

Project finance capability of homebuilding in the Republic of Serbia

Željko Spasenić
*University of Belgrade, Faculty of
 Organisational Sciences*
 Belgrade, Serbia
 zeljko.spasenic@fon.bg.ac.rs

Sladana Benković
*University of Belgrade, Faculty of
 Organisational Sciences*
 Belgrade, Serbia
 sladjana.benkovic@fon.bg.ac.rs

Veljko Dmitrović
*University of Belgrade, Faculty of
 Organisational Sciences*
 Belgrade, Serbia
 veljko.dmitrovic@fon.bg.ac.rs

Abstract—Project finance is characterised by a range of specific features in comparison with standard financing sources such as corporative or credit financing. In most cases, the difference arises from the characteristics of the borrower and way of generating cash for loan repayment. Accordingly, if the project has passed the elimination criteria, that is, golden rules of project finance, it can be regarded as potentially suitable for financing. The application of project finance in the Republic of Serbia is a consequence of experience and expertise of leading foreign banks, due to a need for further expansion on the market, but also in changes that happened in the banking sectors by implementation of Basel regulations. The paper aims to point to the general principles of project finance on an example from business practice and to analyse capability of financing in the area of residential construction, appreciating the fact that significant diversifications of project finance in the Republic of Serbia can be expected in the forthcoming period.

Keywords: *project, project finance, homebuilding, project indicators*

I. INTRODUCTION

In the context of the Basel III standard, project finance is one of the three sub-categories within special financing. Special financing includes exposure of bank to the entity (usually special purpose vehicle – SPV) which was established for the needs of financing or managing certain tangible assets. The primary source of repayment of borrowed funds is revenue achieved from the assets (i.e. its sale or lease). The structure of placement (contracted relation of creditor and borrower) must be such as to provide the creditor with a significant degree of control over the borrower's property and cash revenues it generates.

According to Basel Committee “project finance, as a subcategory of specialised lending, refers to the method of funding in which the lender looks primarily to the revenues generated by a single project, both as the source of repayment and as security for the loan. This type of financing is usually for large, complex and expensive installations such as power plants, chemical processing plants, mines, transportation infrastructure, environment, media, and telecoms. Project finance may take the form of financing the construction of a new capital installation, or

refinancing of an existing installation, with or without improvements [1].”

The basic elements of the above definitions of project finance point to its most important specific features that must be appreciated when structuring bank loans intended to the financing of this type of credit applications. This primarily refers to the fact that the immovable, which is the object of financing, is the basic cash generator for credit repayment. The uniqueness of the project imposes an additional challenge, as every project must be approached with special attention to find a structure most suitable for the given occasion.

Parallel with the development of national economy and banking sector, project finance in Serbia has experienced a positive, rising trend, thereby attracting significant attention of researchers and academic community. Research of domestic market in the domain of project finance refers to risk evaluation of project finance in Serbia [2, 3], potential and challenges of project finance of renewable energy sources [4], capital structure [5, 6], analysis of methodologies of project finance and their applicability depending on the type of project [7], analysis of key factors of successful project realisation in family enterprises [8], project management in the public sector [9], influence of intellectual capital on project performances [10], etc. The paper aims to present and analyse the principles of project finance in the housing construction and point the challenges and potentials of this market segment. We regard the paper as complementary to previously recorded research in this area.

After the introduction, the greatest attention in the second part of the paper is devoted to actual trends on the real estate market of the Republic of Serbia and organisational positioning of project finance in banks as a response to market demands. The third part of the paper presents the basic principles of project finance regardless of the type of project and then explains the methodology of project finance of homebuilding with appropriate analysis from the business practice. The last chapter of the paper is devoted to the final considerations, but also expectations regarding the development of project financing in the Republic of Serbia.

II REAL ESTATE MARKET IN SERBIA

The positive trends and increase of activity on the real estate market of the Republic of Serbia, in the past five years, are confirmed by the data on real estate trading. According to the Republic Geodetic Authority (RGA) the number of registered contracts on estate trading has grown from 87,587 in 2014 to 112,745 in 2017. According to the number of submitted contract, the number of estate trading contracts is in accordance with the degree of development of municipalities, that is, the highest volume of estate trading is present in municipalities whose development degree is above or 80-100% of the republic average, whereas the majority of all contracts in the Republic of Serbia refers to the City of Belgrade [11].

