Real Estate Intelligence Report 2022

Hungary

DLA PIPER

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Welcome to the seventh edition of our Real Estate Intelligence Report on the legal trends of the Hungarian commercial real estate market in 2021. This report gives an insight into the prevailing legal practices in the Hungarian commercial real estate market and provides an indication of the current balance of power between sellers and buyers.

The data used in this study is not publicly available and is based on deals where DLA Piper Hungary advised the seller or the buyer in transactions where the net asset value of the property was over €10,000,000. In the course of our study, we assessed the transactions from various aspects, such as asset class, acquisition structure, purchase price payment protection or limitation of liability. We hope this study will be helpful to those who want to get a snapshot of the Hungarian commercial real estate market before making an entry decision, and to those who are regularly involved in transactions and are preparing their next move.

Szilárd Kui
Local Partner
Head of Real Estate
DLA Piper Hungary

Introduction

In 2021 the Hungarian commercial real estate market was characterized by two main themes: substantial undersupply of assets and the high number of off-market deals. This meant that there was a fierce competition for open market assets resulting in further yield compression, especially in the case of logistics assets where we saw yields fall to around 5.8% by the end of 2021. We saw prime office building yields compress to around 4.8% to 5% in the last few months of 2021.

It was also interesting to see that, despite all the changes in the use of office buildings and the proliferation of home office, there was a renewed appetite for office buildings and several office buildings changed hands throughout the year. That being said, we also saw a few office building deals fall apart due to either inflexibility around pricing or the high proportion of unleased areas (and the perceived challenges in leasing them) within the building.

MAJOR TRENDS AND HIGHLIGHTS OF 2021

LOGISTICS became the second most attractive asset class (14%) behind **OFFICE BUILDINGS** (57%).

There was only a very small number of transactions for **RETAIL OR HOTEL PROPERTIES.**

Roughly three out of four transactions were **ASSET DEALS**.

In 22% of the transactions, **W&I INSURANCE POLICIES** were used to secure seller's representations and warranties.

On the back of COVID-19 concerns and travel restrictions, the investment market was dominated by **LOCAL INVESTORS**, who carved out a market share of 73%.

Asset classes

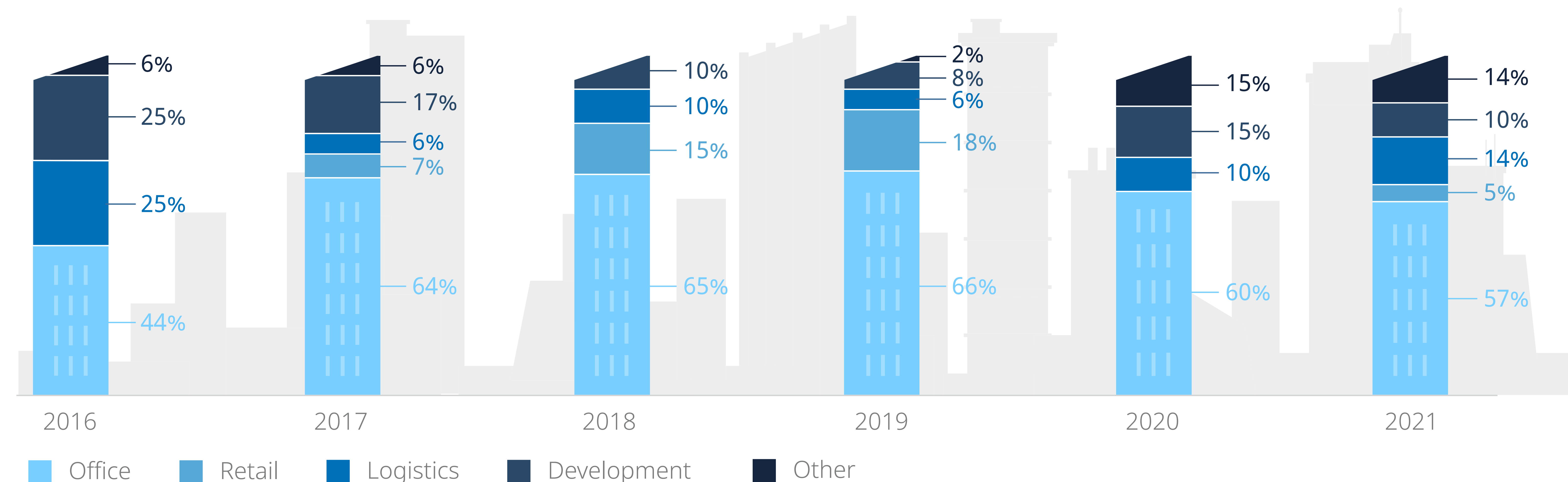
Despite all the talk and buzz around home office and hybrid working, the share of office buildings in our transactions only dropped by a mere 3% compared to the previous year to 57%. With the increasing role of ESG in investor and tenant decisions, it has really became a necessity for developers to obtain a LEED or BREEAM certification for new Class A office buildings. By the end of 2021, prime office yields had fallen into the range between 4.8% and 5%.

Strong investor appetite for logistics was a common theme during 2021; however, most of the logistics parks are owned by a handful of players who are just not willing to sell. We saw fierce competition for those few logistics assets that were put on the market, bringing yields down to around 5.80%.

The share of development/redevelopment properties stood at 10% in 2021, and a substantial part of these were greenfield sites for logistics developments.

Logistics properties became the second largest asset class, accounting for ***14%*** of all transactions.

Asset type

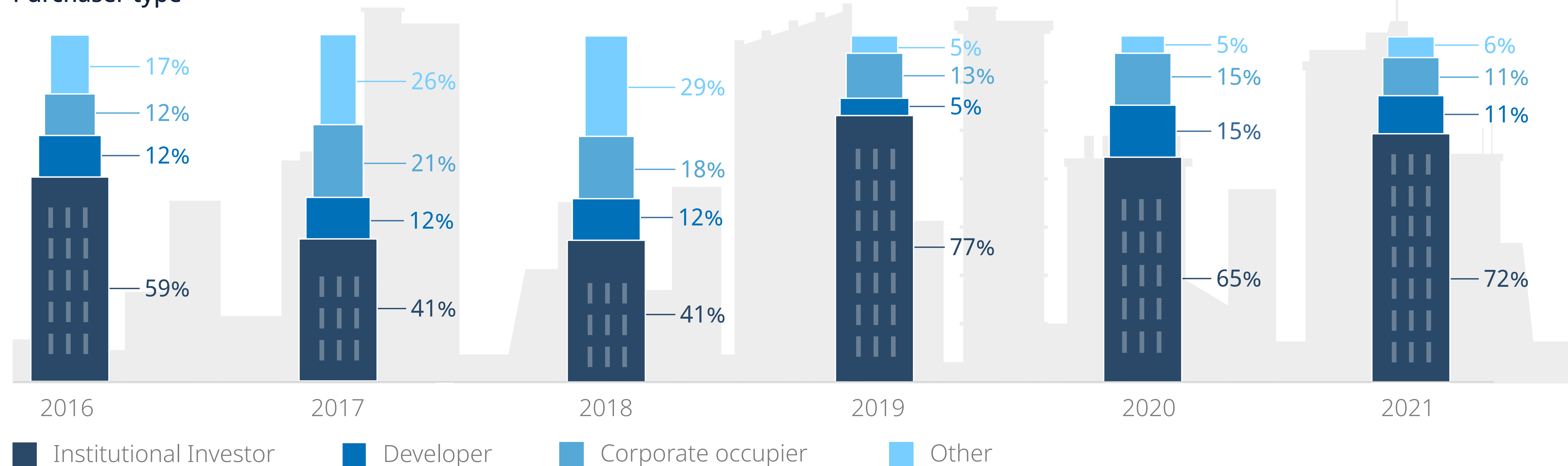


Purchasers

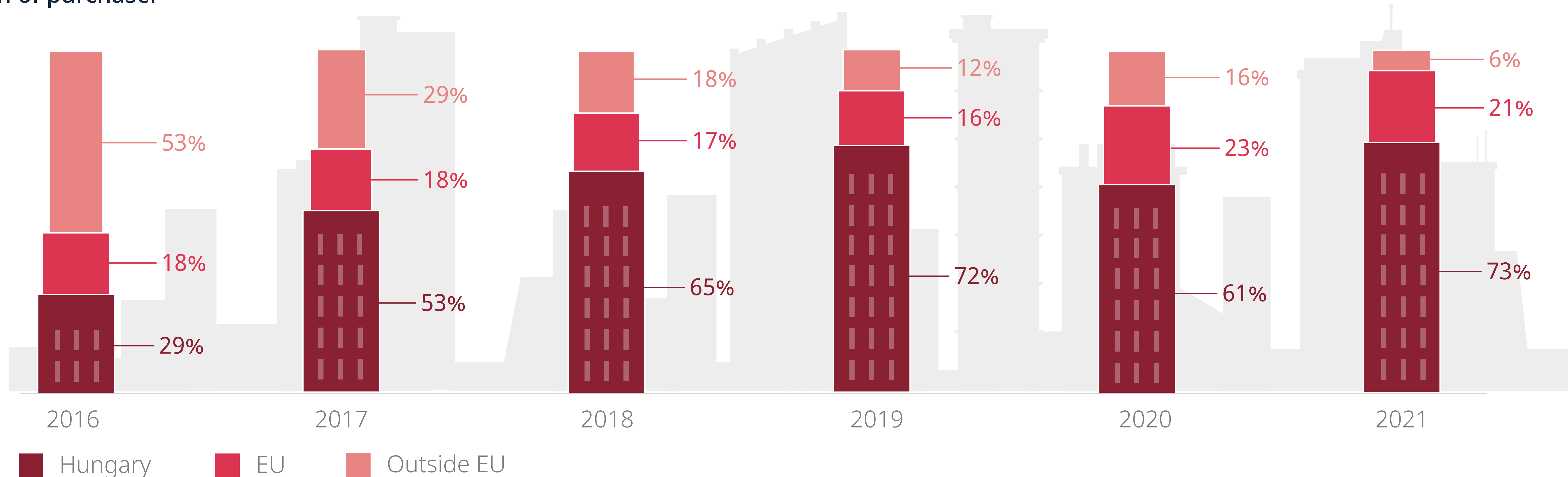
Institutional investors were the most active investor class with a share of 72%, a 7% increase compared to 2020. Private equity funds were particularly active, but we also saw foreign and domestic pension funds, insurance companies as well as foreign real estate funds.

