipality, which uses taxes paid by county residents and funds from a subsidy from the national government to cover the development costs

There have been numerous delays in the Szolnok project Keviterv Akva was forced to wait 1½ years before it obtained a contract from the municipality The first project bid was submitted to the municipality in November of 1993, yet the contract with the municipality was not signed until January 1996 Difficulties in obtaining licensing provisions and forced modification of the project design have also delayed the project According to Mr Kis-Csontos, a major cause of the delay has been the lack of buyers This has prompted Keviterv Akva to proceed slowly on the project

The contract with Szolnok has a three-year time period for performance, i e , construction must be completed or ownership of the land will revert to the local government As a result, Mr Kis-Csontos is redoing his architectural plans and will propose to the local government that the development be completed in two phases The first phase will be 12 units of which four are pre-sold In addition, 80 percent of the ground floor commercial space has been pre-sold Marketing efforts have included advertisements in all the local newspapers, on the radio, and on television, but have yielded no additional pre-sales Mr Kis-Csontos has invested over 15 million HUF in the development to date for architectural plans, public utility connections, demolition of structures on the site, and disposal of materials In addition, the contract with the local government stipulates that the site's acquisition price will be 18 million HUF Mr Kis-Csontos stated that political differences with municipal officials have prevented him from asking for a reduction in the land price based on the costs he has incurred to date in preparing the site for construction

In exchange for the land, Keviterv Akva agreed to develop several social housing units for the municipality The funds being provided for the social units do not cover the cost of materials As a result, these units will not be built until the market rate units are sold If the municipality were to abandon the idea of developing new social units and instead purchase some of the market rate units to use as social housing from Keviterv Akva, the developer would be able to pay for the cost of the land The municipality would still have a mortgage on the commercial space and therefore would receive revenue from that space

Mr Kis-Csontos has received a preliminary commitment letter for construction financing from OTP Bank However, OTP is requiring 200 percent collateral for their loan and 50 percent of the housing units pre-sold Mr Kis-Csontos said that he is in a very precarious position financially, and could go bankrupt if he does not complete the development He is trying to develop a joint venture corporation with his subcontractors to help him meet the collateral requirements of OTP He is also considering asking the municipality to take back housing units in lieu of an acquisition price for the land, which would help him pass OTP's pre-sale requirement He wishes that there were a developer's association to help him lobby for housing program and banking reform, develop marketing programs, combat competition from black labor companies, and locate new sources of financing for housing construction

Meeting with Mr Ferenc Pataki, Chief Architect, Szolnok

Mr Pataki admitted that negotiations with Mr Kis-Csontos took much longer than anticipated due to political changes in the local government in Szolnok In addition, the national government's housing program reforms, unpredictable inflation, and stringent bank requirements have complicated the developer's ability to perform under the executed contract However, in his opinion, the developer should have been more prepared to locate buyers for the housing units, and his self-marketing efforts have been inadequate and too localized The local government even gave the developer access to local radio and television stations Yet the developer failed to fully exploit these marketing opportunities It is doubtful that the local government will agree to adjust the contractual performance deadline, as many of the new officials are not familiar with the developer and would have to acquaint themselves with the situation Other officials feel that the developer wanted to delay the negotiations because he could not obtain construction financing, and that it is his fault that his ability to access credit has deteriorated

The local government has also recently been approached by SEM IX, and, at their recommendation, invested 10 million HUF in the formation of an independent, non-profit development company The members of this company's Board of Directors are paid salaries and, unfortunately, the majority of them are political appointees with little or no real estate experience SEM IX has been hired by this company to perform feasibility studies for the conversion of the municipally owned, former Russian military base into housing and for the development of a tourism industry The local government had formerly issued an RFP for a small parcel of land in the military base, and one Canadian and four American development companies requested copies of the RFP, but none of them submitted a bid for the site Most of the local developers that responded wanted to shift the development risk to the municipality, and were reluctant to build rental units due to the national law that prevents eviction of renters The local government itself ended up constructing

24 socially assisted rental units on the site themselves No other housing has been built in Szolnok since that time other than private homes

10/21/96

Meeting with Mrs Jolán Csomós, OTP Bank, Budapest

Mrs Csomós is head of the Company Relations department of OTP

The majority of OTP's lending is for the purchase of homes OTP would like to do more lending for the construction of residential housing OTP is responsible for the administration of the construction loan interest subsidy program Their underwriting standards for residential construction loans do not differ from those used for any other type of OTP lending The real estate itself may be used as collateral, but the development company also undergoes a rating process However, the cash flow of the development company is rarely recognized as acceptable collateral Ms Csomós feels that, since April, OTP's collateral requirements have been reduced, but the depth of that reduction depends on the quality of the borrower Of course, 30-50 percent of the units also have to be pre-sold before construction begins OTP's lending decisions are usually made within 15 days of submission of a loan request

Out of a total entrepreneurial loan portfolio of 110 billion HUF, OTP has made 600 million HUF available in 1996 to finance housing construction loans under the housing construction interest subsidy program Only 4 million HUF has been lent under this program so far this year No other bank is so involved in housing finance The Commercial & Credit Bank is the only other bank financing housing construction, with four or five additional savings banks lending residential mortgages However, due to the high interest rates, very few medium-quality housing developments are built with construction loans Most developers require high down payments and prepayments of the purchase price from the home buyers to finance their construction activity

Although, as mentioned above, there is a construction loan interest subsidy program, the collateral requirements for participation in this program are very high Unfortunately, with the federal interest rate at 30 percent and a bank prime rate of 25 percent (23 5% + 1 5% administrative fee), the 75 percent construction loan interest subsidy (75% X 25% = 18%) still yields an effective interest rate to the developer of 12 percent (30% - 18% = 12%) The 75 percent interest subsidy is only available if construction is completed within a one-year period If a two-year construction period is required, the subsidy drops to 60 percent, and then drops to 25 percent if a three-year construction period is required Usually the resulting interest rates are too high to allow the small and medium-sized developers to borrow for construction and still achieve a comfortable profit margin

Ms Csomós feels that there is no housing shortage in Hungary because few people can afford to purchase housing with the existing subsidy programs She is optimistic about the contract savings program that will begin in January 1997, and feels that it will increase the real demand for housing Under the contract savings program, deposits are made over a four-year period The depositor receives an annual 40 percent match in the form of a government assistance grant, and earns a low rate of return (3 percent) on his funds At the end of the period, he receives a low

interest rate mortgage loan (6 percent) that is hopefully greater than the sum of his deposits and sufficient to purchase a housing unit Ms Csomos further stated that a new mortgage program is also under consideration by the national government that would complement the contract savings program

OTP would like to participate in a demonstration housing development, and feels it is important to show developers how housing construction can be accomplished She would also be interested in seeing a guaranty program OTP did have a guaranty program, but it was discontinued because the risk was too high [13] Even though OTP infrequently forecloses on its loans and is very careful with its underwriting, OTP inherited many bad loans from before it was privatized as a commercial bank, and has a high percentage of loans that need restructuring

10/21/96

Meeting with Mr Mihály Koszta, Máttra and Bukk, Ltd , Budapest

Mr Koszta is developing 220 housing units in District XIII in Budapest Ultimately, he hopes that the total development will consist of 600 housing units It has taken him two years to get the development underway, and five additional months to secure a building permit The first phase of the initial 220 unit development consists of 80 housing units It is currently under construction, and will take 12-14 months to complete The balance of the 220 units will be constructed in three consecutive phases of 80, 40, and 20 units, respectively