According to the type of real estate in trade, the most represented contracts are those with trade or lease of separate parts of buildings – 43%. The participation of contract referring to land encompasses 38%, trade-in buildings participate with 13%, whereas mixed contracts appear in 6% of trade. Participation trends of different real estate, whereas mixed contracts appear in 6% of trade. The trends of participation of different types of real estate in the total trade are stable, where the primacy is held by flats and agricultural land. The most significant percentage in buying, selling and leasing separate parts of buildings is held by flats, which is why this market segment is regarded as the most attractive and most liquid. Business premises are traded in a small percentage, as the business operations are mostly done in leased premises [11].

The average value of traded immovables in the Republic of Serbia for 2017 amounts to 2.79 billion EUR. From the aspect of the type of immovables, the greatest share is taken by flats, with 58%, then residential buildings with 9%, agricultural land with 6% and building land with 5%. The positive trend on the real estate market is also confirmed by the average prices of real estate, recording a constant growth in the past three years [11]. With the purpose of transparent information of the public, DOMEX – real estate index in Serbia – was created in early 2012. DOMEX for a certain period (month, quarter or year) is calculated by dividing the average value of all prices per m² achieved in a given period on a given territory with the average value of all prices per m² on the stated territory [12]. This is also the first and only index of prices of real estate in the Republic of Serbia, which certainly contributes to better understanding and monitoring market trends. Traditionally, business operations with real estate and construction industry, in general, are regarded as high risk for financing on the domestic market. However, the positive inclination of banks in financing real estate in Serbia is contributed by the positive results of the total banking sector. According to the latest report of the National Bank of Serbia, the share of NPLs in total gross loans amounts to 6.6% at the end of Q3 of 2018, which is the historical minimum from

the introduction of uniform reporting in 2008 [13]. Viewed by industries, the highest degree of NPLs is present in real estate business (gross NPL indicator 10.8%) and construction industry (gross NPL indicator 10.6%). This represents a significant improvement in relation to Q1 of 2012, when NPL rates amounted to 37% and 32.4% respectively, [14], or in relation to Q4 2012 when NPL rates for these two industries reached 34.4% and 45% respectively [15]. As a result of negative experience in financing these industries, it was necessary to regain the confidence in project sponsors and develop an adequate set of standard providing, from the creditors' perspective, an adequate evaluation of financial justification of individual types of real estate. To enable banks to respond to the requirements of project finance adequately, with the appreciation of differences existing in relation to standard (corporate) placements, it is advisable to separate these operations organisationally to develop specific expertise required for realisation and monitoring of this type of placements. On the domestic market, we can identify three types in organisation of project finance operations:

1. A separate project finance department is formed in banks that regard project finance as a significant segment of their credit activity. This is the best approach, as it provides a concentration of expertise in the area of project finance, providing the highest efficiency of processing this type of client applications. Parallel with the formation of a separate project finance department, it is also necessary to have support activities (e.g. within legal affairs and credit administration affairs) specialised for servicing this type of loans;
2. Project finance affairs are located in the organisational unit for structural financing which, apart from project finance, can provide commodity financing, LOB, trade finance, mergers and acquisitions. It is an internal rationalisation within the bank providing separation of standard corporate crediting from other forms of structural (special) financing. This type of organisation provides a lower degree of bank specialisation for project financing, but it enables it an a priori recognition as a special form of crediting.
3. Project finance operations are not separated in terms of the organisation from other loan operations, but employees are allocated who will deal with this form of financing in case of client applications. It is applied in banks not recognising project finance as a significant potential on the domestic market. These are mostly smaller banks, dealing project finance only exceptionally, in case of existence of simpler requirements.