Developers and corporate occupiers both accounted for *11%* of all transactions.

Purchaser type



Origin of purchaser



The share of domestic investors climbed to *73%*, which represents a *12%* increase compared to 2020.

Within the domestic investor group, local private equity funds and real estate funds were the most active. We have seen continued interest from clients both from the Far East and the Middle East; however, a limiting factor for them was that large ticket size assets are few and far between on the Hungarian commercial real estate market. The market share of purchasers domiciled in the EU declined slightly to 21% in 2021.

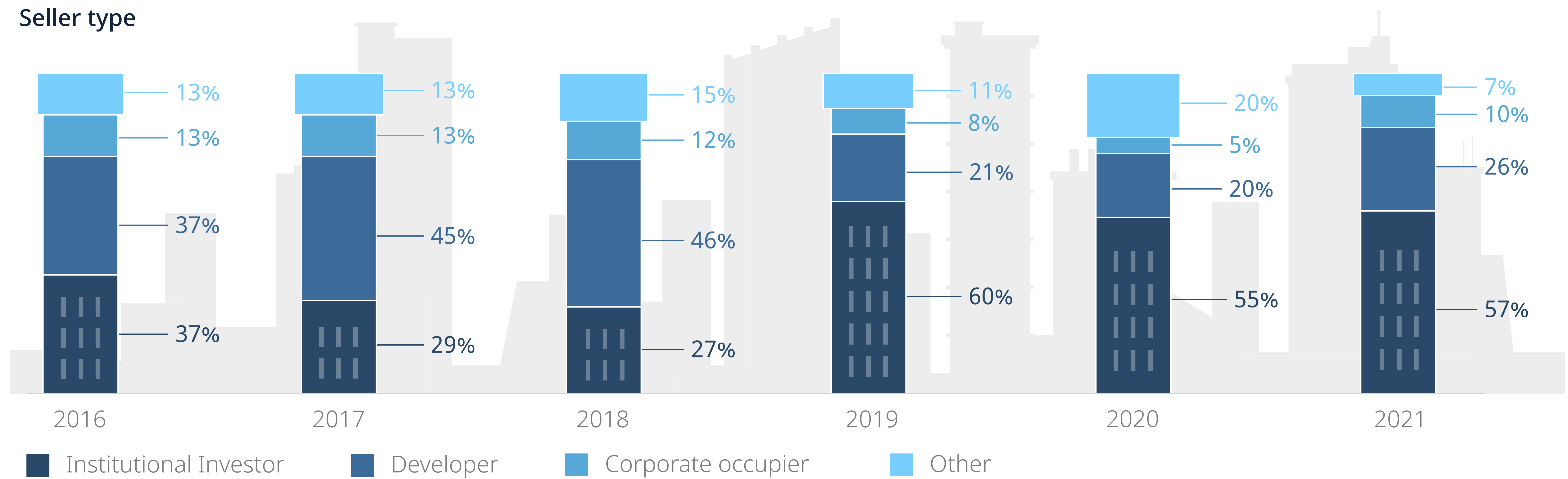
Sellers

On the seller side, institutional investors accounted for ***57%*** of all transactions, which was around the same level as the ones in 2020 and 2019.

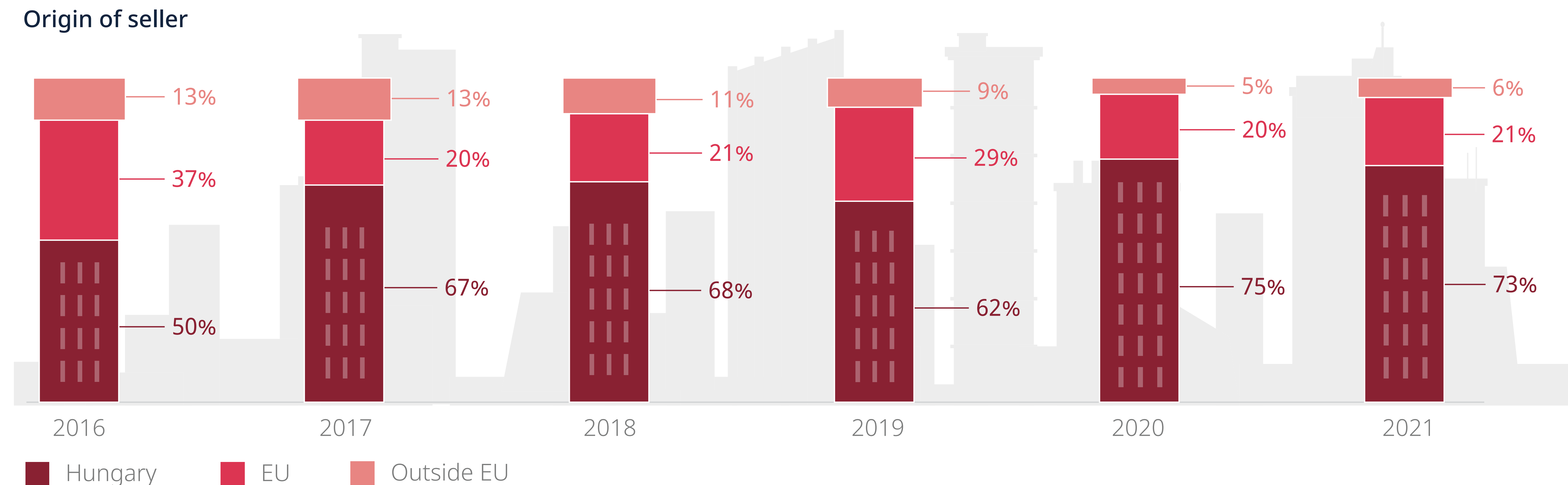
In line with the previous two years, there was a substantial shortage of new investment assets introduced to the market by developers and, as such, they accounted for only 26% of our transactions on the seller side.

Just as on the purchaser side, the majority of sellers were domestic players, who took a share of 73% of all of our transactions. This was in line with the trends observed in the last few years. The share of non-EU based sellers stood at 6%, which was the second lowest figure in the last five years.

