THE CYPRUS DEBATE: FROM BLACK CYGNET TO SWAN?

APRIL 2013

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INTRODUCTION

The events of the last few weeks would lead many to believe that Icarus was a Cypriot, flying too high without fully appreciating the risks involved. We wrote about the various risks regarding Cyprus in our article 'Black Cygnet' released in Q4 2011, when we predicted a backlash regarding the tax haven status of the country within an increasingly austere EU. The banking system had grown to eight times the size of the Cypriot economy's annual GDP – with much of this due to the country's role as an offshore tax haven.

Equally, local banks in Cyprus were offering north of 6% on deposit while the rest of Europe's banks were offering around 1%. This implied both liquidity issues in the bank and the use of high risk investments, namely Greek sovereign bonds. Although the European Banking Authority (EBA) is getting a lot of criticism for 'clearing' the Cypriot banks in its 2011 stress tests, it actually qualified them in its 2012 capital adequacy report accounting for sovereign risk exposure.

To be honest we didn't think it would get this brutal this quick. But it has, and we all know why with hindsight. As wealthy nations struggle to maintain their own fiscal health there is no longer any tolerance of, nor pity towards nations who think they can have their cake and eat it too.

THE CYPRIOT STATUS QUO

Following the €10 billion bailout deal with the European Union and the International Monetary Fund, Cyprus has seen the introduction of capital controls. The second largest bank, Laiki, is being closed, with substantial losses to be absorbed by holders of its bonds and those with deposits over €100,000. Those with savings of €100,000 or less will see their cash transferred to the Bank of Cyprus, the country's biggest bank, and kept intact. The Bank of Cyprus is being reconstructed (in actual fact nationalised), and the costs of making sure it has enough capital to operate safely in the future will fall on its deposits of greater than €100,000.

This creates a very difficult position for Cyprus, its residents and economy as tourism and retirement planning will be impacted negatively and banking capacity will be severely restricted. But what are the wider ramifications?

In this article we focus on the real estate impact, especially given the large number of special purpose vehicles and companies established in Cyprus to hold and manage real estate located in Eastern Europe.

1 Will reduced Cypriot banking capacity directly impact on property markets in Eastern Europe?

2 Will Cypriot capital controls limit the operational capacity of Special Purpose Vehicles (SPVs) and holding companies in place; what impact will this have on Eastern European investment markets?

3 What are the implications surrounding the use of offshore vehicles in domiciles such as Cyprus to hold real estate long-term?

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HOW DOES THIS IMPACT EASTERN EUROPEAN REAL ESTATE MARKETS

1. **Will reduced Cypriot banking capacity directly impact on property markets in Eastern Europe?**

In a word, no. Whilst Cypriot banks do have business interests in Greece and some countries in Southeast Europe, their exposure and influence on property markets is very limited. Neither Laiki Bank nor the Bank of Cyprus has any direct commercial real estate (CRE) lending legacy.

2. **Will Cypriot capital controls limit the operational capacity of SPVs and holding companies in place; what impact will this have on Eastern European investment markets?**

Cypriot SPVs are a common form of holding vehicle for owners of real estate located in Russia and Ukraine in particular, to a degree in Poland and to a lesser extent in other Eastern European countries. Investors in most Central and Eastern European (CEE) countries tend to favour vehicles domiciled in Luxembourg and Holland. So while the potential Cypriot impact is significant, it is not necessarily widespread.

Using Cyprus as a domicile does not necessarily require anyone to keep a lot of money in the country. It merely requires them to channel their profits through a Cypriot holding company which, in turn, is typically owned by another company or individual in another country. Thus Cypriot tax vehicles are still largely functional, even though Cypriot corporate income tax (CIT) reportedly went up 2.5% on the back of last month's events.

There are also operational risks to businesses that use Cypriot vehicles to trade - the risk being capital controls can restrict, but not ban, payments out - but these are minimal when it comes to real estate SPVs. To date, we have only come across anecdotal evidence of owners of Cypriot vehicles are considering shifting their SPVs and operations to alternative domiciles.

3. **What are the long-term implications for utilising offshore vehicles in domiciles such as Cyprus to hold real estate?**

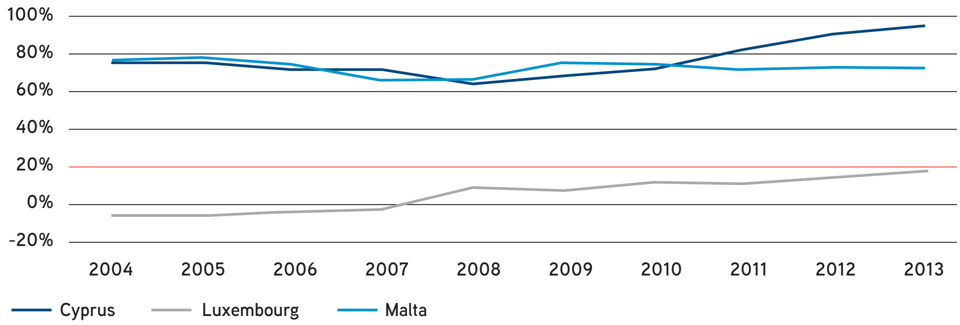
Let's go back to Lehman Brothers and the crushing events immediately after which led to the initial socialization of losses under the 'Geithner doctrine' and its 'too big to fail' philosophy. In the original context 'too big' really meant the interconnectivity between banks was too big to ring-fence. After four years of stress testing, regulation and re-stress testing the 'too big' rule is less about systematic risk and more about specific risk of a bank or, more frighteningly, a country.