III METHODOLOGY OF PROJECT FINANCE IN THE REPUBLIC OF SERBIA

The application of project finance in the Republic of Serbia is defined by generally accepted principles of project finance, regardless of the project type. Fulfilment of the requirements of

creditors (banks) represents a prerequisite for providing funds from loan sources required for project realisation. The importance of project finance in the context of the relationship between investor (sponsor and creditor) banks arises from the fact that almost all real estate project on the market of the Republic of Serbia, demanding borrowed financing sources, is realised with the help of banks. Two initial criteria for measuring the success of realisation of a project, which are equally important for all sides involved in the project are time and cost analysis of project efficiency, which is, in most cases, measured by degree of harmonisation or deviation of the project from the time plan. In complex projects, both plans (budgets) are created for different phases that can be identified during the whole period of project realisation, implying a certain degree of completeness in relation to the whole. Separate monitoring of these performance indicators provides a good information basis for taking corrective actions by the investors or creditors in early stages of project realisation.

Creditors pay great attention to the analysis of the justification of the credit application because decisions on this type of placement are almost irreversible due to large amounts of placements, long repayment periods and inability of sponsors to provide refinancing. An additional reason is asymmetrical information of sponsors and creditors. Flyberg, Holm and Buhl show that the costs (budgets) of large infrastructural projects are underestimated and that project sponsors often present non-credible information [16]. Project realisation within the framework of the adopted budget is only one of the aspects that must be adequately managed in the process of project realisation. Typical project finance begins by establishing a separate enterprise whose sole purpose and business activity is construction of immovables and sale or renting thereof — thus established entity (SPV) cannot have any other business activity, nor can it realise simultaneously a large number of project, implying the strict adherence to the principle: one SPV – one land plot – one immovable construction project. As a rule in case of deviation from this application, the bank will impose limitations returning the borrower into the desired structure. For instance, if a residential complex construction projects realised in phases, the subsequent phase of building can be commenced after the completion of the previous, or total project independence of different phases must be provided if the size of the whole project if the size of the entire project surpasses the bank's credit appetite. Consequently, this is limited or non-recourse financing of a newly developed project through the establishment of a vehicle company, that is, repayment capacity of the borrower above the cash revenue directly generated by renting or sale of the financed assets is negligible.

The first knockout criterion adopted in domestic practices is investor reputation. Due to the

previously presented negative experience from the previous period, creditors insist that the project sponsor must be a reputable investor with experience in real estate projects (i.e. professional real estate developer). Investor reputation is confirmed through a reference list of realised projects and an overview of the existing immovables in the portfolio. The minimal set of information that must be presented to the bank includes immovable property overview by purpose, location, lessees and construction year, including basic performance indicators enabling the analysis of the financial state of the portfolio and drawing conclusions on the business model of the sponsor and the desired model of financing. The sponsor's experience in project realisation, for the immovable that is the object of finance, zero or negligible rate of default of realised project and conservative or moderate financing policies represent the profile of an ideal investor. If, however, the sponsor does not have satisfactory real estate experience, crediting is still possible, but for certain types of projects, with a smaller amount of loan application, with engagement of professional agencies that would deal with individual aspects of projects (e.g. asset management, facility management, marketing etc), whose costs will fall at the sponsor's expense. Such an approach can be regarded as an exception rather than a rule. The second knockout criterion of financing is the incompleteness of project documents. The required minimum of project finance documents includes evidence of ownership of the plot, external valuation, valid construction permit and evidence of eligibility of the immovable for registration of the first-order mortgage for the benefit of the creditor. The third knockout criterion is speculative financing. In the domestic practices of project finance, speculative financing is the realisation of projects with unforeseeable cash generation potential. The speculative component exists in the case of construction of a building to be rented, financially weak lessee, absence of satisfactory degree of interest for purchase and/or renting the immovable which is the object of construction, or the project budget is so high that its profitability is questionable, which is expected to overcome by growth in selling price or lease price during the construction period of the building.

If the project is evaluated positively from the aspect of the stated elimination criteria, it can be regarded as potentially eligible for project finance. The following section contains the most significant criteria for evaluating the financial performance of loan application for project finance of homebuilding.