Seller type



Origin of seller

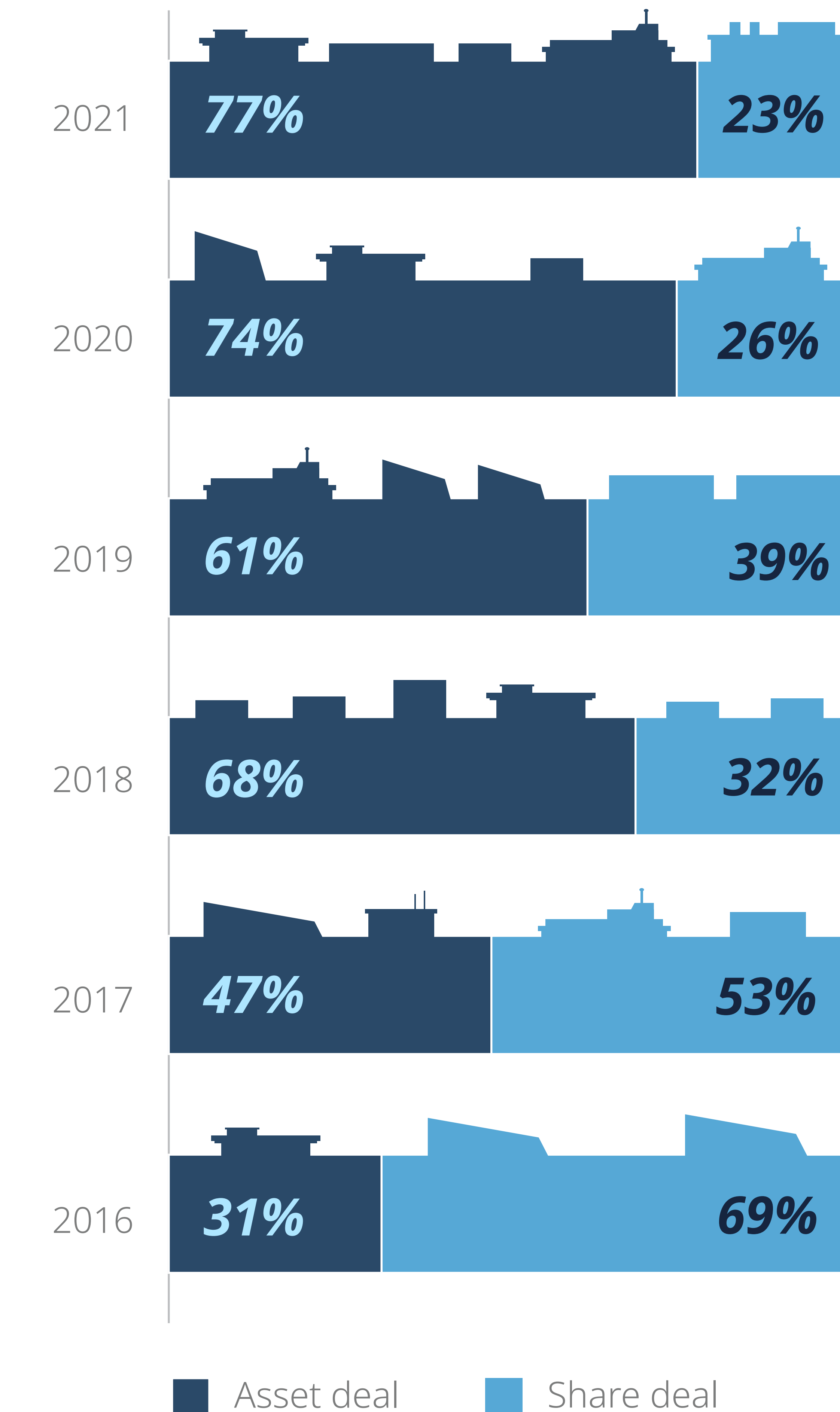


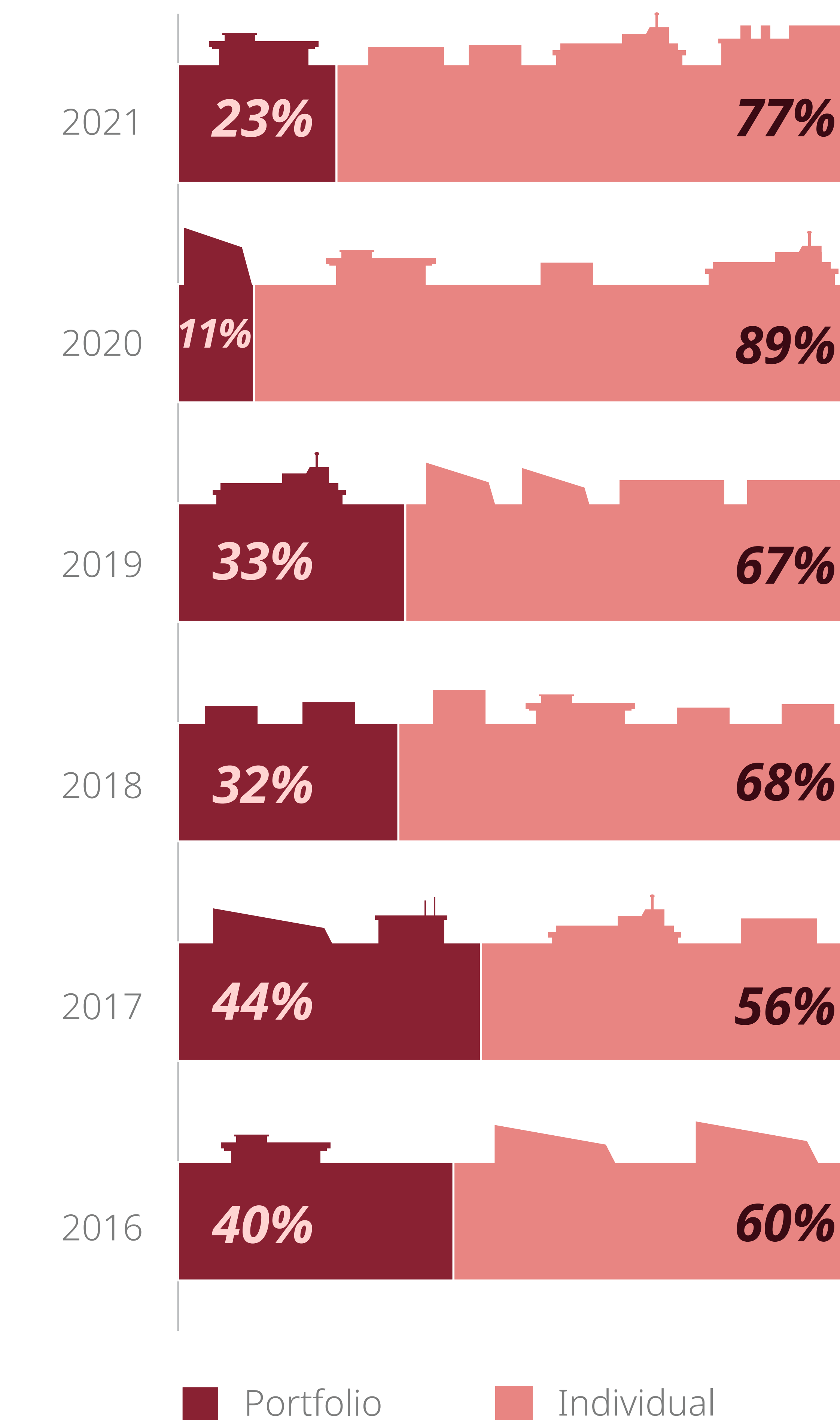
Deal type

Real estate transactions are either executed in the form of an asset deal (i.e. by acquiring the real estate) or in the form of a share deal (i.e. by acquiring the special purpose vehicle (SPV) holding the property). Each one has its own advantages and disadvantages, and their tax treatment is different.

A share deal is generally easier to execute as only the share in the SPV needs to be transferred. External financing already in place may also be retained, provided that the bank is happy to continue lending to the new owner. The drawback is that the SPV is inherently acquired with all historical liabilities. These can, however, be mitigated to some extent by way of thorough due diligence, warranties and indemnities given by the sellers.

An asset deal is a bit more complicated to execute than a share deal. Although lease agreements are automatically transferred to the new owner of the property by the force of law, tenant securities, architects' and contractors' warranties, supply agreements and other contracts of interest have to be transferred to the new owner, in many cases requiring the approval of a third party not involved in the transaction. On the other hand, in an asset deal the property is acquired clear of any historical liabilities.





In 2021, the proportion of asset deals continued to rise and peaked at an all-time high of *77%*.

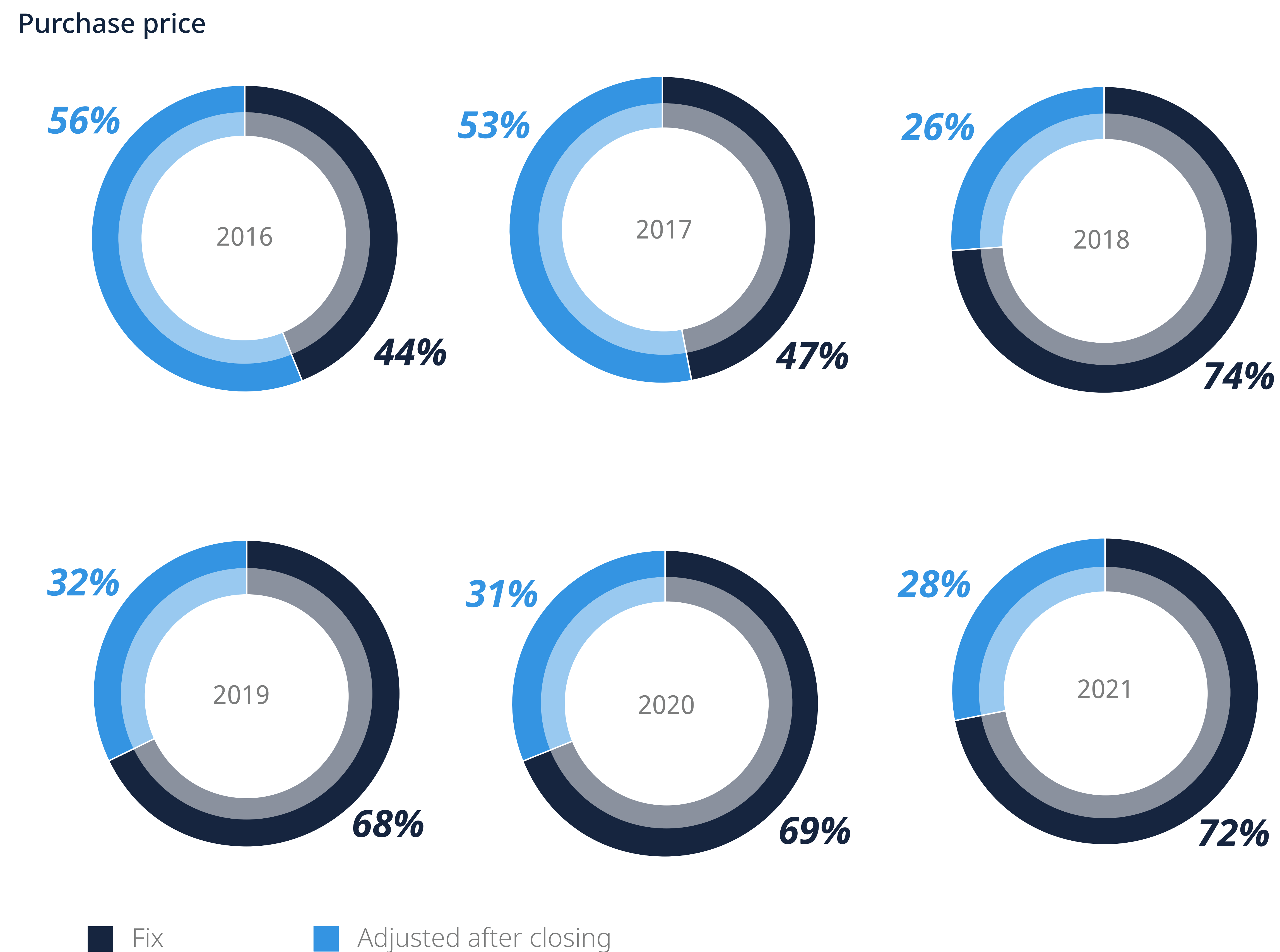
The high ratio of asset deals is partially explained by the fact that domestic real estate funds, which executed the majority of transactions, enjoy a highly beneficial tax treatment if the deal is structured as an asset deal, as the real estate transfer tax is set at 2% (in contrast with the generally applicable 4%) and the funds are exempt from corporate income tax and local business tax.

The proportion of portfolio transactions climbed to 23%, which came on the back of two major off-market office portfolio transactions.

Purchase price

When it comes to agreeing on a purchase price, the parties may either opt for a fixed purchase price or a variable purchase price. In an asset deal, a fixed purchase price is usually agreed on, and any event occurring between the signing and the closing of the sale and purchase agreement (SPA) is addressed by a covenant/warranty claim or a right to withdraw.

In a share deal, a variable purchase price is usually negotiated. This addresses the issue that the value of the SPV changes between the signing and the closing of the SPA. In real estate related transactions, the closing accounts mechanism is the preferred option for the calculation of a variable purchase price as usually there are only a few assets and liabilities in the SPV that are closely connected to the operation of the property. If a fixed purchase price is negotiated in a share deal, then a locked box mechanism is usually used to protect the purchaser's position.

