

# Capital growth and real estate buys

## EXPERT FILE

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What is the expected capital growth for Prague? For the Czech Republic? I am asked this so frequently by investors that a response has become almost automatic; 99 percent seem content with a simple numerical answer. Occasionally, a diligent investor will pursue me for the reasoning behind my given figure. This is my favorite type of client, as few conduct any investigation on their own these days before diving into the first heavily promoted project they find in the U.K. classifieds.

There are many apparent factors that drive capital growth in any market: Supply and the condition of housing stock, gross domestic product, wages, rental parity, mortgage terms and interest rates, to list a few. Of all the factors that drive the prices of housing, I have observed the availability and terms of mortgage financing as the single most important factor that influences the home-ownership demand curve.

### Co-op or private ownership?

To illustrate how mortgage financing (or the lack thereof) directly affects the price one can get on the sale of a given property, it is interesting to look at the two main types of flat ownership: the *družstvo* (DR), or

cooperative ownership, and *osobní vlastnictví* (OV) or private ownership. Generally speaking, with an OV flat, one owns a specific definable area within a building (ignoring common areas for now). With a DR flat, one does not own a title to a specific dwelling space; rather, one owns shares or a shareholding interest in a building cooperative with specific rights to inhabit a defined area in accordance with the bylaws of the cooperative.

From the bank's perspective, the differences in these two ownership types are paramount: a bank cannot easily place a lien on "shares" within a cooperative as it can on the actual

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property title held under private ownership. Special cases aside, banks generally don't offer mortgages on DR apartments; thus, selling a property via a cooperative structure eliminates 70-90 percent of your prospective buyer pool. Unfortunately, this is not the type of "exclusiveness" that creates value like that of restricted membership in a club. Any time you eliminate this large a chunk of your buyer pool, you will have to discount the price to make a sale.

Although cooperative flats make up only 17 percent of the housing stock, a little more than half the properties offered for sale are coop-

erative; a little less than half are privately owned, with the less than 1 percent remaining offered under company ownership (s.r.o.) or "other." However, the average sales price of a privately owned flat is often at a 20-50 percent premium over those sold under the cooperative structure. The ruling factor underlying the premium is the availability of mortgage financing to prospective buyers.

The key to understanding how interest rates and mortgages affect property prices is to understand the psychology of how people make decisions about what they can afford. The end price is obviously important, but the majority of people buying a

means they can afford a flat priced about Kč 2.4 million (a loan of Kč 1.9 million) at a standard that perfectly satisfies the families' needs.

While they are shopping, banks introduce the possibility of 85 percent financing via 20-year loans. Suddenly, the family is able to "afford" an additional Kč 377,000 for their flat with no change in their monthly payment. On the other hand, it also means the seller can charge up to an additional Kč 377,000 for a flat with the same standards and the family on a budget of Kč 15,000/month can still buy it.

Interest rates have a similar effect. The family with a monthly payment budget of Kč 15,000/month can afford an additional Kč 130,000 when the interest rates drop from 5 percent to 4 percent on a 15-year loan. Combine the lower interest rate with a 20-year loan and only 15 percent down, and our family is suddenly able to afford a home for Kč 3 million.

The market reaction to loosening credit terms and interest rates is that demand for more expensive flats increases. The offsetting reaction from the supply side (sellers) is that prices increase to balance out the demand, and we see an instance of capital growth, all else being equal, due entirely to financing terms. My advice to those looking for the "next market boom" is to look at those areas where the mortgage availability to homeowners is in its early stages, yet maturing steadily in the foreseeable future. ■

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