Cyprus as we now know didn't meet the rule, but it is only one of many jurisdictions used across Europe as a domicile for real estate SPVs and particularly holding companies. Malta and Luxembourg are popular alternatives, so what are the risks concerning their longer-term use?

In the EBA's 2012 capital adequacy report it was noted that none of the home banks of Malta or Luxembourg had any sovereign exposure, so there is no obvious risk from this perspective.

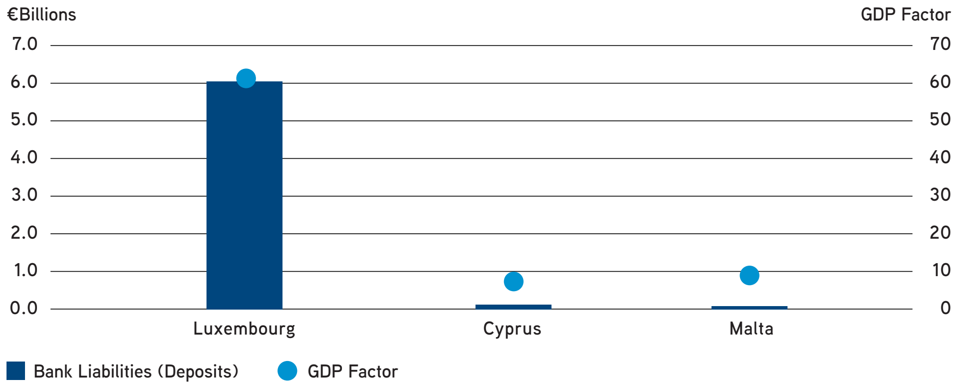
If we look at the wider macro-economic risks, notably government debt, we can see Cyprus let its balance sheet slide post-2008, the year it adopted the Euro, while Malta got things back under control quickly and assuredly. Luxembourg has maintained a very healthy position in this regard, although government debt and current account deficits have started to creep up in recent years.

FIGURE 1: GOVERNMENT DEBT AND C/A DEFICIT AS % OF GDP



When we look at bank liabilities (deposits) as a proportion of GDP, however, we see a very different picture. Whilst bank deposits in Malta and Cyprus are both around a factor of 8 to GDP, the volume of banking deposits relative to the Luxembourg economy is excessively high at closer to 60. When placed in a wider European context, we can see why Luxembourg has set a few alarm bells ringing, when the Eurozone average is just 3.7.

FIGURE 2: BANK DEPOSITS AS % OF ANNUAL GDP



This puts a very different spin on things and European officials have been drawing worrying comparisons between the two countries' oversized financial industries. Mario Draghi, president of the European Central Bank, cautioned on Thursday 4th April that "the recent experience (of Cyprus) shows that countries where the banking sector is several times bigger than the economy are countries that, on average, have more vulnerabilities....Financial shocks hit these countries stronger, simply because of the size of their banking sector."

FOCUS ON LUXEMBOURG

Luxembourg is a much larger financial beast than Cyprus or Malta. The country is reportedly the world's second-largest centre for investment funds, with some 3,800 funds holding assets worth €2.5 trillion ($3.2 trillion) — around 55 times the country's GDP. It has 141 banks based there, with five of them domestic institutions and the remainder mainly divisions of foreign banks. The balance sheets of the banks in Luxembourg have swollen to about 22 times the country's annual GDP of €44 billion (compared to 8 times in Cyprus).

BAIL-IN RATHER THAN BAIL-OUT

Although Luxembourg has relatively little debt, if it faced a widespread problem it might not be able to cope as help from its Eurozone partners may not be so forthcoming. For one thing, it won't be able to say it wasn't warned. Jeroen Dijsselbloem, the plain-spoken chairman of the bloc's 17 finance ministers, warned countries with outsized banking sectors to "deal with it before you get in trouble….Strengthen your banks, fix your balance sheets, and realize that if a bank gets in trouble the response will no longer automatically be 'we'll come and take away your problems'."

This message reinforces the adoption of a 'bail-in' model, not the 'bail-out' one we've become more accustomed to of late. Luxembourg's government has naturally gone on the defensive, rejecting calls to shrink its country's main source of wealth to a more manageable size, claiming that its banking industry is much more secure than that of Cyprus and any crackdown would not only harm its own economy but that of the wider Eurozone.