The development complex will contain two floors of underground garage parking, a swimming pool, fitness room, grocery store, bank, beauty parlor, doctors' offices, and 24-hour security Ten different unit types are being constructed within the five-story structure, including several townhouse style units Unit sizes range from 43 to 115 square meters, with an average selling price of 95,000 HUF per square meter The 80-unit first phase also includes 30 socially assisted housing units The total construction cost for the first phase is estimated at 750 million HUF, including 100 million HUF to construct the socially assisted units Mr Koszta is a fully insured contractor, and provides all unit buyers with a one-year warranty against latent construction defects

The firm is also developing 139 single-family homes about 20 km from Budapest Construction is scheduled to begin in the summer of 1997 Mr Koszta is anticipating that the firm will develop a building for senior citizens, and one for young couples who cannot afford to purchase flats The young couple, while renting a flat in this building, will buy savings certificates each month until they accumulate enough cash to either purchase a flat outright, or make a sizeable down payment The certificates currently carry an interest rate of 37 5 percent When the couple accumulates enough cash, they can either use the cash to purchase a flat or sell the certificates [14]

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[13] Theoretically, there are some guarantee programs that enable small and medium-sized enterprises to obtain credit USAID and OTP signed an agreement in which USAID agreed to guarantee loans through the SME loan program for a fee

[14] An example of how this would work is as follows
A young couple has a net income of 70 000 HUF per month Their rent and utilities equal 30 000 HUF per month Each month they purchase 10 000 HUF worth of securities At the end of two years the accumulated funds plus interest may be used as a down payment on a flat Mattra and Bukk can arrange a loan for them at half of the interest rate charged by the banks payable in five years, for the balance of the purchase price of the flat

Mr Koszta thinks that the savings certificate program is better than the government's proposed contract savings scheme He feels that after four years of saving under the contract savings plan the amount paid into the contract would be worthless due to inflation The savings certificates are therefore a much better investment, they are distributed by a real estate agency cooperative and are regulated by the Hungarian government

Mr Koszta was very cynical concerning construction lending practices in Hungary He feels that developers practically have to bribe loan officers to secure construction financing He prefers to finish construction one to two months late than to borrow construction financing Hungarian banks take stock in helping development efforts fail, and, as a result, housing developers are producing no where near the 40,000 housing units per year that should be being built to meet demand Mr Koszta's company employs 210 workers and could be building 160-180 housing units per year, but, due to governmental and financial restrictions, he is only able to build 80 units per year

Máttra and Bukk gives a one-year warranty on its construction work and carries several insurance policies to cover any construction defects The company has a policy that covers the building with a face value of 650,000,000 HUF and a policy that protects workers in case of injury valued at 40,000,000 HUF The policies are with Generali, which Mr Koszta considers to be the best insurance company operating in Hungary

Mr Koszta is very proud of the fact that his company is able to offer five-year mortgage loans to his buyers at one half of the bank's base interest rate He would not provide any details on where he obtains the funding for these loans, other than to say that it came from investors Mr Koszta also scoffs at the proposed contract savings plans He believes that the growth of the buyers' deposits will fail to keep up with future inflationary increases in housing prices, and that the funds available at the end of the contract term will be insufficient to purchase a housing unit

Mr Koszta said he would be interested in participating in an Association of Real Estate Developers if the Association had worthwhile, realistic goals

10/22/96

Meeting with Dr József Hegedus and Dr Iván Tosics, MRI, Budapest

Bill Claggett, Sharon Lowenthal, and Toni Sanders met with Jozsef Hegedus and Iván Tosics of Varoskutatas Kft (MRI) to discuss options for offering technical assistance to the developer sector

József and Ivan would like to see the upcoming work plan address three areas The first area would be to foster a deeper understanding of the type of enterprise that is attempting to develop housing How large are these companies? What are their long-range goals? How much housing are they producing? What constraints and obstacles are they experiencing in the development of rental housing? The second area would be to explore what reforms are necessary to improve the housing assistance programs, to combat black market labor, and to improve the access to equity and financial resources The third area would be to develop a way to educate developers and

government officials about the constraints in the development process, why reform is necessary, and how new assistance programs could be used to produce more housing

József is a member of the Hungarian Housing Policy Committee and has links to the Central Budget Office The Committee is chaired by the Minister of Finance, Tétenyi Every ministry of the national government that has any responsibility for housing (such as the Ministries of the Interior, Social Welfare, the Environment, Law, and Industry) is represented on this Committee In addition, local governments, NGOs, housing owners, housing experts, and housing managers have representatives on the committee In the past, the Committee had no substantive role in making government decisions József suggested that a subsidy subcommittee be formed in order to suggest a program of subsidy reform The aim of this program would be change tax incentives and the existing subsidy programs to support a shift in the housing market The Ministry of Finance is also currently working on a new construction program for low- and middle-income home buyers

It is important that any technical assistance to developers be supported by someone at the national level A link with such a person could be established through the Housing Policy Committee Bill Claggett explained the concept of establishing special enterprise zones to test special tax incentives and loan guarantees Such a pilot demonstration could lead to a program that could be duplicated throughout the country, if it successfully demonstrated that housing development could be facilitated without a great financial drain on the government

Iván feels that all suggested reforms should be linked to demonstration developments National and local governments must be involved in the development of joint public-private partnerships He does not believe the Futó site would be appropriate for a demonstration development, as District VIII's mayor is in conflict with the Ministry of Finance and the local government is too difficult politically Iván will try to come up with better locations for a public-private demonstration development József will try to determine where better development cost and market data could be obtained

Meeting with Mrs Maria Kollár Szekeres, Providencia, Budapest

Providencia is a 17 billion HUF firm that is part of the Generali Group, an Austrian/Italian insurance company, with offices in Vienna and Trieste The company employs over 2,000 people in Hungary (1,500 by Providencia, 500 by Generali) It is the third largest of 15 insurers currently operating in Hungary [15] The majority of Providencia's premium income comes from the provision of open peril, broad form property insurance Only two other insurers in Hungary provide a similar form of property insurance — Hungaria and Ahico Though Providencia insures all types of property, it collects over 200 million HUF annually from premiums on residential real estate The premium on a property insurance policy depends on the size and type of development, but ranges from 2-3 percent of each 1,000 HUF of property value, which is relatively inexpensive In January 1996, the national government enacted an insurance act, which requires all insurers

[15] In 1989 there were only two state-owned companies operating in Hungary Hungaria and Allami Biztosito These firms have since been purchased by Alliance and Ægon

to be supervised by a national insurance commissioner Providencia developed a standard property insurance policy, based on a French model, which was recently approved by the commissioner

Providencia also offers a form of worker's compensation insurance In Hungary, if a worker is injured, social security pays the worker, and the employer is responsible for reimbursing social security for these payments, whether or not the employer is found liable for the injury Providencia's insurance pays the employer an amount sufficient to reimburse social security, but only in the event that the employer is found not liable for the worker's injury Subcontractors must carry their own liability insurance, and are not covered under the general contractor's policy

Mrs Szekeres stated that no type of surety bonds or insurance coverage is available to insure a contractor's completion of construction either in Hungary (or throughout Europe to her knowledge) It is common for a 10 percent construction retainage to be held by the construction lender for two to three years after construction completion to cover the cost of repairing any latent construction defects Providencia does offer a third form of residential insurance that covers that portion of the cost of repairing any latent construction defects that exceeds the 10 percent retainage

Meeting with Larry Birch, USAID, Budapest

Bill Claggett, Sharon Lowenthal, Olga Mendez, and Toni Sanders met with Mr Birch to discuss their findings and recommendations for technical assistance to the developer sector