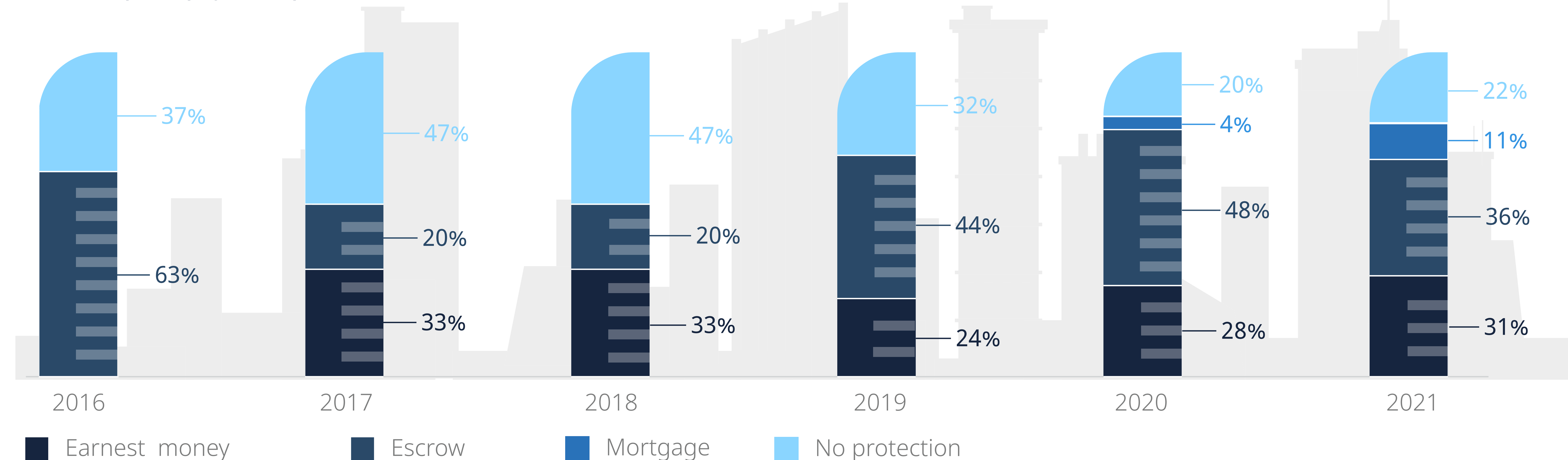


In 2021, we saw a ***slight increase in fixed purchase price transactions.*** This, as in previous years, shows a close correlation with the proportion of asset deals.

Payment protection

In case of split signing and closing, a seller will usually require some form of security from the purchaser to ensure the deal will be closed and the seller will be paid once the seller satisfies all conditions to closing.

On the Hungarian market, two instruments are typically used for this purpose: ***earnest money and escrow.***

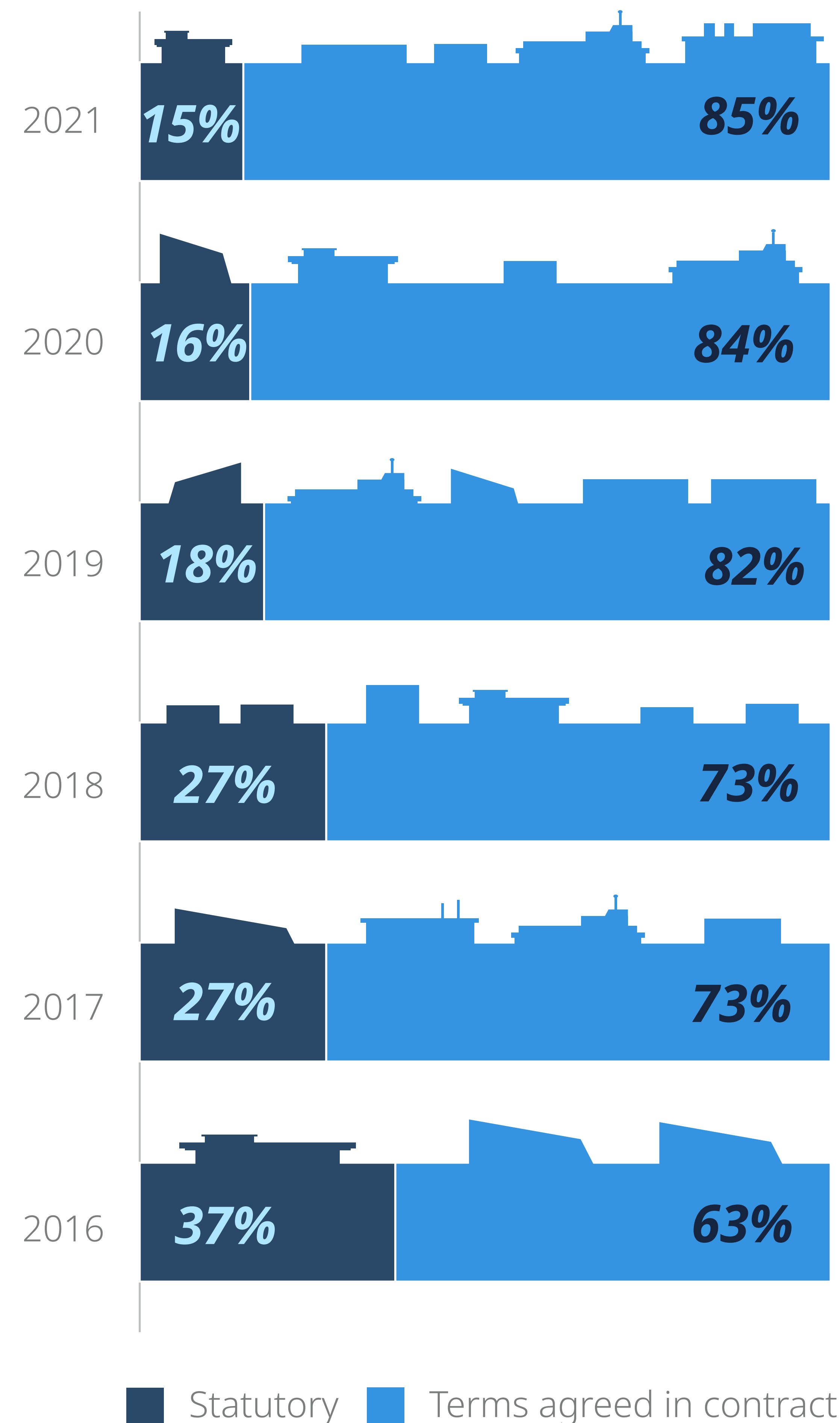


Under an escrow structure, the purchaser is required to deposit the purchase price to be paid at closing into an escrow account opened in the name of the escrow agent, who will make payments out of the escrow account to the seller or other parties in accordance with the terms of the SPA and the escrow agreement. An escrow account offers the seller security against the risk of the purchaser's inability to pay the purchase price as and when due. However, it may be unattractive from the purchaser's perspective, as the purchaser is not able to use the escrow amount which is locked in the escrow account and bears almost zero interest. Nevertheless, escrow was the most widely used form of security in 2021 as it featured in 36% of our transactions.

Earnest money was used in 31% of the transactions we advised on. Earnest money is a portion of the purchase price, usually 10%, which is paid by the purchaser to the seller at the time of signing to demonstrate the purchaser's commitment to closing the deal. With the earnest money paid the seller is incentivised to proceed with the satisfaction of the conditions to closing, a process that sometimes requires the seller to restructure certain aspects of the asset or business being sold. Under Hungarian law, if the purchaser does not close the deal after the seller satisfied all conditions to closing, the purchaser forfeits the earnest money. On the other hand, if the seller backs out of the deal after the earnest money has been paid, the seller must return double the amount of the earnest money to the purchaser. In this way the earnest money also protects the purchaser from the seller weaselling out of a deal up to the point where the seller can secure a purchase price difference from a second purchaser that is higher than the earnest money received from the first purchaser.

Warranty period limitations

Limitation of title warranty period

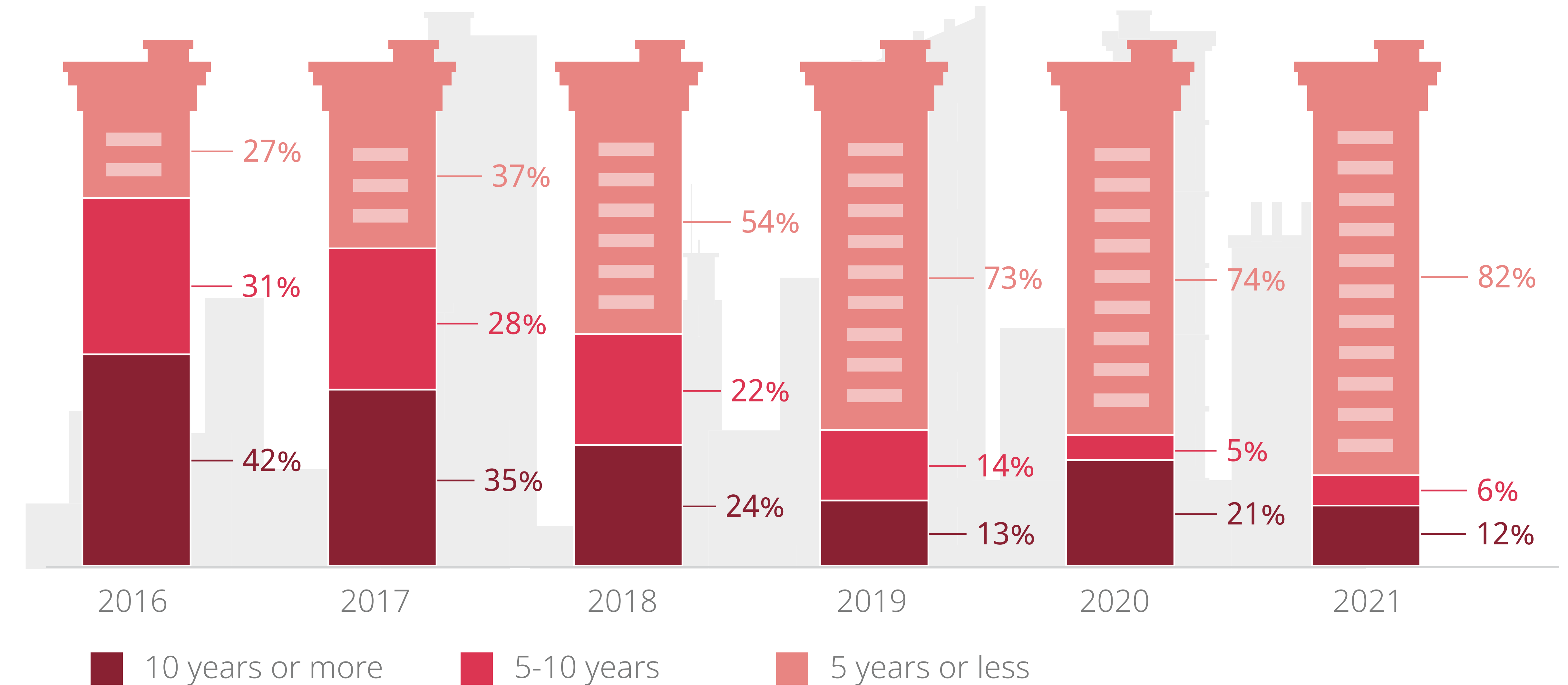


It is customary in an SPA to agree on limitations to the seller's liability for warranties. These limitations consist of time limitations, monetary limitations and other specific limitations, such as disclosures. Generally, sellers are keen to obtain as many limitations on and protections against liability as possible.