According to Ambrose and Peek, a sustained decline in the large private homebuilder market share series over the period from 1988 to 1993 when many banks with deteriorated health reduced their lending to raise capital ratios. Also, their research confirmed that in areas where banks were less well capitalized and had more problem construction loans, the market shares of large

private homebuilders that relied primarily on bank credit to finance their production suffered at the expense of the public homebuilders that had better access to external funds, in large part due to their direct access to public capital markets [17].

Homebuilding projects can be regarded as the least risky for project finance, which is why they are widespread on the market of the Republic of Serbia. The basic reasons of acceptability of homebuilding for project finance are: first, a relatively short period of project realisation (as a rule, up to 24 months), making the project resilient to market changes in the long run and second, liquid flat market, providing reliable data on the current prices and demand.

The basic financial parameters of the project that are analysed are:

1. The project budget includes all expenses necessary for project realisation. To minimise uncertainty in terms of reliability of the presented budget, verification must be provided by an independent party specialising in monitoring this type of projects. A reliable budget is a basis for establishing the client's share (min. 20%) and reliable calculation of financial indicators of the project;

2. Creditor breakpoint represents the minimal average selling price per square metre of built housing space that provides full loan repayment. It can be calculated as quotient of the total loan and net construction area. In practice, the minimal calculated price is often divided by the expected market price of flats to get the maximum acceptable percentage of reduction in market price upon the completion of the project. Maximum acceptable percentage of reduction in market price is called Risk at Completion (RAT);

3. Advance sale: The most reliable indicator of the existence of demand for future flats is advance sale, that is, sale of a certain number of flats before the commencement of their construction. In domestic conditions, advance sale of minimum 20% is a prerequisite for loan realisation. The positive influence of advance sale on loan realisation is confirmed by Chan, Fan and Yang [18];

4. Taking into account the amount of achieved advance sale, it is possible to calculate the discounted bank breakpoint as a quotient of the loan amount reduced by the amount of advance sale and net building value reduced by pre-sold surface. Analogous to the previously explained, Discounted Rate at Completion (DRAT) is calculated, which should be higher than if there had been no advance sale.

As project realisation is expected within the period of up to 24 months, factors influencing the price of flats in newly built dwelling in the long term (population, real net earnings, interest rates and GDP [19]) remain outside the range of detailed

analysis of justifiability of the project. Also, as a rule, it is not necessary to make a detailed projection of cash inflow, as the sale of flats, in the conditions of liquid market, is mostly realised within a period of 6 to 12 months upon completion of the project. In condition of above-average market activity, sale of flats can be realised even before the completion of the project, enabling investment loan early repayment by the investor.

The methodology of project finance will be presented on the example of project finance of homebuilding approved by a bank operating in the Republic of Serbia. The case is based on a realised homebuilding project, but the figures of parameters of the project itself were modified for the needs of this paper.

The investor approached the Bank with an application for project finance of IV phase of construction of a residential complex in one of Belgrade municipalities. The bank had financed the previous three construction phases successfully, where an individual phase includes the construction of a block on a joint plot intended for construction of the entire project. The project has a total of six blocks (residential buildings) and was presented to the Bank in advance, in the form of project plan and conceptual solution, during the realisation of application for financing I phase.

SPV structure: The investor was established in the legal form of a limited liability company. The investor's only activity is construction and sale of the residential complex that is the object of application for project finance. The enterprise owns the plot on which the complex is built, and does not own any other property. Following the stated, it is an SPV enterprise. The only owner of the SPF is a company from the Netherlands, owned by a foreign national. It is a professional real estate investor, whose expertise was confirmed by referent list of realised project in the countries of Eastern Europe, including projects in the Republic of Serbia. The investor is involved only in homebuilding, which is regarded as extremely positive, as it confirms the relevant experience and expertise for realisation of the project.