Mr Birch liked the idea of trying to assess how the housing programs could be improved to overcome some of the existing constraints to residential housing development He also liked the idea of looking at ways to increase the access of developers to financial resources During our next visit, he suggested we assess the national government's interest in housing reform He also suggested talking to the European Bank for Reconstruction and Development and the World Bank about possible involvement in a demonstration development Any financial resource used in the demonstration must be available to developers long after U S involvement is terminated Twenty million dollars in Housing Guaranty funds are also available if the demonstration development applies to one of the participating banks There is also $8 million in unprogrammed funds that could perhaps be used as a guaranty fund, as long as 50 percent of the funds were used to increase housing affordability

Whatever form the work plan takes, it should have tangible results within 2½ years, using predominantly local institutions The demonstration development should be reproducible by and transferable to other localities It should act as a market catalyst changing the attitudes of developers toward the feasibility of housing construction and increasing the rate of future residential real estate production If the formation of an association is one of the goals of the program, it will only be successful if developers discard the old Soviet way of growing your business by withholding information from others and are convinced that the sharing of knowledge will improve everyone's profitability

The overall strategy and goals of the program should be coordinated with those of ICMA's regional managers, the Urban Institute, the World Bank, the training programs for association executives being run by the Center for International Private Enterprise, as well as MRI

3 The Private Rental Market

10/8/96

Meeting with József Hegedus, Iván Tosics, Sándor Erdősi and Andrea Iván of Metropolitan Research Institute, and Katharine Mark of the Urban Institute

The problem with the private rental market in Hungary is that no one knows very much about it The number of private landlords is not known, nor is the number of units that are either being rented or left vacant This is partly due to unwillingness of landlords to publicize the fact they are renting their flats Traditionally, landlords were required to pay a substantial tax on rental income

There has been a change in the rate of taxation for rental income Apparently, a change to the tax regulations was passed in 1996 that requires that private landlords pay 5 percent of the income they earn from the rental of flats This is an improvement, as the percentage was previously much higher We must clarify the tax changes relevant to private rental housing and development that occurred in the past few years

József and Iván suggested that a study of the rental market be conducted, which would provide us with market information on the Budapest market The study would provide information on supply and demand Indirect methods to obtain this information would have to be used Rental advertisements should be collected and the researchers would have to talk to real estate brokers, etc A lawyer must be consulted to obtain information on the latest tenant-landlord laws, enforcement policies, etc Of the 1,000 units covered in MRI's panel survey, 12 were rental units These could be analyzed as a starting point for the feasibility study

One suggestion for technical assistance is to provide private landlords with up-to-date information on applicable laws and tax regulations

Another potential project would be to advise a local government to establish a company, partly owned by the local government, to allocate, rent, and manage rental flats at a cost somewhere between the current rents for municipally owned flats and private market rents

Government assistance in real estate investment would be an incentive to entice investment in the private rental sector The logical type of assistance would be a system of tax incentives

A tax incentives expert could be used to assist in the analysis of the private rental sector, to review available literature, and to prepare a profitability analysis of the private rental market

A possible outcome of the next three months could be to design a survey and test the methodology

10/21/96

Meeting with Mrs Blasko and Mrs Rácz, Resideal Kft , Budapest

Resideal is a real estate company that handles both sales and rentals, primarily in Budapest The company's clients are mostly foreign companies that rent housing for their expatriate employees The company works with landlords who rent housing in Districts I, II, XI, and XII Most landlords rent exclusively to foreigners Some Hungarian companies, both new and established, rent units for commercial rather than residential use

There is a demand from Hungarians for studio apartments No stock, however, is available on the market This is because Hungarians can generally afford rents of 35,000 to 40,000 HUF per month Luxury units, however, command rents of 1,000 HUF per square meter, while Hungarians are generally only willing to pay 700 to 1,000 HUF per square meter Renters who do not wish to pay a premium for space do not come to Resideal

Landlords have recognized that foreign businessmen have different aesthetic tastes than the average Hungarian, and have begun to renovate flats according to these standards

When Resideal was established, its mandate was to find industrial spaces for business clients For residential units, its clients are usually companies, since individuals generally do not want to pay any commission The commission is equal to 3 percent of the sales price of the unit, or one month's rent

Resideal helps locate warehouses, office buildings, and industrial sites for its clients It also addresses its clients' housing needs Foreign clients, who are not planning to live in Budapest for an extended period, generally prefer to rent rather than buy office spaces Rent can be considered an expense item rather than a capital expenditure, and can therefore be used as a deduction from gross income

Resideal helps obtain luxury housing rentals for its clients, but this is a small part of its activities When asked about the level of business investment in rental housing, Mrs Racz answered that some business people buy blocks of flats and rent them out It is her opinion, however, that after these units are renovated, they are too expensive for most Hungarians She said that most of the private rental of lower-cost flats occurs when parents purchase flats for their children, and rent out the flats until the children become adults

Mrs Rácz said that the housing situation in Hungary is difficult for young people, who cannot afford either to purchase or rent flats in the city These couples tend to build their own houses at the periphery of the city or in the suburbs Flats can still be purchased in Budapest for less than 10 million HUF in the less fashionable sections of the city Demand is high for lower-cost housing

Mrs Rácz does not know the number of luxury flats that either are being rented or are on the rental market Mrs Blasko said that she thinks that there are roughly 5,000 in Budapest, and that

currently there is a shortage of this type of flat They suggested that we visit specialized housing rental agencies

Mrs Rácz said that Hungarian landlords used to rent out flats for use as office space This trend is decreasing because numerous office buildings have been built in the center of town These office buildings are equipped with infrastructure and offer various services Therefore, flats in residential buildings are less competitive than suites located in offices buildings

Resideal works mostly with companies that want to rent or buy space, and also with particular properties The company filters buyers to determine who is seriously interested in a given property Resideal works hard to match supply with demand Because of the commission Resideal charges for its services, its clients must be prosperous enough or busy enough to agree forego finding the appropriate space on their own

Commercial lessors generally require lessees to sign rental contracts that have strict provisions These contracts generally include an eviction clause that states that nonpayment of rent may be punishable by eviction Other clauses require that the unit is left in the same condition as it was when the lease period commenced

Mrs Blasko and Mrs Rácz said that all agencies use similar rental contracts These contracts, however, can be concealed from the tax authorities When asked if they thought we might be able to discuss the situation with landlords of private rental flats, they said that this would be difficult, as private landlords are reluctant to reveal themselves and their activities

10/23/96

Meeting with Mr Fellner, Founder of Pension, an Association of Landlords, Budapest

Rather than being an association of private landlords, this organization is for owners of short-term vacation rental property, those who manage these properties, and related service providers

Mr Fellner feels that housing is affordable in Hungary and that 50 percent of Hungary's population could own a home after one year if they worked hard and saved their money During the previous regime, the average Hungarian would receive a flat almost for free after waiting 8-10 years According to Mr Fellner, this has resulted in a lack of willingness among today's youth to work hard to own a home Due to past conditions, he feels that today's youth are accustomed to being paid whether they do a good job or not and that people are not accustomed to creating conditions to further their career advancement

According to Mr Fellner, there is a large number of apartments available and no demand for them Developers and investors put their money in the bank rather than in real estate due to lack of demand for housing He feels that the government should assist people by providing them with free or quasi-free modest, low-comfort units (one room/one room and kitchen) and in return expect the person to improve the units themselves (e g , install plumbing)