Under Hungarian law, the limitation period within which an action may be brought for a breach of a commercial warranty is five years. In the case of title warranty breach, the purchaser may lodge a claim without any time limit. Sellers will always try to agree on warranty periods that are shorter than these statutory warranty periods.

As far as title warranties are concerned, the parties agreed to limit title warranties in time in ***85%*** of the transactions.

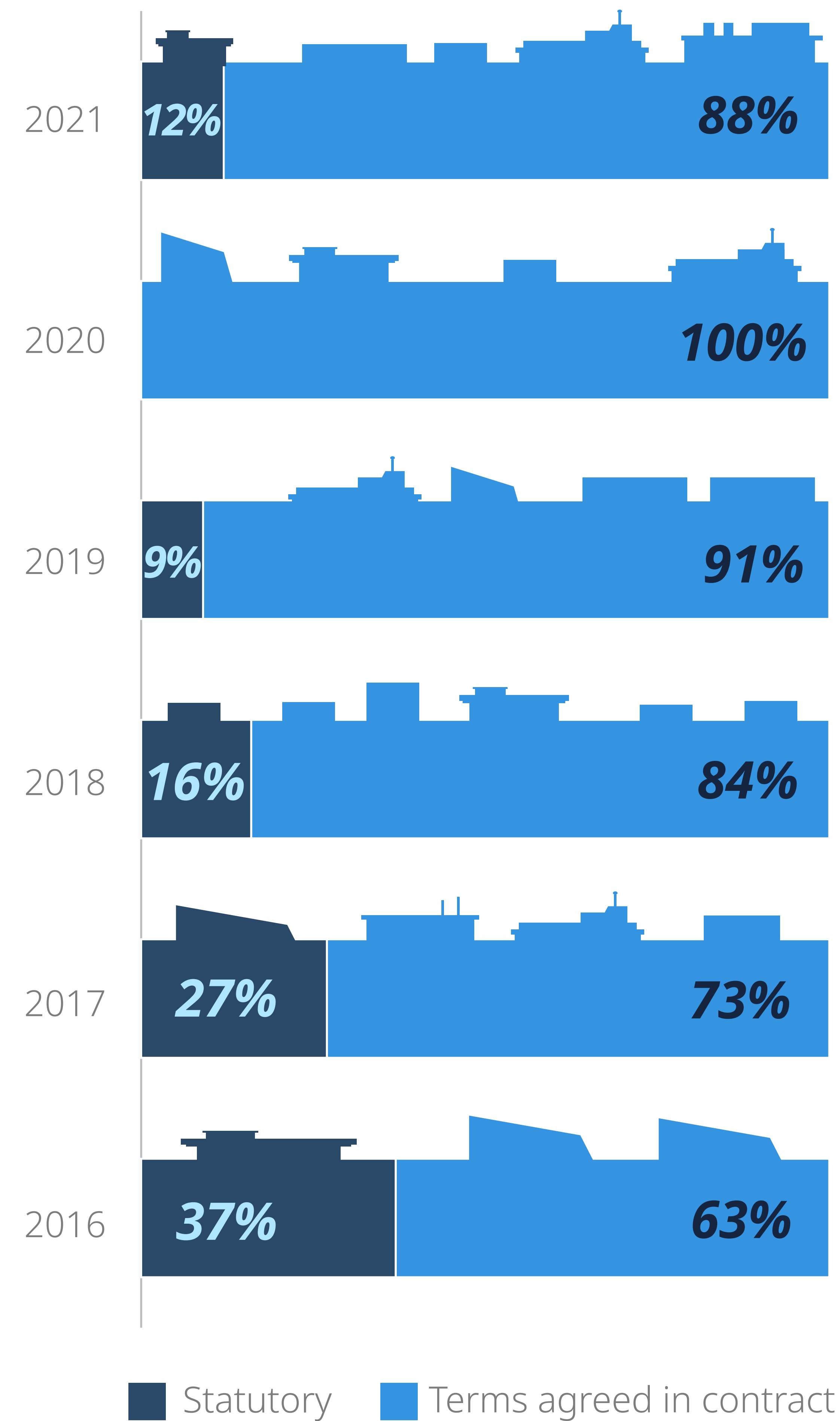
Term of agreed title warranty limitation period



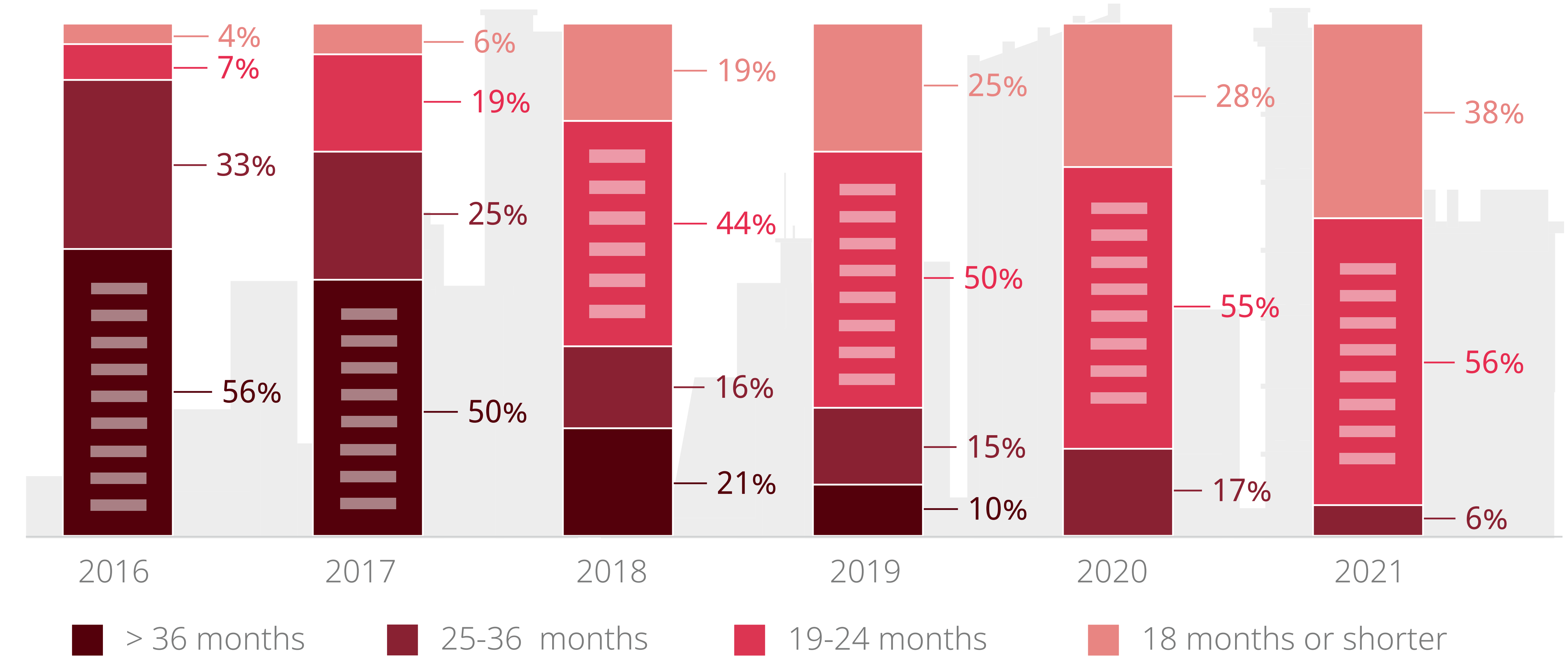
The time limitation of the title warranty was five years or shorter in ***82%*** of the deals.

Parties departed from the statutory time limits for commercial warranties in 88% of our transactions in 2021 and negotiated a term shorter than the statutory five-year period.

Limitation of commercial warranty period



Term of agreed commercial warranty limitation period



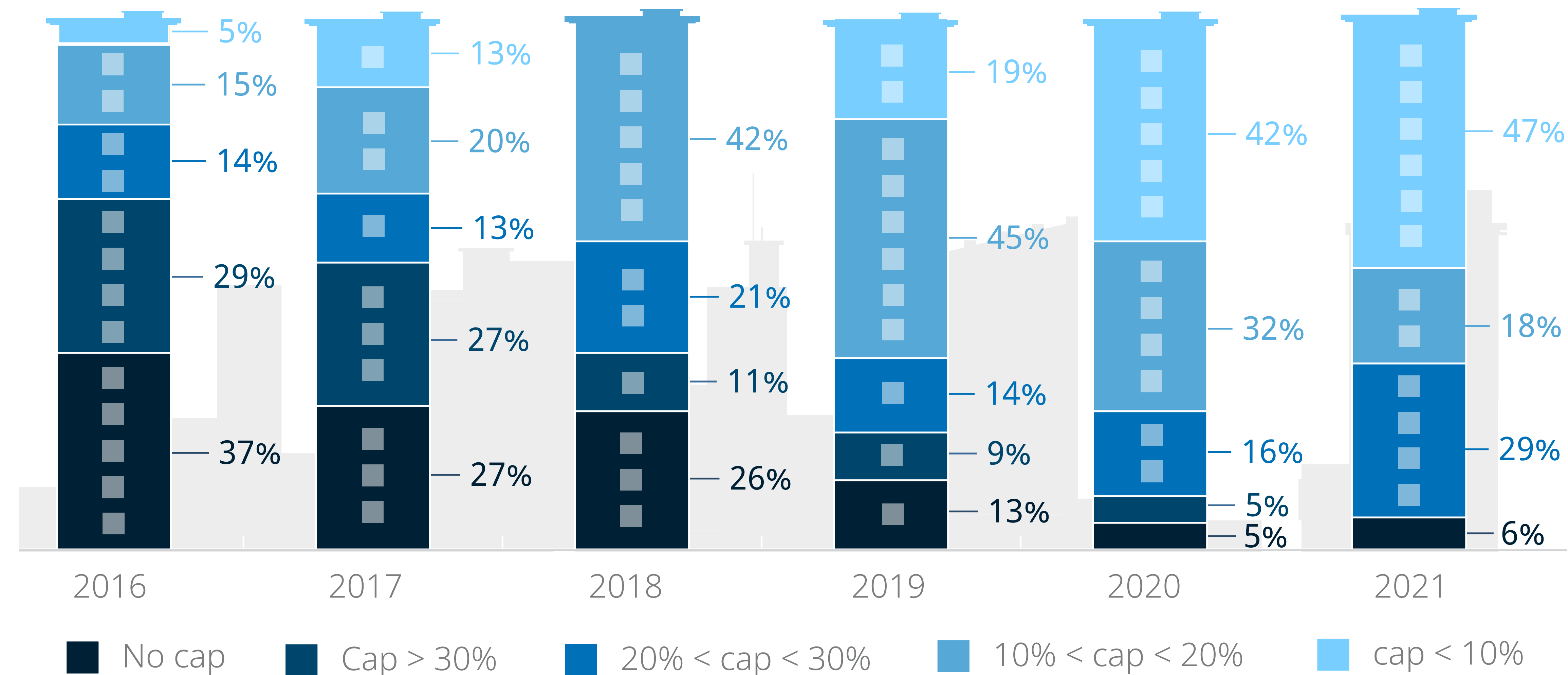
The trend to negotiate ever shorter commercial warranty periods continued in 2021. In 38% of the transactions, a time limit of 18 months or shorter was agreed on, while only in 6% of the deals was a period between 25 and 36 months negotiated. Being a seller was certainly lucrative in 2021 from this perspective.