Project metrics: the basic project parameters are presented in the table below:

TABLE 1. PROJECT PARAMETERS

Flat Structure	Number of flats	Area in m ²	Average area of flat in m ²
Studio	5	145	29
Single-room	48	2.025	42
Two-room	17	1.096	64
Three-room	22	1.786	81
Total	92	5.052	55

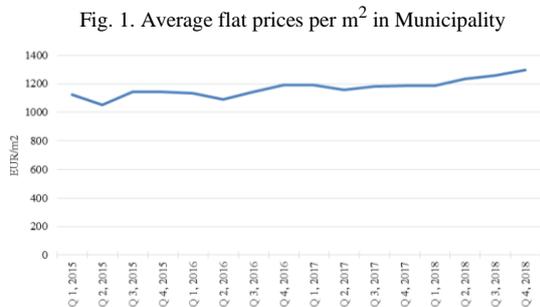
Flat structure	Average expected sales price in EUR/m ²	Total expected sales in 000 EUR
Studio	1.357	197
Single – room	1.366	2.766
Two-room	1.333	1.461
Three-room	1.320	2.358
Total	1.342	6.781

Source: Authors

Project budget: The total project budget, including all the construction costs of the residential block, amounts to EUR 5.200.000, where the loan application is EUR 3.640.000. Consequently, the investor's share amounts to EUR 1.560.000, which is 30% of the share. The project budget was confirmed by a domestic branch of a reputable foreign company involved in monitoring construction of immovables. Project timeframe, predicting construction of 18 months, was also evaluated positively by the same company in charge of monitoring.

The contractor is a domestic construction company, thereby reducing the construction risk to an acceptable measure. The contract with the contractor was concluded on a turnkey basis, which reduces the risk of exceeding the project budget.

Market: the average expected sales price of 1.342 EUR/m² could be regarded as reachable, as we have an increase of 3% compared to the previous phase, whose sale was successfully completed before submitting a new application for project finance. Also, the prices of flats show a positive trend and have reached an average of 1.300 EUR/m² for all flats bought and sold in the Municipality (old building and new building).



Source: [20] <http://www.nkosk.rs/content/indeks-cena-nepokretnosti-nacionalne-korporacije-za-osiguranje-stambenih-kredita>

The investor proposed advance sale of the total net residential area of 1.080 m² (20% of the total net residential area) in the minimum acceptable amount of EUR 1.350.000. Advance sale in the stated percentage reduces the speculative component of financing.

Starting with the available information, we can calculate the most important project indicators:

TABLE 2. PROJECT INDICATORS

Indicator	Formula	Indicator value
Investor breakpoint	$\frac{\text{Project budget}}{\text{Net residential area}}$	1.029 EUR/m ²
Creditor breakpoint	$\frac{\text{Loan amount}}{\text{Net residential area}}$	720 EUR/m ²
RAT	$1 - \frac{\text{Creditor break point}}{\text{Expected sales price}}$	46%
Discounted breakeven point	$\frac{\text{Loan amount} - \text{Presales}}{\text{Net residential area} - \text{Presales}}$	576 EUR/m ²
DRAT	$1 - \frac{\text{Discounted break point}}{\text{Expected sales price}}$	57%

Source: Authors

All the stated indicators show satisfactory profitability reserves (investor breakpoint is 1.029 EUR/m², which is significantly below the expected market price), whereas project solvency parameters are acceptable for the bank, as they provide for bank loan repayment in case of execution of collateral when it is realistic to expect a significant discount in relation to market price.

Collateral: Security structure implies establishing a pledge in favour the creditor on all property parts that are suitable for pledging. More precisely, in the case of homebuilding process, collateral implies first-order pledge on the shares of SPV and first-order mortgage on building under construction. Also, as security in favour of the bank, transfer of performance guarantee that the contractor is obliged to submit can be requested, as well as transfer of advance guarantee for the full amount of advance payment to the contractor. Both guarantees must be transferred (pledged) in favour of the bank.

Realisation and monitoring of investment loan are more complex in relation to standard commercial loans. Before disbursing the first loan batch (over the availability period of 18 months, which is also the expected period of building construction), it is necessary to register the collaterals in favour of the bank, confirm that the client fully invested their share in project realisation, and that advance payment reached 20% of the building area.