Mr Fellner founded Pension, a nonprofit association, in 1993 He felt there was a need for a central location to which a person could come to rent an apartment Rooms, pensions, and hotels are primarily rented to visiting guests and companies An average Hungarian could not afford these units Most apartments are rented to foreigners for one to two days, but some are long-term rentals He feels that it is more profitable to rent at a much higher rate for one night than for a lower rate for one month Breakfast, sheets, and towels are provided

The association was founded with the purpose of finding continuous work for its members Members do not charge time they devote to the association since their companies benefit directly, as a result of their work, they receive commissions and/or employment The association maintains a directory of quality services and rates each service provider The information provided by each member is recorded in a computer database program and is accessible to all of the association's members This allows each member to know the quality of another member's work or service Using the computer program, members can contract with other members for services needed in their hotels, apartments, and pensions Members are confident in each other's work and there is a level of trust among service providers and property owners that otherwise would not exist

The association membership consists of real estate owners and those individuals managing or operating properties (including the individuals who actually rent out the units, those who provide maintenance and construction services to the properties, and laundry services) A property owner is usually an investor who owns 3-15 flats The average investor generally has nothing to do with the operation of the apartment Members of the association find the apartments for the investors, contract for and manage any necessary renovation, rent the apartments to the guests, and act as brokers Members hear about the association via word of mouth and through advertisements for service providers There are 150 member companies that belong to the association Each company designates one of its employees to be an association member Most of the member companies have 6-8 employees

The association provides approximately 1,000 people with work Among the members are 10 companies that own and operate properties Non-associations may have access to the service database

The association provides a reasonably priced advertising vehicle for its members A company would have to pay 1,000,000 HUF to participate in a promotion fair The association, however, published a glossy brochure about its properties and available services Each advertiser only has to pay 100,000 HUF Those companies that actually market available units are not included in the brochure However, each day the association's reception area is manned by a representative of a different marketing company, and is able to steer clients to that company's listings According to Mr Fellner, this is such an effective marketing tool that the one frequently finds a company's managing director manning the association's reception desk

Annex B
Concept Paper on a Proposal for Technical Assistance to Developers in Hungary
by
William Claggett, Sharon Lowenthal, and Antonia Sanders

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1 Background

In the next several years, USAID will focus on strengthening small and medium enterprises in Eastern Europe as a vital part of a developing market-oriented economy The development of small and medium enterprises is critical to Hungary's transition to a sustainable market economy Currently, the greatest constraints to the success of small and medium enterprises in Hungary are lack of access to credit, insufficient access to market and technology information, lack of knowledge of business systems and practices, and the existence of a tax structure that provides few incentives for small and medium-sized businesses and inhibits the honest reporting of labor utilization and revenues Technical assistance efforts in the next few years must focus on the removal of these constraints

Housing production is essential to meet one of the basic needs of Hungarians and is a fundamental aspect of a sound, balanced, and growing economy The housing industry is comprised of numerous small, medium-, and large-sized enterprises The housing industry in Hungary is currently experiencing a serious and prolonged depression Field research and low overall production rates overwhelmingly describe an industry in crisis The lack of housing development is due to various financial, legal, administrative, and market constraints In large part, these problems are institutional in nature That is, issues of financing, taxation, social subsidies, and market demand are entwined with the condition and practices of the banking industry, knowledge of market conditions, public understanding, national and local government planning and practices, functioning of labor markets, and developer competence The recent changes in the national housing programs, depressed local economies, spiraling inflation and high interest rates on loans, high collateral and pre-sale requirements of lenders, high value-added taxes (VAT) on construction supplies, black market labor, unit prices not meeting market demand, ineffective marketing techniques, few effective mortgage loan programs, and insufficient investment equity are just a few of the obstacles that must be overcome by residential housing developers

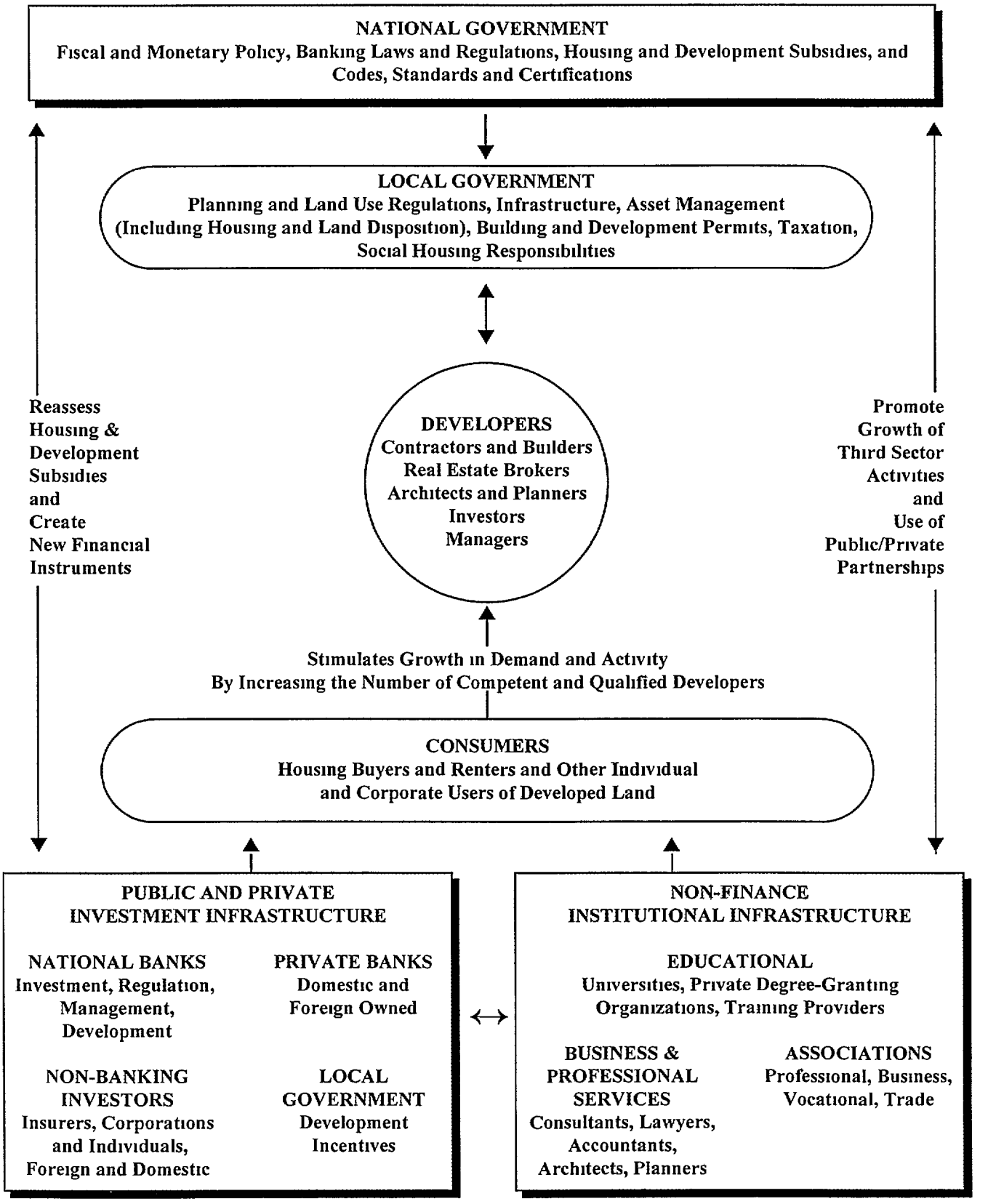
In attempting to address these constraints, the housing sector in Hungary faces further obstacles due to the lack of accurate production figures, lending statistics, market data, and, most importantly, technical knowledge to assess development feasibility Few developers actually pre-test the financial viability of a proposed development, and proforma projections are rarely prepared There is a vital need for a technical assistance program that incorporates all of institutional components of housing production, and demonstrates new tools, techniques, and processes that can be used on a broader scale to stimulate production and meet latent demand with more suitable methods of financing than are currently available