Quantum limitations

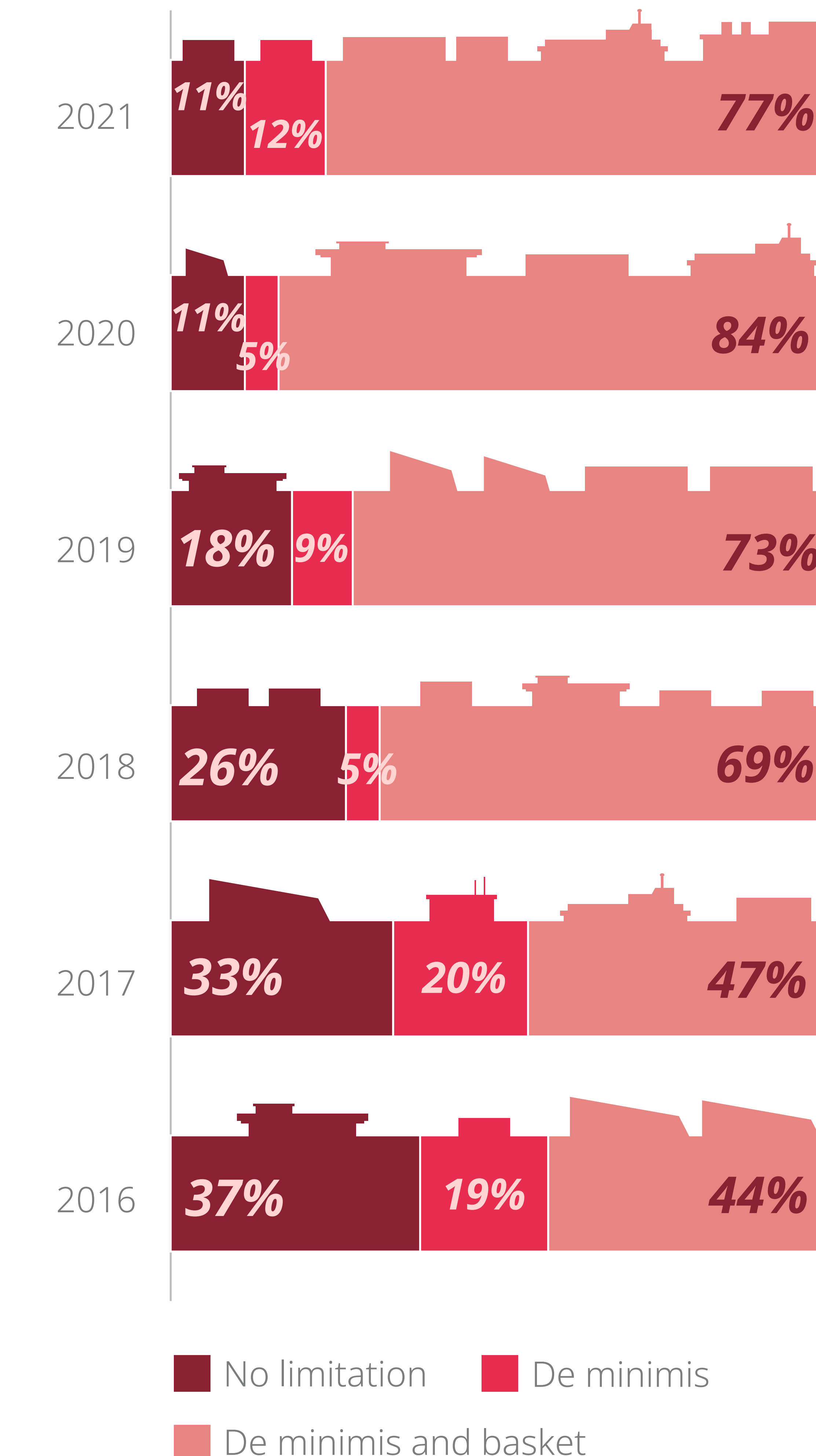
Sellers will want to cap their financial liability towards the purchaser in a share deal or asset deal. In real estate transactions, the cap typically applies to liability under commercial warranties (warranties other than title warranties) and, in some cases, also to liability under indemnities.

Sellers have been more and more successful in ***negotiating lower caps*** in recent years as competition between purchasers for quality assets has intensified.

Commercial warranty liability caps (% of purchase price)



Quantum limitation on warranty claims

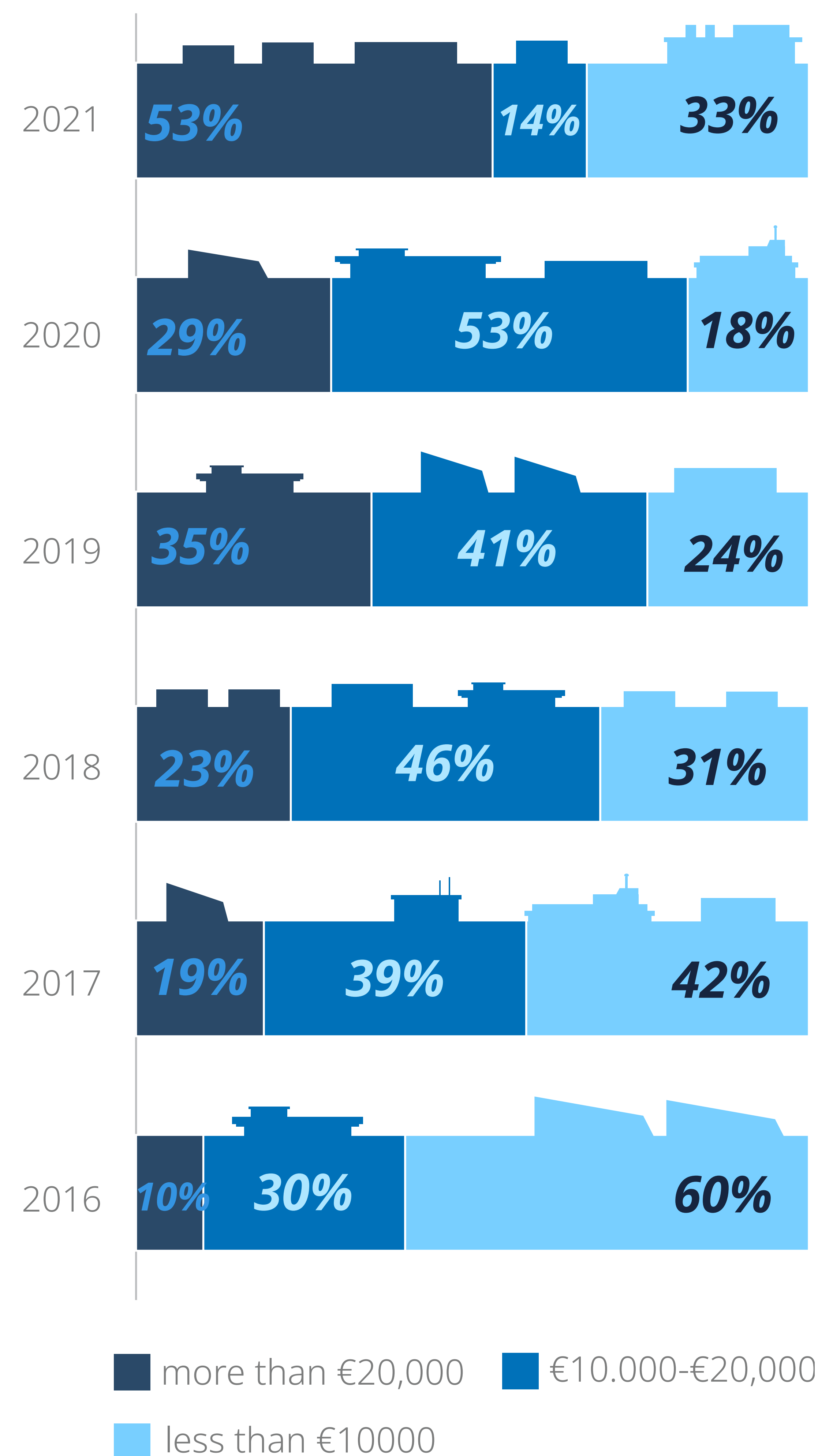


In 47% of all transactions, the liability cap for commercial warranties was 10% of the purchase price or lower. Only in 6% of the deals was no cap agreed on at all.

In addition to the liability cap, the seller will usually try to insert into the SPA a small claims exclusion and a basket. The parties agreed on both a small claims exclusion and a basket in 77% of our transactions in 2021.

If a small claims exclusion is agreed on, a warranty claim made by the purchaser against the seller will only be considered if the amount of such claim exceeds the small claims amount. The rationale for this is that claims for small, immaterial sums should not be brought as they take a disproportionate amount of time and resources to manage and investigate. Purchasers try to avoid small claims exclusions as even small claims can add up over the warranty period. If a small claims exclusion is conceded, a purchaser should ensure this does not allow a series of small claims to be excluded where they arise from the same cause. This can be achieved by appropriate wording to ensure that small claims arising out of the same set of circumstances, or those which are otherwise related, are aggregated and treated as a single claim.

