Box 12. Commercial real estate market cycle

The real estate market is a significant source of risk for financial stability, as it closely interacts with the business and financial cycles. The assessment of risks from the commercial real estate market is hindered by the low level and quality of related information. The EU initiatives[1] are aimed at mitigating these deficiencies. In this context, the NBR started to collect data and develop risk monitoring tools.

The commercial real estate market in Romania is small in terms of volume and number of projects and investors, ranking among the smallest markets of this kind at European level. In 2019, the estimated level of commercial real estate market transactions was EUR 1 billion (up 7 percent from a year ago), which is a 5-year high, but stands below the EUR 1.5 billion figure recorded in 2007 (Chart A). Transactions at regional and European levels amounted to approximately EUR 15 billion and EUR 315 billion[2] respectively. The most active markets in the region are those in Poland (EUR 8.4 billion) and Czechia (EUR 3.1 billion). Romania has the second smallest market after Slovakia.

Most investors in Romania's commercial real estate market come from outside Europe: Israel (36 percent), South Africa (17 percent), the United States of America (8 percent). In 2019, local investors carried out approximately 20 percent of total transactions, which is almost double as compared to 2017 (CBRE data).

Developments in the past years, such as the strong rise in investment activity (including that financed by loans), robust trading and the further low vacancy rates, show that the commercial real estate market in Romania has entered the rapid growth phase of the cycle (Chart A). These developments are in line with what has been observed in Europe[3], being also ascribable to low interest rates.

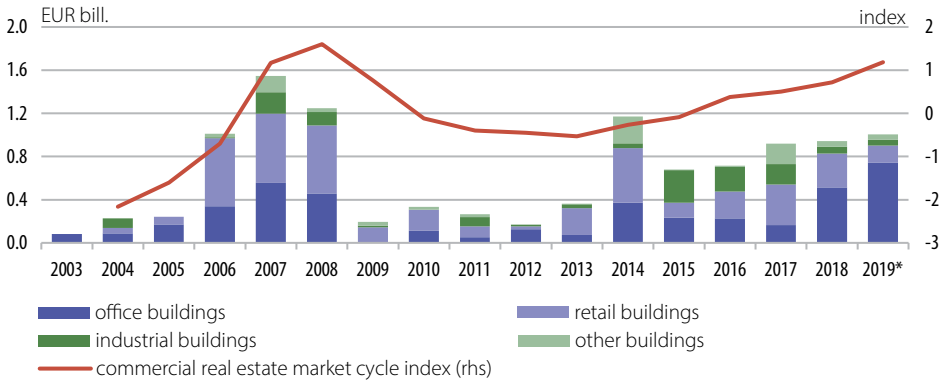

Chart A
Commercial real estate market cycle and commercial real estate transactions volume in Romania

*) data estimated for some of the variables used in the calculation of the commercial real estate market cycle index

Note: The commercial real estate market cycle indicator was calculated based on the principal component analysis.

Source: CBRE Romania, NIS, NBR calculations

1 Recommendation ESRB/2016/14 on closing real estate data gaps and Recommendation ESRB/2019/3 amending Recommendation ESRB/2016/14.

2 CBRE Europe Real Estate Investment in Q4 2019.

3 The ESRB's *Report on vulnerabilities in the EU commercial real estate sector*, November 2018.

Commercial real estate market indicators point to a strong recovery in 2019. Construction works posted a rate of increase of 49 percent, exceeding the high seen before the 2008 crisis, and non-residential real estate investment increased by 63 percent in 2019 from the year before[4]. The vacancy rate remains below the historical average. Commercial real estate yields in Romania, albeit significantly lower in recent years, are the highest at regional level on all segments under review (office, industrial, retail).

The commercial real estate market implies a distinct series of risks compared to the residential market, due to its specifics, such as the high value of real estate projects, the low liquidity and transparency of the secondary market, the small number of investors (particularly in certain market segments).

An important characteristic of the firms operating in the commercial real estate market is the high level of indebtedness. In Romania, the level of indebtedness (calculated as the debt-to-equity ratio) of construction and real estate companies was 2.7 and 3 respectively versus 1.96 economy-wide. Moreover, few such companies (only 1 percent of total) are substantially financed by non-residents (lei 38.8 billion, December 2019, i.e. 60 percent of total indebtedness of firms in the two segments).

The banking sector had a significant exposure towards the non-residential real estate market in December 2019, both directly, via the loans extended to construction and real estate companies (20 percent of loans to non-financial corporations), and indirectly, via loans to companies holding commercial real estate properties (39 percent of total). Construction is one of the riskiest sectors where non-performing loans make up one fifth of the volume of loans granted. Conversely, the real estate sector was at the opposite pole, with a non-performing loan ratio of merely 3.5 percent. In fact, this also helped real estate companies take a larger volume of bank loans, i.e. one third of the corporate credit flow of banks in Romania in 2019.

Financial system risks triggered by the commercial real estate market are significant despite the small size of the market, given the material exposure of the banking sector and high level of indebtedness of companies in this market. Furthermore, given the low market depth caused by the small number of investors, the small share of local investors, the reliance on foreign financing and the high concentration of financing, commercial real estate market developments are marked by strong volatility, being vulnerable to changes in investors' risk aversion on the international financial markets.

4 National Institute of Statistics, *Net investments in the national economy and construction works in 2019.*