National and local governments must also be included as a full partner in strengthening the housing sector Housing assistance programs are currently pushed and pulled by national ministries trying to juggle political interests and tight budgets, and are frequently amended or eliminated altogether Many developers have invested substantial equity in projects only to have an amendment in the housing programs diminish the project's feasibility Local governments complicate these woes by imposing an added layer of politics and bureaucracy to the real estate development process, and by failing to understand how successful real estate development positively affects the financial condition of the city

PADCO's proposed program is designed to address the issues described above and to produce tangible results within the next two to three years It builds on our previous work to create public-private partnerships between municipalities and private developers to stimulate housing production and attempt to transfer the experience to different localities The attempt to successfully introduce this process in Hungary, however, was impeded by the problems noted above Much of what was learned through the effort to successfully introduce and assist public-private partnerships and from the PADCO team's visit to Hungary in October 1996 helped form the basis of what is proposed below

2 The Housing Development Enterprise Zone Project — A Comprehensive Approach to Stimulating Housing Production in Hungary

The following figure illustrates the primary elements of the housing development industry in Hungary It identifies the major government and private sector entities that affect and/or are involved in housing production It also shows the critical role played by housing consumers in establishing demand and the importance of stimulating that sector of the industry More important, the figure illustrates the need for effective relationships, or partnerships, among the various entities in both solving the more critical institutional barriers and constraints to housing production and in the actual production of housing itself It is a pictorial representation of the types of institutions that must be included and needs that must be addressed if technical assistance to the developer sector is to be effective


NATIONAL GOVERNMENT
Fiscal and Monetary Policy, Banking Laws and Regulations, Housing and Development Subsidies, and Codes, Standards and Certifications
LOCAL GOVERNMENT
Planning and Land Use Regulations, Infrastructure, Asset Management (Including Housing and Land Disposition), Building and Development Permits, Taxation, Social Housing Responsibilities
Reassess Housing & Development Subsidies and Create New Financial Instruments
DEVELOPERS
Contractors and Builders
Real Estate Brokers
Architects and Planners
Investors
Managers
Promote Growth of Third Sector Activities and Use of Public/Private Partnerships
Stimulates Growth in Demand and Activity
By Increasing the Number of Competent and Qualified Developers
CONSUMERS
Housing Buyers and Renters and Other Individual and Corporate Users of Developed Land
PUBLIC AND PRIVATE INVESTMENT INFRASTRUCTURE
NATIONAL BANKS
Investment, Regulation, Management, Development
PRIVATE BANKS
Domestic and Foreign Owned
NON-BANKING INVESTORS
Insurers, Corporations and Individuals, Foreign and Domestic
LOCAL GOVERNMENT
Development Incentives
NON-FINANCE INSTITUTIONAL INFRASTRUCTURE
EDUCATIONAL
Universities, Private Degree-Granting Organizations, Training Providers
BUSINESS & PROFESSIONAL SERVICES
Consultants, Lawyers, Accountants, Architects, Planners
ASSOCIATIONS
Professional, Business, Vocational, Trade

It is proposed that USAID, in cooperation with the national government of Hungary and participating municipalities, establish a demonstration program that will increase the capacity of Hungary's private housing developers to produce housing in a competitive, market-based environment The other program objective is to remove impediments at the national and local level to the private production of housing and to provide a replicable process by which the public and private sectors can work together in the development of housing

The Housing Development Enterprise Zone (HDEZ) program would be a demonstration project in which new laws and regulations affecting the development of housing, new construction finance instruments, and new insurance products could be tested in connection with actual development/ redevelopment projects If these new laws, instruments, and products are effective in removing or relaxing the impediments to housing development, and results are shown to be replicable, this could lead to permanent legislative change The demonstrations could serve as models for development projects throughout the country

There would be four components to the program, which could either be undertaken simultaneously or could stand alone These include

- working with the national and local governments to promote legislative change,
- working with banks and insurance companies to develop lending mechanisms and products,
- training of national and local government officials, bankers, and developers, and
- conducting actual housing development/rehabilitation demonstration projects

The HDEZ program would include

- Designation of up to three sites (in Budapest and two other cities) for the development of new housing and/or rehabilitation of existing housing consistent with the local and regional needs These sites would have existing plans for development/redevelopment that were stalled due to one of the constraints listed in the Background section above
- Working with the national government and banks to evaluate existing laws and regulations pertaining to land use controls, design standards, construction lending, mortgage banking, and other controls over how projects are developed, financed, and marketed For the designated HDEZ sites, some of the laws and regulations would be revised to overcome some of the constraints to the development of housing
- Working with the national government, participating local governments, and banks to design new tools to assist municipalities and developers with project financing These new tools would be tested in the three demonstration sites
- Commitment from the national government, in partnership with USAID, to allocate a portion of financial assistance to the HDEZs for housing development in the form of one or more of the following more equitable construction lending, guaranteed construction loans, or guaranteed mortgage loans, etc
- Technical training to be offered to facilitate the shift away from the government's traditional role of a housing provider to one of a housing enabler This training could be offered through a Hungarian Land Development Institute, which would foster the interests of developers and

others associated with land development Activities would include training and education programs and the provision of assistance to local governments interested in upgrading their development planning and execution

- Pre-qualification of developers who would be interested in bidding on the HDEZ demonstration projects
- Establishment of a "Development Incubator," an entity that would consist of on-the-job training on an actual development project Training would be offered to developers on assessing the financial feasibility of projects, job costing, marketing, and responding to Requests for Proposals Only pre-qualified developers would be admitted to the incubator, and only developers associated with the incubator could bid on the HDEZ demonstration projects Participants would have to agree to adhere to all of the experimental laws and regulations in effect at the demonstration site and would have to make their accounting books and records transparent and accessible to the USAID HDEZ team This would enable the team to determine the financial ramifications of the experimental regulations

3 Expected Results

The HDEZ demonstration program would be in line USAID' s Strategic Objective 1 3 Improved, more sustainable business operations, by aiming to achieve the following results

- increased accessibility of construction financing for the use of private housing development firms (SO 1 3 1, Capital available to businesses),
- creation new mechanisms to address the collateral and equity needs of private development firms (IR 1 3 1 2, Equity venture capital provided),
- demonstration of a process by which the public and private sectors can work together to remove the impediments at the local level to the private production of housing (SO 1 3 2, Business skills and system developed),
- increased availability of production figures, lending statistics, and market data to private housing development firms (SO 1 3 2, Business skills and system developed),
- technical training to foster the replication of demonstration developments and improve the skills of private developers in assessing the financing feasibility of proposed projects (IR 1 3 2 2, Business lessons disseminated),
- increased housing starts by private housing development firms, and
- increased number and employment base of private housing development firms

The HDEZ project would also help remove the impediments at the national and local level to the private production of housing and provide a replicable process by which the public and private sectors can work together in the development of housing This relates to USAID's Strategic Objective 1 3 3, Policies, laws, and regulations conducive to enterprise profitability in place The aim would be to achieve the following

- evaluation and reform of existing construction financing subsidies to increase accessibility of these funds to private housing developers (SO 1 2 2, Policies, laws and regulations conducive to enterprise profitability in place),