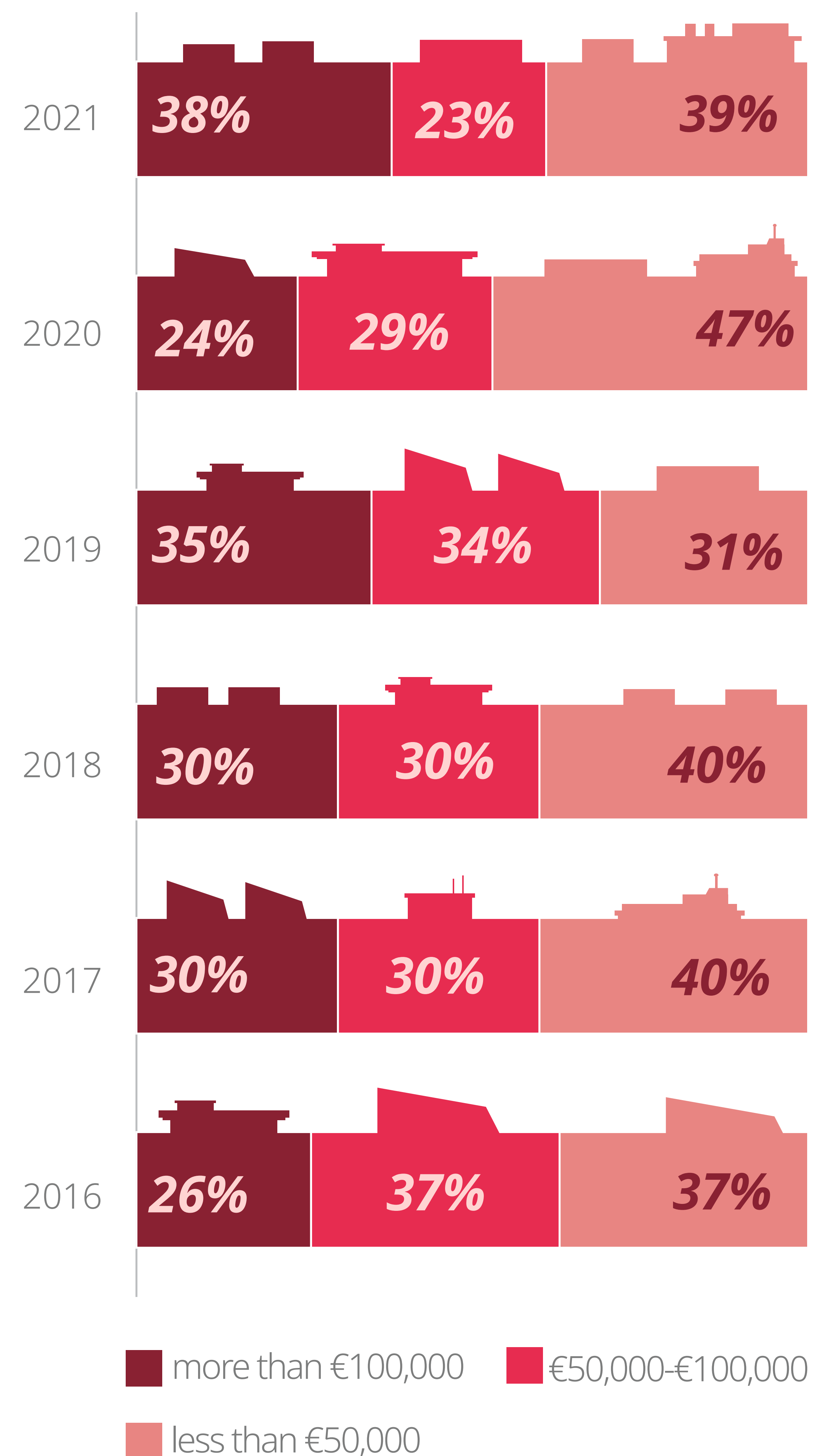
De minimis amount



In 53% of our transactions, the small claims threshold was higher than EUR 20,000.

In addition to small claims exclusion, parties may also agree on a basket clause whereby the purchaser may only assert warranty claims if the aggregate of all individual warranty claims exceeding the small claims amount also exceeds the agreed basket amount. A secondary but important issue is whether that threshold should act as a "trigger" or an "excess." A "trigger" means that once the threshold is reached, the value of all the claims will be recoverable by the purchaser. In contrast, an "excess" means that once the threshold is reached, either by a single claim or by a series of claims having an aggregate value above the threshold, only the value of such claim(s) in excess of the threshold will be recoverable by the purchaser, i.e. the purchaser will bear the loss up to the threshold. As a rule of thumb, the basket threshold amount is usually five times bigger than the small claims exclusion amount.

Basket amount



In 2021, the basket amount was less than EUR 50,000 in 39% of our transactions.

Security

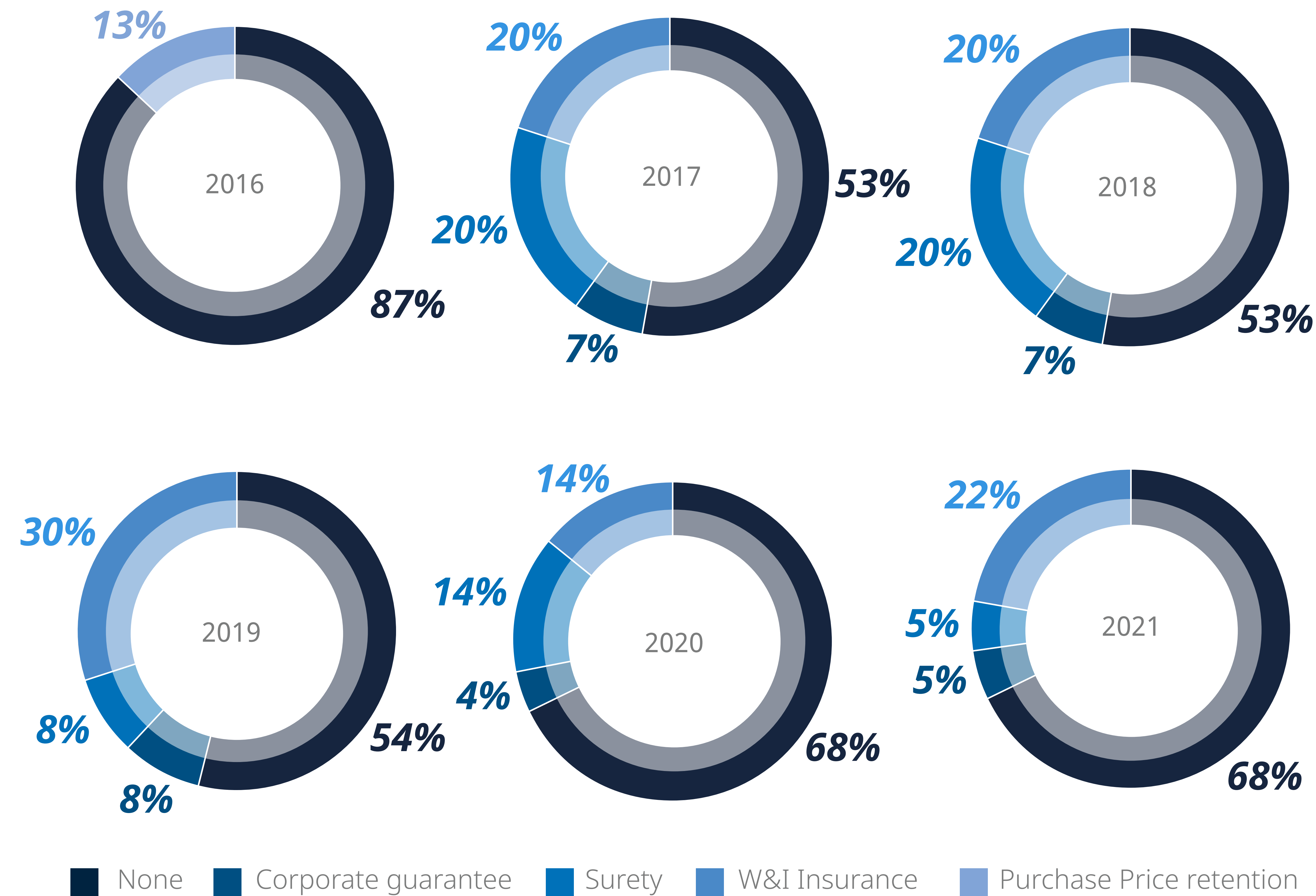
Substantial resources and time may be spent negotiating the warranties section of an SPA. However, all these resources and time will be wasted if no funds are available to cover a warranty claim. Likewise, if there is a possibility that, at some point, the parties will owe each other money pursuant to their respective obligations under the SPA, they will have an interest in ensuring that funds will be available to meet these payment obligations. The question of whether a payment obligation needs to be secured will depend on the circumstances of each individual acquisition. This is underlined by the fact that, in 2021, no security was provided at all in 68% of our transactions.

The most commonly used securities on the Hungarian market for commercial real estate deals are corporate guarantee, surety and W&I insurance.

A corporate guarantee under Hungarian law works the same way as a bank guarantee, the only difference being that it is issued by a parent company and not a third-party bank. This means that the guarantee is a standalone undertaking of the guarantor that is independent from the underlying obligations which it guarantees. If the conditions for drawdown prescribed in the guarantee are met, the guarantor must make payment without being entitled to investigate the status of the underlying obligations.

In contrast, a surety is a contractual promise to fulfil the obligations of a third party if such third party fails to do so. It is a secondary obligation, meaning that the party issuing the surety is only liable to the same extent as the third party whose primary payment obligation it secures, and it may use the very same tools to challenge the primary payment obligation which the third party can.

Security for warranty claims



W&I insurance is a form of insurance taken out to provide cover in respect of liabilities under warranties and indemnities given by the seller in the SPA. In recent years, buy-side policies – where the insurance is taken out by the purchaser, with no direct involvement from the seller – have become the norm. The purchaser must satisfy the conditions under the W&I policy, with the proceeds of any claim being paid directly to the purchaser.

In 2021, W&I insurance was used to cover warranty or warranty plus indemnity obligations under the SPA in *22%* of our transactions.