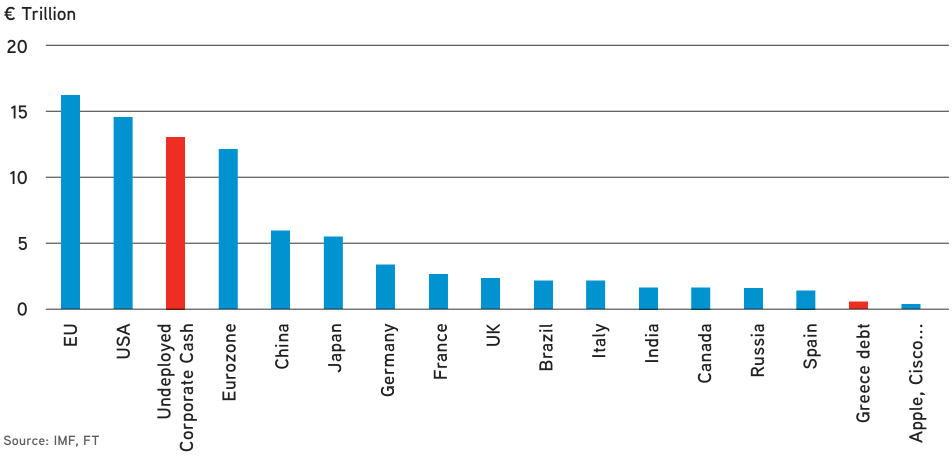
TRANSPARENCY & TAXATION AT SOURCE

Yet the real problem is not just the risk associated with an overweight banking sector, it is the lack of transparency that comes with it. The success of Luxembourg's financial sector was initially fueled by lax regulation, secrecy and low taxes. The country later changed many of its laws following pressure by its European partners, but critics say the financial industry still lacks the necessary transparency.

To counter this, Luxembourg Finance Minister Luc Frieden recently reported that they are preparing to ease banking secrecy rules and work more closely with foreign tax authorities. This comes quickly on the heels of German Finance Minister Wolfgang Schaeuble's statement that Berlin would push the EU to take legal measures against tax havens amid growing outrage over the scale of tax evasion. This is the critical area which is growing in importance, and with increasing momentum. It is quite clear why.

Firstly, the realisation that austerity measures are now at marginal levels, even excluding the issues of voter fatigue, limits government action on the expenditure side of deficit control. On the income side, the fact that companies are hoarding cash rather than re-investing or spending it renders somewhat lame the assumption that low headline taxes drive commercial consumption and economic growth.

FIGURE 3: NOMINAL GDP (2010) AND UNDEPLOYED CORPORATE CASH



Source: IMF, FT

Secondly, increasing headline tax rates is often difficult so there is more of an incentive to close tax loopholes. This might seem a remote risk to Double Taxation Treaties (DTT's) but, as the Russians have demonstrated with regard to their treaty with Cyprus, this is closer to the OECD model of taxing at source in order to increase domestic tax revenues.

DTT CHANGES IMPACTING REAL ESTATE HELD IN CYPRUS

In October 2010, Russia and Cyprus amended their double taxation agreement part of which related to real estate investment. The most important change in the treaty allows Russia to apply its domestic capital gains tax under certain conditions. This conforms to articles contained in the standard OECD model tax convention. Prior to this change, capital gains taxing rights were applied in the country of residence of the selling company. In addition, real estate investment trusts and funds will have their dividends treated as being income from real estate for the purposes of the treaty. This amendment comes into effect from January 1, 2015.

In June 2012, Poland and Cyprus amended their DTT changing the way dividends from Cypriot companies are assessed. From 1st January 2013 dividends continue to be taxed at 19% in Poland but can only deduct 10%, if withholding tax is actually paid and withheld by Cyprus.

If this can happen with Cyprus, then there is a very strong chance that the tax treatment of 'offshore vehicles' is likely to change.

CONCLUDING COMMENTS

Momentum is clearly building behind certain European governments push for greater transparency, in order to target increasing revenues through taxing at source. Tax havens are in the firing line, so domiciles such as Luxembourg will have to resign themselves to increased scrutiny, which could impact their longer-term suitability as locations for investment vehicles.

How tax is treated will ultimately boil down to the bilateral agreements made between countries. But as we've seen with Cyprus, these changes do impact how real estate taxes will have to be managed. Given the large number of Eastern European assets held in SPVs in both Cyprus and Luxembourg, the message for real estate investment markets is straightforward.

No matter where or how an asset is held, ensuring that deals are being priced to account for the impact of tax - particularly capital gains tax - is paramount when conducting transactions. Whilst accounting for latent capital gains tax has become more commonplace in recent years, the chances are that whether a deal is priced at a yield of 6.5% or 8%, there could be an increasingly wide variation in returns around that number, as a result of the deal structure/domicile involved.

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Damian Harrington, MRICS; MSc
Regional Director - Research & Consulting
CEE Investment Services
Eastern Europe Regional Team

Colliers International
Porkkalankatu 20 A
FI-00180 Helsinki
Finland

MOB +358 400 907 972
MAIN +358 9 856 77 600
FAX +358 9 856 77 611
EMAIL damian.harrington@colliers.com

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> The future role of Banking and the impact on the real estate industry.

> The impact of Latent Capital Gains Tax on commercial yield pricing.

> Generational change and the impact on office space demand and supply.

> The market positioning of the Business Process Outsourcing industry in Eastern Europe.

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