- evaluation and reform of existing national tax laws to improve the financial incentives of private housing production (SO 1 2 2, Policies, laws, and regulations conducive to enterprise profitability in place),
- evaluation of local approaches to residential development to highlight the legal and policy reforms required to facilitate zoning approval, land valuation and transference, infrastructure and improvements, and housing construction (SO 1 2 2, Policies, laws, and regulations conducive to enterprise profitability in place),
- promote local government participation in public-private partnerships through HDEZ demonstration developments located in Budapest and east and west Hungary, using improved programs (SO 1 3 2, Business skills and system developed),
- increased local and national government participation in new housing constructed by private housing development firms, and
- increased number of units built as a result of public-private partnerships

4 Complementary Technical Assistance Effort — Facilitating Consumer Access to Housing

The aim of the technical assistance effort outlined above is to increase the supply of housing in Hungary Some of the obstacles to housing development, however, are connected to the consumer's limited ability to purchase housing, which is a result of the lack of effective mortgage loan programs, ineffective subsidy programs, and insufficient investment equity A program to increase housing development must address the demand as well as the supply side, and must aim to achieve the following

- improved national housing programs that facilitate the sale of residential units to consumers,
- improvement in marketing techniques to increase the pool of potential buyers for new residential housing units, and
- evaluation and reform of existing national housing subsidies and mortgage programs to better facilitate the marketability and sale of residential units to consumers

USAID attempted to achieve some of these results by introducing a new mortgage loan instrument, the Housing Guaranteed Loan Program (HG) This program has never been successfully implemented In connection with the HDEZ demonstration program, the issues connected to consumer accessibility to credit should be revisited USAID must address the problem of the consumer credit and targeted housing subsidies with the national government

5 Next Steps

The elements of the proposed HDEZ program outlined above in Section 2 subsume a number of issues and actions that must be further defined for implementation In addition, refinement of the HDEZ concept will require a collaborative effort involving key agencies of the national government, USAID, local government officials, and educators/practitioners involved in the housing production system

A consensus must be reached among the participants of the proposed program on the following aspects of the housing industry in Hungary

- Housing production is a fundamental aspect of a sound economy and is essential to meet the needs of the Hungarian people
- There is a housing production crisis in Hungary
- Housing production involves a number of institutional constraints and barriers, any one of which is sufficient to depress the industry
- Piecemeal approaches will not resolve the many underlying issues that currently inhibit the growth of a healthy housing industry
- A comprehensive method of resolving housing industry problems is desirable
- It is important to develop new tools and techniques that facilitate and encourage the growth of an effective development sector of the housing industry, and at the same time stimulate and enable consumers to acquire new and/or improved housing
- Training and education programs are required at all levels of the housing system — for developers and would-be developers, government planners, and intermediaries (bankers, real estate brokers, architects, etc)

Although each of these statements or assertions is based on our understanding of the current housing development situation in Hungary, they need to be tested among key policy-makers at various levels of the government and among leaders in allied fields who are familiar with the various aspects of the housing problem

The focus of the PADCO team's field trip to Hungary in December will be to test the underlying assumptions of this proposal and to refine the elements of the HDEZ program defined in Section 2 The result of this effort will be a more detailed proposal for a demonstration program that can best define the practical steps that should be taken by the government and the private development sector to stimulate housing production in Hungary

Annex C
Financial Analysis of Rental Real Estate
by
Sharon Lowenthal

The financial analysis of a rental real estate investment initially involves four basic calculations

- **Net Operating Income** = The amount of cash annually received by the investor, including all revenues collected, minus all cash operating expenses incurred
- **Before-Tax Cash Flow** = The amount of cash annually received by the investor, including all revenues collected, minus all cash operating expenses and financial payments incurred, with the exception of income taxes
- **Cash-on-Cash Return** = The rate of return generated by the real estate investment as measured by the ratio of the before-tax cash flow to the amount of equity investment
- **Capitalization of Income** = The value represented by the real estate investment given its actual or projected net operating income

These four calculations provide a basis for not only measuring the actual or projected rate of return, but also for establishing the value of the investment to be acquired Through periodic recalculations, an investor can monitor the effect of various income or expense changes on the return on equity or market value of the investment Even if the investment is not producing income, these calculations still provide a measure of the opportunity costs involved in continuing to own the investment by computing the amount of annual loss, and, therefore, the amount of additional equity required to be placed at risk to cover these losses

1 Net Operating Income

Net Operating Income (NOI) is the amount of cash annually received by the investor, including all revenues collected, minus all cash operating expenses incurred By following the procedure outlined below, the net operating income for an investment can be determined

Gross Revenue	Basic rental rates Expense reimbursements Other income
- Vacancies and Concessions	Losses from unit vacancies Losses from poor collections or bad debts
= Net Revenue	Also known as Effective Rental Income

- Operating Costs	Administrative Maintenance Utilities Insurance Real estate taxes Replacement reserve (if applicable)
= Net Operating Income	Also known as Free and Clear Cash Flow

The calculation of NOI may be made with either actual or projected revenue and expense figures However, it is critical that a prospective investor know what kind of information is being used, particularly if the financial analysis is prepared by the seller In the West, lenders examine projected income and expense items very critically, and most will use only actual operating figures where available to determine the value of the rental real estate being offered as security for a mortgage loan The proportion of rental income allocated to each of the operating expense categories varies significantly according to the type of property, its age and location, and whatever agreements might exist between the landlord and tenant concerning the apportionment of expenses Allowances for replacement reserves deserve careful consideration and are especially critical in older properties subject to more rapid depreciation and higher maintenance expenses

1 1 Gross Revenue

1 1 1 Basic Rental Rates

The analysis of an income property should start with the establishment of the basic rental rates This involves locating comparables Comparables are rents or revenues generated by properties with similar features (e g , size, age, layout, amenities, quality of construction, etc) and in similar locations Newspapers offer a first source of comparable data, with the advertised rental rates usually slightly above the actual market The investor should also consult with local realtors and landlords to confirm the rental ranges of the existing competition, noting vacancies and any new developments to be offered for rent in the area Once the comparables are identified and it is determined that the proposed investment can compete in the rental market, a realistic standard can be set for the gross rental revenue to be obtained from the property

1 1 2 Expense Reimbursements

Often a tenant will agree to reimburse a landlord for certain expenses over the basic rental rate These expense reimbursements can be for such individual items as real estate taxes, heat, electricity, water, and insurance For a multi-tenant building, an individual tenant's portion of these charges can either be set as a flat amount, or as a percentage based on total space occupied In acquiring a property, it is critical to analyze the terms of each individual lease and to have a reporting system that takes such complexities into account

1 1 3 Other Income

Sources of other income include parking charges, furniture rental, special cleaning services, etc , and often represent a major source of supplemental income for housing investments Assumptions underlying such other income projections should be carefully examined, and the terms for the collection of such fees confirmed Local practices should also be analyzed regarding inclusion or exclusion of these items in the basic rental rates For example, if within a given locality, amenities such as parking are normally included in the basic rental rate, charging an additional fee for such parking could affect a development's competitiveness and decrease its overall occupancy rate However, other income may also represent an opportunity for the investor to increase the return on a marginal investment by charging separately for various amenities It is important to explore the unrealized potential that may come from the other income category when contemplating a future purchase or development

1 2 Vacancies and Concessions

A vacancy allowance is always necessary for rental real estate developments, and the difficulty lies in determining what is a reasonable rate Failure to incorporate such an allowance into the financial projections may materially distort the potential future return of an investment The investor should always keep an eye on the trends in local vacancy rates and prospective entries into the market that might adversely affect the proposed development Guidance can be obtained from local trade and business publications, existing competitive rentals, and changes in consumer tastes and spending patterns National economic trends, such as growth or reduction in particular industries, are also important to note