FDI regulatory developments in real estate acquisitions

Screening of foreign direct investment (FDI) has been present in Hungarian law since 2019 in relation to certain specific investment-related activities. During the COVID-19 pandemic, additional FDI screening legislation was introduced in May 2020. The 2020 regime has had an impact on a significantly wider range of business transactions and, therefore, this summary focuses solely on the 2020 regime (FDI Rules). Given that a real estate asset deal may also fall within the scope of the FDI Rules, assessing the potential application of the FDI Rules has become an important item on the real estate due diligence to-do list. Below you will find a summary of the applicable regime based on our experience to this date.

Strategic companies and strategic sectors

Any Hungarian limited liability company or company limited by shares that pursues its activities in one of the strategic sectors may qualify as a strategic company and, therefore, may be subject to the FDI Rules. While the relevant provisions of the FDI Rules on strategic companies and strategic sectors are quite vague and allow for a broad interpretation, the NACE codes listed in the FDI Rules may serve as points of reference when assessing whether a certain business activity of a company (or an asset deal in a strategic sector/activity) triggers the application of the FDI Rules.

As both the main and the additional business activities of companies must be considered, the mere fact that the main activity of a company is buying/selling or leasing/operating real estate (NACE 6810 or 6820) does not necessarily mean that the entity is not going to qualify as a strategic company. This is due to the fact that all activities of the company (including, in particular, activities registered in the company register, encompassing also the additional activities of such company) must also be considered, and those may also trigger the application of the FDI Rules even if such activities constitute a side business to the main business activity and are practically never pursued. Strategic sectors include, amongst others, retail, warehousing, accommodation, food and beverage services, etc. and cover 19% of the real estate transactions DLA Piper Hungary worked on in 2021. We also note that the FDI Rules apply to both share deals and asset deals; therefore, the review of the activities of a given company and the use of a given piece of real estate have become key elements in the due diligence process.

Acquisitions via share deals

It has become common practice in share deals to assess, as a preliminary transactional question, whether the contemplated transaction structure is covered by the FDI rules, considering mainly (i) the residence of the investor and the entity having majority control over such investor, (ii) the ownership structure existing at the time and the shareholding to be acquired in a strategic company, and (iii) the transaction value (if the latter one should be considered at all).

The key point is to determine whether the target entity qualifies as a strategic company. A target company qualifies as a strategic company if (i) it is registered in Hungary and operates as a limited liability company, a private company limited by shares or a public company limited by shares; and (ii) it carries out, as part of its main or additional business activities, one or more of the business activities set out in the Hungarian FDI Rules as being in strategic sectors.

Acquisitions of real estate via asset deals

The transfer of the title of any infrastructure, equipment and assets that are essential for carrying out activities in certain strategic sectors (as referred to in the definition of 'strategic company') may also be subject to the FDI Rules if the acquirer is a foreign investor (as defined by the FDI Rules) or an entity in which a foreign investor has, directly or indirectly, a dominant influence as defined under the Hungarian Civil Code.

The term 'infrastructure' is not defined by statutory law, but based on our experience, it is to be interpreted broadly. Therefore, an asset deal involving a piece of real estate required for pursuing an activity in a strategic sector (i.e. hotel building, logistics park, retail park) may also be interpreted as falling within the scope of the FDI Rules, even if none of the companies involved in the transaction qualify as a strategic company. Additionally, it is worth considering whether only a completed piece of real estate, or also ongoing developments may trigger the application of the FDI Rules in cases where the strategic activity concerned will undoubtedly be conducted on the real estate. As a result, the FDI Rules must be analyzed on a case-by-case basis in each asset deal where the target real property may be related to a strategic sector.

FDI reporting rules

If the transaction is subject to the FDI Rules, then the investor/acquirer of the real property is obliged to submit a notification to the Minister of Innovation and Technology and to obtain an acknowledgement from the Minister for the completion of the relevant transaction. The notification must be submitted in writing in Hungarian within 10 days after the conclusion of the relevant agreement or other legal declaration made for the purpose of the transaction. The Minister has 30 business days (which can be extended by 15 days) to acknowledge or reject the notification.

The Minister inspects compliance with the FDI Rules. If during such inspection the Minister comes to the conclusion that there is a breach of the notification obligation, such breach may render the transaction document invalid, and the Minister may also impose a fine on the investor and/or the acquirer of the real property up to an amount of 200% of the transaction value, provided that, in the case of foreign investors which qualify as legal entities, such fine may not be lower than 1% of the net revenue of the strategic company concerned.

While FDI reporting rules may affect preliminary due diligence tasks and also stretch the transaction timeline, so far we have not experienced any issues around real estate investments being approved by the Minister of Innovation and Technology.

Angéla Tóth

Senior Associate
Real Estate
DLA Piper Hungary

How does competition law affect your transaction?

EU and Hungarian competition law considerations are also highly relevant in any real estate transaction, especially from a merger control and information exchange perspective.

Under merger control rules, certain transactions must be notified to the various national competition authorities (including the Hungarian Competition Authority) and, in some cases, the European Commission. The notification requirement depends on the type of the transaction and the size (typically the turnover) of the companies involved.

- As to the type of the transaction, it is clear that share deals (e.g. acquisition of a majority shareholding in a company which owns a certain piece of real estate) clearly qualify as relevant. In addition, asset deals may also be scrutinised by competition authorities, provided that the assets in question qualify as a so-called "part of an undertaking", i.e., a standalone business unit to which turnover can be attributed. For example, the acquisition of a plot of land which has a shopping mall on it can typically qualify as a "part of an undertaking" as it would enable such shopping mall to be operated by/integrated into the buyer's own business.
- As to the size of the companies involved, most competition laws apply turnover thresholds, i.e. the net sales revenues of the companies involved in the transaction for the previous business year are reviewed. For example, under Hungarian law, the thresholds for notification are twofold:
  - all the undertakings concerned have to achieve at least HUF 15 billion in turnover from Hungary in the previous business year, and
  - there have to be at least two undertakings concerned that each achieved at least HUF 1 billion in turnover from Hungary in the previous business year.

From an information exchange perspective, companies engaged in real estate transactions need to make sure that they only exchange information that is absolutely necessary and only to the extent that is required depending on the stage of the transaction. This obligation is particularly relevant in case of a transaction involving real estate companies that are competitors to each other. In such cases, information barriers need to be erected, e.g. in the form of personal/company-wide confidentiality obligations or "clean teams" (i.e. persons dedicated to a certain transaction who are not involved in the strategic decision-making of the company) or via external advisors.

Compliance with the above rules is essential and may significantly affect the structure and timing of a transaction. Specifically, from a merger control perspective, if a notification requirement applies, it typically entails that the transaction may not be closed/implemented before clearance by the competent competition authority (or authorities). Competition law envisages serious sanctions in the form of fines for the breach of this obligation. Similarly, the illegal exchange of information could also entail fines by the authorities.

It is therefore suggested that competition law considerations be taken into account as early as the transaction planning stage and compliance with the relevant obligations be continuously monitored as the deal proceeds further.

Zoltán Marosi

Co-Head
Competition and Antitrust
DLA Piper Hungary

Fundamentals of a successful real estate transaction

A sound investment requires an understanding of all the risks involved in the transaction. The main objective of real estate financial due diligence is to thoroughly inspect the fundamentals of the property, financing, seller and compliance obligations to be able to reduce and mitigate financial uncertainties.

Whereas the pricing of transactions is mostly driven by the capitalized NOI approach, further price adjustments have been common in the market in cases where the acquisition target is a special purpose vehicle or other company owning the properties.

Such adjustments are specific to each and every transaction and are typically triggered by the key findings of financial due diligence processes carried out by third-party advisors on behalf of the purchaser. Financial due diligence contributes to a deeper understanding of the transaction perimeter and helps identify potential issues which may not be in line with market standards. As a result, in addition to price adjustment implications, these analyses often highlight matters which need to be addressed in the reps & warranties section of SPAs or regulated in indemnification clauses.

Verifying NOI figures and reconciliation with actual rent roll data are amongst the top priorities of the due diligence process. Collecting and summarizing historic datasets for a 3-5 year period is beneficial for recognizing potential trends, assessing the time required to find new tenants in case expiring leases are not renewed and to get a general overview of the development of NOI over the past years. In-depth analysis also contributes to the elimination of one-off effects and the calculation of a long-term stabilized NOI.

Financial due diligence also targets the quantification of potential service charge leakages or, in some cases, the verification of profit margins applied on service charges. It also assists in calculating the effect of specific contractual terms which may be effective for certain tenants, such as rent-free or discount periods, in quantifying profits or losses on fit-outs or in assessing structural vacancy rates.

Analysing the financing structure of the target is of utmost importance as it contributes to the assessment of related risks and may help identify topics that need to be addressed. Key conditions, such as the currency of related loan facilities and bearing interest at a floating or fixed rate, may all be critical from the purchaser's perspective when considering a potential transaction.

Overall, there are numerous aspects of real estate transactions which require detailed financial due diligence in order to be able to properly address the specific attributes of the asset or entity subject to the envisaged transaction.

Áron Kovaloczy

Managing Director
DLA Piper Business Advisory

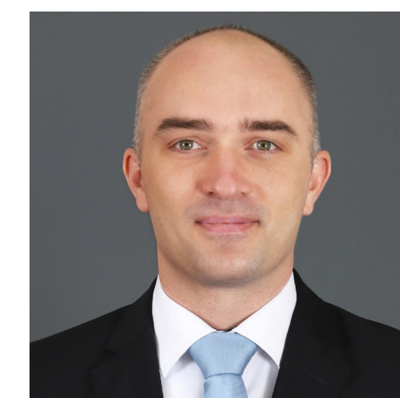
About us

Our experts at DLA Piper Hungary's Real Estate Team cover all sectors related to Real Property, in both local and international markets. We possess extensive experience in supporting real estate developers and investors and our team provides commercial and innovative advice that adds value at all stages of the investment and development cycles of a real estate transaction. We have outstanding reputation for advising on transactions regarding logistics centres, industrial properties and infrastructure developments. Our experts provide support in relation to the planning, procurement and construction phases of these projects.

We cover all aspects of property law, as well as full-scale tax and business advisory services, providing our clients with a truly 360 degree business support service. Our team works closely with our Corporate M&A, Litigation and Regulatory, Finance, Tax and Business Advisory teams, which allows us to structure all real estate transactions efficiently from inception to implementation.

Furthermore, we are part of one of the largest real estate practices in the world; a single unit, cutting across borders and simplifying projects. We work across a diverse range of sectors and we have a rounded view of the market that adds more insight to the advice we give you. If you have any questions, please feel free to contact us.

Contact us



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