All loan batches are realised based on the contractor's temporary situations confirmed by the engaged project monitoring company. The investor has the obligation to submit monthly reports on the sale of flats to the bank, with detailed reports on sold flats, achieved sale prices and agreed payment schedule which is, as a rule, previously harmonised with the bank's requirement. The entire cash flow related to project realisation is performed exclusively through the investor's current accounts opened at the bank creditor.

During the loan realisation period, that is, up to the period of full loan repayment, the investor is not allowed to open accounts in other banks, which provides full control of money flows (verification of credibility of data) by the Bank. Bank employees, who worked on transaction structuring, have the obligation to visit the building site regularly to get visual confirmation of the progress of the project. The importance of project control, in all its phases is also confirmed by O.A. Chibueze et al. [21].

Incomes earned by sale of flats can be used for the needs of financing the construction of the building with the bank's approval. The loan must be paid in full within 24 months from the date of drawdown of the first loan batch. Upon the full repayment of the loan, the bank will release the mortgage from the plot and remaining unsold flats.

Unlike financing flat construction projects, where loan repayment is financed from the inflow of money earned by sale of flats, which provides a relatively short loan maturity for this type of project, projects of construction of office, industrial or retail space, that the sponsor will rent require financing with loans of much longer maturity period. This is the result of the characteristic of money flow generating immovables in the form of rent, which represents the main source for loan repayment. Consequently, the investor and the bank remain connected through the project during the entire loan period.

When assessing the project repayment capacity, it is necessary to make a detailed projection of inflow of cash inflow from rent and make a few levels of stress test, simulating the change of repayment capacity in conditions of reduced demand for this type of real estate. It is also necessary to analyse different circumstances that may result in increase or decrease of rent at the end of the lease period [22]. Generally, a detailed cash flow analysis represents an indispensable part of evaluation of this type of project. Advanced tools (e.g. Monte Carlo Simulation) can be of great use for the needs of projection of project repayment capacity.

IV CONCLUSION

The presented methodology of project finance in Republic of Serbia is adjusted to realisation and financing of traditional, infrastructural, real estate projects. As a result of the relatively long development period of its principles investors in Serbian market, also, become familiar with financial and other requirements they will be faced with when seeking bank loans. The methodology is quite similar in all banks which operate in Republic of Serbia and are active in real estate financing, but it also may be the source of competitive advantage among banks.

From the bank's perspective, described methodology secures adequate assessment of credit

risk involved in proposed transaction and full control of borrowed funds. The main drawback of existing methodology is that many bank's requirements are considered complicated and unnecessary by investors. This is no drawback of methodology by itself, but rather it is result of inadequate communication and explanations given by creditors to prospective borrowers. Also, as mentioned, methodology is suitable for financing of traditional infrastructural project and can't be used for another type of projects (for example when financing IT projects).

In the forthcoming period, we can expect an evolution of the above described, traditional project finance model towards its harmonisation with the financing model present in the EU and the USA, due to the increasing number of infrastructural projects, but also current changes brought on by Basel III. By implementation of Basel III, commercial banks will find it increasingly difficult to place project finance loans due to stricter requirements in terms of liquidity imposed by this standard [23].

The practical consequence of implementation of Basel III standard will be reduced banks' interest in long-term placements characteristic of large real estate projects, due to more rigorous requirements for maturity harmonisation of bank assets and liabilities. In addition, to achieve higher liquidity of long-term placements, banks will insist on greater transferability of loans that could be realised without the borrower's consent, with a prerequisite of standardisation of conditions under which it could be done. The mentioned factors could make a positive impact on bond market development in this area, with a larger number of problems that need to be overcome (regulations, increasing capital market transparency, adequate management of construction risk that investors in bonds will probably not be willing to take over, etc.).

The changes mentioned above will primarily influence financing projects demanding longer construction periods, whereas homebuilding could, to a large extent, remain outside the expected influence of changes brought on by Basel III. The key factors of sustainability of high activity on the homebuilding market include available housing loans with low-interest rates, decreased unemployment rate, and increase in real personal income on the territory of the Republic of Serbia.

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