The vacancy rate should always be set as a percentage of gross revenue, including other income, and should not be underestimated The rate should reflect projected losses due to the inability to rent units immediately upon turnover and the inability to collect rental income from existing tenants Poor collection practices, as well as the extension of credit to tenants delinquent in all or a portion of the basic rent (i e , bad debt), can trigger such losses In addition, the vacancy rate should reflect any rental concessions (reductions)

1 3 Operating Expenses

Controlling operating expenses is one of the key elements in the profitability of a real estate investment Unfortunately, it is also the area in which the investor is subject to the highest degree of deception Information on current operating expenses is difficult to confirm, often unreliable, and almost impossible to project into the future Expenses vary in relation to gross rent, square meters involved, number of units, services provided, and the age, condition, and cost of the property In preparing forecasts, it is critical for the investor to understand the various categories of operating expenses One of the most frequent mistakes made in the analysis of operating expenses is leaving out a category of expense

1 4 Administrative

Rental, advertising, accounting, and management expenses are included under administrative operating expenses A residential property owner may choose to manage the investment himself, or contract with a local firm specializing in the management of similar properties The two primary trade-offs are cost and degree of owner involvement For smaller properties, the cost of contracting with an independent management firm may be prohibitive and severely affect the profitability of the investment However, most lenders will input an allowance for administrative expenses in considering the building's value Even if the intention is for the owner to perform the services, some cost or value should be imputed for the investment of this time and effort

Professional fees also should be included under administrative expenses Legal assistance may be needed in such areas as lease and financing negotiations An accountant may be necessary to file tax returns and prepare audited financial statements, as real estate investments often trigger special tax implications and reporting requirements Other administrative costs that should be included here are advertising, computer, telephone, and payroll assistance costs

1 5 Maintenance

The age of the building or rental unit is one of the prime determinants of the maintenance required Even if the maintenance history is known, simple projection of that history into the future will understate maintenance expenses substantially The design of a building, including the quality of materials and equipment, the number and sizes of units and public spaces, the accessibility of mechanical systems and exterior surfaces, and the remaining life of depreciating assets, will all influence the magnitude of future maintenance outlays Maintenance payroll for a janitor and supplemental staff, as well as employment taxes on that payroll, also represent a significant part of maintenance expenses The cost of maintenance supplies and contracts necessary to perform ongoing repairs, cleaning, redecorating of common areas, extermination, trash removal, and seasonal tasks, such as landscaping and snow removal, should not be forgotten Contractual costs for the maintenance and systematic upkeep of major building elements, such as boilers, elevators, etc , should also be included here

1 6 Utilities and Insurance

Both of these items are generally verifiable when purchasing existing properties and easily estimated by competent professionals for new developments However, considerable expense may be incurred if present utility costs are underestimated, and major risk is assumed if insurance coverage is insufficient A high acquisition price for an investment property may trigger the need for additional insurance

1 7 Real Estate Taxes

This is obviously dependent on existing and proposed real estate tax regulations in Hungary Taxes can be the single greatest source of uncertainty in real estate investment, as they almost always grow at unpredictable rates Before any investment is made, the investor should examine the public tax records for the property in question and make an analysis of comparable properties

1 8 Replacement Reserve

In any property, there are items that are subject to physical deterioration and, therefore, must be periodically replaced Carpets, roofs, appliances, and mechanical equipment will not last the economic life of the building It is critical, therefore, in calculating the cash flow to be derived from an investment to consider the impact of such required replacements If the investor cannot fund such replacements when needed, the relative attractiveness and future value of the property will decline Seventy-five percent of the value of the physical structure of the property, excluding land value, is often considered an appropriate level for annual contributions to the replacement reserve

2 Before-Tax Cash Flow

Before-tax cash flow is the amount of cash annually received by the investor, including all revenues collected, minus all cash operating expenses and financial payments incurred, with the exception of income taxes By following the procedure outlined below, the before-tax cash flow for an investment can be determined

= Net Operating Income	Also known as Free and Clear Cash Flow
- Financial Payments	Mortgage interest payments Mortgage principal amortization Land lease payments, if any
= Before-Tax Cash Flow	Also known as Cash Flow after Financing

2 1 Financial Payments

If a mortgage is placed on the real estate, the cost of the debt is the annual total of the interest and principal payments The size of the mortgage, the time period over which it will be paid off, and the interest rate all affect the cost of the debt and subsequently the return on equity to the investor To the extent allowed by the market, these items can be controlled by the investor and adjusted according to his needs The borrowing of debt can have a positive effect on an investor's return on equity, known as positive leverage If a mortgage can be borrowed at an interest rate that is less than or equal to the return that an investor can achieve on equity placed in an alternative investment, the mortgage will have a positive effect on the investor's return on equity This is because the investor will still have some return on equity remaining after making the payments on the mortgage debt Lower interest rates and longer amortization periods for mortgage debt obviously lead to higher return on equity

Of course, if the cost of the mortgage exceeds the return an investor is earning on his equity, the borrowing of debt will have a negative effect on the investor's return, known as negative leverage In this case, the investor may increase his return by using his own equity instead of borrowing to acquire the investment, borrowing less mortgage debt, or rejecting the investment altogether if the return on equity proves insufficient If mortgage debt is borrowed under these circumstances, the investor is not necessarily "losing money," but rather sacrificing some current return on equity to build up the equity position through the repayment of the mortgage debt Because equity build-

up cannot be realized until sale or refinancing of the building, it is usually not included in the calculation of cash return from operations

Financial leverage offers obvious benefits to the investor seeking to maximize return on investments Heavy use of leverage is normal in most real estate markets For the investor, leverage allows control of a greater asset base than would be possible simply through the use of equity Often non-recourse clauses in mortgage debt instruments, or a deed held in trust, limit the investor's risk to the equity interest held in the particular asset, with the creditor having no claim to other assets owned by the investor Since the repayment of the debt is a fixed sum, the rate of return on equity is increased rapidly in the event of appreciation in value, and similarly decreased or eliminated if the price of the asset should fall The use of heavy leverage, however, can increase the risk to the equity owner by placing a large cash drain on operations, causing a negative cash flow position, and often forcing a sale at an inopportune time when values for such properties are low

2 2 Land Lease Payments

Often the underlying land is not acquired as part of a real estate investment, but leased on a long-term basis To satisfy the collateral requirements of lenders, the term of such a lease usually must be equal to or longer than the term of any mortgage loan The cost of the lease payments must be subtracted from the net operating income to determine the before-tax cash flow

3 Cash-on-Cash Return

Cash-on-cash return is the rate of return generated by the real estate investment as measured by the ratio of the before-tax cash flow to the amount of equity investment Cash-on-cash is a basic first step in calculating the return of a proposed investment, but can also be useful in determining the effects of the costs of borrowing on this return By recalculating the return at various levels of debt, the most appropriate and profitable financial structure for the real estate can be selected

$$\frac{\textit{Before-Tax Cash Flow}}{\textit{Equity}} = \frac{\textit{Cash Flow after Financing}}{\textit{Equity}} = \textit{Cash-on-Cash Return}$$

The before-tax cash flow is one year's cash flow remaining after financing payments are made Equity is defined as the initial cash investment For these reasons, cash-on-cash return is often considered the most rigid measure of an investment's profitability and the toughest to pass This is because it is "static" in nature, reflecting only the initial year's cash flow and the initial equity investment The measure ignores any tax effect, the present value of future cash flows, and the future value of the investment upon sale or refinancing

The cash-on-cash return is then compared to the return that could be achieved on alternative investments If the cash-on-cash return yields a return higher than alternatives, the investment should be made only after carefully projecting and examining the prospects of future cash flow

and value appreciation Rental income can vary drastically with changes in occupancy rates and escalations in operating expenses, and inflation and unstable economic trends can wreak havoc on even the most thoughtfully prepared projections Such fluctuations make forecasting cash flow many years into the future extremely difficult Current estimates of future cash flow can, therefore, should be viewed as only tentative at best

4 Capitalization of Income

Capitalization of income represents a way to confirm the value of a real estate investment given its actual or projected net operating income Appraisers often supplement the value determined by the capitalization of income with an analysis of comparable sales, replacement cost, and the discounted value of future cash flows

$$\frac{\textit{Net Operating Income}}{\textit{Rate}} = \frac{\textit{Free/Clear Cash Flow}}{\textit{Capitalization Rate}} = \textit{Net Value of the Real Estate}$$

The capitalization rate that should be used is the rate of return that could be achieved on alternative investments The chosen rate is a measure of the perceived risk of investing equity in the real estate based on current and projected interest rates, expected return on equity, and future growth rates By using the net operating income, i e , the net income before any financing payments, the entire free and clear cash flow is assumed to be available to support the value of the investment The value that is determined by the capitalization of income should be equal to or exceed the proposed acquisition price for the real estate The investor must then decide how much of that value should be posted as equity and how much should be borrowed as mortgage debt The cash-on-cash return assists the investor in determining the most appropriate financial structure and loan-to-value ration for the investment

The before-tax cash flow can also be capitalized at the same rate to reflect the equity value of the investment

$$\frac{\textit{Before-Tax Cash Flow}}{\textit{Capitalization Rate}} = \frac{\textit{Cash Flow after Financing}}{\textit{Capitalization Rate}} = \textit{Value of Equity}$$

This can be used to determine whether the investor has selected an appropriate level of equity to be invested in the real estate If the capitalized value of the equity is equal to or greater than the actual equity to be invested, the investor will be receiving a rate of return greater than the capitalization rate If the capitalized value of the equity is less than the actual equity to be invested, the investor should reconsider whether the investment should be made

4 1 A Word about Future Value

Rental properties are obviously long-term investments and may generate cash flow for many years However, they are certainly not liquid assets and often lack marketability This is especially true during periods of high interest rates, low occupancy rates, or political uncertainty The investor must recognize that non-economic factors may affect the profitability of a real estate investment Consumer tastes may change, or new and unfavorable rent control and tax laws may be imposed Future appreciation in the value of real estate critically depends on the local economy and the physical condition of the immediately surrounding neighborhood Real estate investments are fraught with future uncertainties

Though the above measures of profitability are static in nature and do not take into consideration future cash flows or value, they are the toughest tests to pass Certainly, if a real estate investment cannot demonstrate profitability in the present, it will be difficult, if not impossible, for it to demonstrate it in the future The longer the time horizon, the more difficult it is to calculate future benefits Probabilities increase for major changes that may be either beneficial or detrimental to an investment's profitability Analysis of real property investments is complicated, and it is often well to err on the conservative side Projections of future income and expenses must always be considered to contain a risk

However, in any financial analysis, it often becomes necessary to make judgments about the future value of a real estate investment The degree of complexity in calculating and achieving the future value depends on the projected holding period, the nature of the property, the patience of the person attempting the sale or refinancing, and the complexity of the financial structure through which the property was initially purchased The reliability of the calculated value will also depend on estimates of many future conditions These include, but are not limited to, the physical condition of the asset, the economic and money market environment, changes in the physical neighborhood, consumer preference for the kind of property involved, the inflation rate, the rate of return on alternative investments, the tax position of the seller, and the contemplated holding period Despite the daunting nature of these uncertainties, the investor should attempt to estimate future benefits when evaluating any real estate investment

The next discussion will incorporate the net present value of future cash flows, the tax position of the investor, and sale or refinancing proceeds into the analysis of the profitability of a real estate investment

4 2 Tax Effects

Once the before-tax cash flow has been established, the second step is to calculate the effect of income taxes This is determined by first calculating the taxable income from the investment and then multiplying by the appropriate tax rate of the investor The amount of the tax is then subtracted from the before-tax cash flow to arrive at the after tax cash flow

Before-tax Cash Flow	Also known as cash flow after financing
+ **Replacement Reserve**	Not tax deductible until expensed
+ **Mortgage Principal Amortization**	Not a tax deductible expense
- **Depreciation**	Value of property (excluding land) deductible over its useful life
= **Net Taxable Income**	
* **Tax Rate of Investor**	
+ **Tax**	

If the investment is not producing cash flow, but instead generating operating losses and these losses are tax deductible against other income, the amount of these losses is considered a tax benefit and is added to before-tax cash flow to compute after tax cash flow Therefore, the calculation of after-tax cash flow is completed by deducting the taxes paid or adding the tax benefit of losses deductible from the before-tax cash flow

Before-Tax Cash Flow - Tax = After-Tax Cash Flow

4 3 Additional Questions to be Answered to Complete Rental Profitability Analysis

- Average market price of rental units acquired in HUF/sq m
- Average size of rental units acquired (sq m)
- Other costs involved in the purchase and sale of real estate — legal, brokerage, land transfer taxes, recording stamp fees, VAT, etc in HUF or percentage of acquisition price
- Average cost of improvements needed prior to rental in HUF/sq m
- Average rental rates in HUF/sq m Does this include any rental subsidies? What operating expenses are paid separately by the tenant, including inflationary increases in those expenses?
- What categories of operating expenses are normally paid directly by the owner/investor? How are utilities, real estate taxes (if applicable), insurance, and common area charges normally assessed, and who pays them?
- Average operating expenses in categories delineated above in Section 1, Net Operating Income (HUF/sq m), particularly those that are paid by owner/investor
- What, if any, real estate taxes are currently being charged? Are there any planned changes in the real estate tax rates?
- Percentage of total acquisition cost normally paid in equity by owner/investor
- Percentage of total acquisition cost normally borrowed from a lender
- Term (e g , 25 years), amortization period, and market interest rate for any mortgage borrowed, including second mortgages if applicable

- What is the debt service coverage ration normally required by lenders (NOI/Debt Service = 1 10, 1 15, 1 20, etc)?
- Income taxes that are paid on the annual income produced by rental real estate Who is taxable income calculated? What expenses are deductible from rental income? What is the marginal tax rate that is applied to the taxable income? Is the income taxed at individual or corporate rates? Are depreciation allowances allowed? Over what periods? Is personal property (appliances, etc) depreciated, and, if so, is it depreciated on a different schedule than real property? Is mortgage interest deductible? Are losses deductible against other income, other passive income, other business income, or just against income produced by the real estate investment?
- What are the appropriate inflation rates to use on rental income, operating expense categories (e g , inflation on utilities will be higher than on real estate taxes, etc), and the overall market value of the investment?
- What is an appropriate discount rate? What rate could an investor's equity be earning in an alternative investment?
- What is the current capitalization rate? The cap rate is generally derived by using a comparable sales approach, whereby similar properties that have recently sold are analyzed to determine their cap rates Is the appraisal industry mature enough to have begun to compute such rates? Otherwise, it can be guesstimated from lending rates and the equity ratio
- How are capital gains computed and taxed? At what tax rate? What may be included in the tax basis, e g , value of improvements completed, etc ?
- How long are real estate investments held on the average?
- What is the projected overall inflation rate? PV and IRR should be adjusted for the effects of inflation?