CB RICHARD ELLIS

MarketView

Ukraine Property Investment

H1 2009

Quick Stats

	Change from H1 2008	Change from H1 2007
Investment volume	↓	↓
Number of deals	↓	↓

Hot Topics

- The volume of direct property investment in H1 2009 was extremely small with most deals occurring across highly discounted and readily available work-in-progress assets, such as project on various stages of construction, land holdings, etc.

- Banks' unwillingness to foreclose remains one of the major impediments to capital movement, as forced sales of distressed properties have not yet occurred on the level necessary to revitalize the market.

EXECUTIVE SUMMARY

Following a sharp contraction of worldwide economic activity in q4 2008, the Ukrainian commercial real estate (CRE) investment market essentially came to a standstill. The deal flow over H1 2009 was negligible and consisted of small, one-off and uncommon transactions. Investment activity fell sharply across all property sectors, resulting in nearly a record low turnover. The few transactions that did take place were almost exclusively carried out by small local property companies, while cross-border transactions effectively equalled nil.

With such a limited number of significant deals taking place there are serious doubts among the participants about the current price level. There is no doubt, however, that prices are substantially lower than they were six months ago. Weak investor and occupier demand – brought about by a combination of curtailed financing and severe economic malaise – have depressed values by no less than 50%.

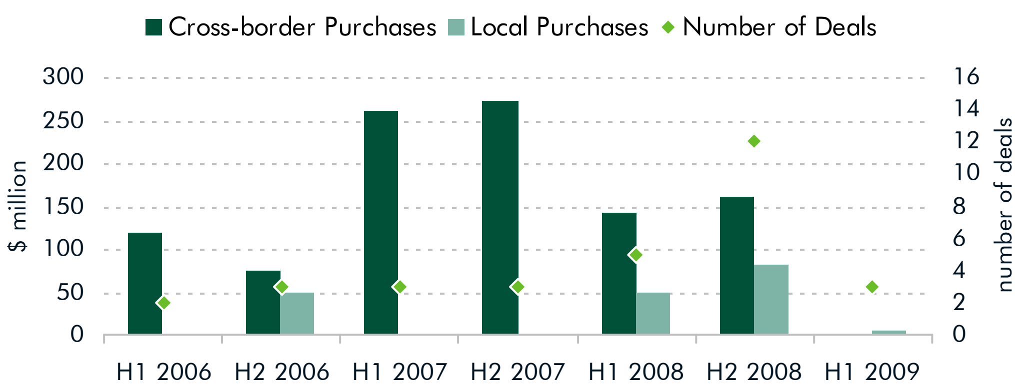
Nevertheless, we expect to see a pick up in investment activity in late 2009 and in 2010, as capital values bottom out creating opportunities for long-term strategic investments. Furthermore, there is a growing likelihood that sellers may finally adopt more realistic price expectations, amid rising foreclosures and forced sales. In fact there are already a number of major deals in the pipeline, which are most likely to be completed before the year end.

MARKET OVERVIEW

Turnover

Total investment turnover plunged some 97% from H1 2008 amounting to less than $10 million – one of the lowest six-monthly figures on record. Such a sharp decline is a direct result of the global financial crisis that has left Ukraine's economy among the hardest hit in the region. This steep correction made vendors and purchasers adjust their expectations, and while the latter have done so swiftly, the former have been largely reluctant to come to terms with new market conditions. There are however signs that sellers may finally be conceding amid a weak market and mounting pressure from creditors. We therefore expect turnover to increase in H2 2009, as the gap between vendor and purchaser perceptions of value levels off.

Semi-annual Property Investment Volume and Number of Deals



Source: CB Richard Ellis

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Investors

There was a minimal presence of foreign purchasers in the market during H1 2009, due to the increased risk aversion and general decline in business sentiment. However, it would be a mistake to write them off at this juncture, as today's prime opportunities (which almost universally offer solid long-term value) begin to look attractive for many private, equity rich investors, who know and understand local markets. Therefore, while there is little chance of new foreigners entering the market in 2009, there is definitely a key role to play for incumbent ones. The same, however, cannot be said about investors from Russia, whose perception of local risks differs little from that of Ukrainian players. Indeed, a major mixed-use transaction is currently under consideration involving investors from Russia who were previously inactive in the market.

With debt capital leaving the market, the array of purchaser types has been greatly reduced. Institutional funds did not complete any transactions on a par with other collective vehicles – previously, the most active group on the market. The difficulties with financing have also greatly reduced the amount any given investor is prepared to put into property. The level of acceptable one-off investment is somewhere between $30 and $40 million. Likewise, purchasers now demand a much greater return on equity – typically at 20-25% – and are fixed on buying at today's prices only. While sensible in itself, the given approach may prove misplaced as time progresses – that the high cost of equity results in passive, risk-free and non-yielding money market investments, when in reality it can already be put to good use in lucrative opportunities in the real estate market. Buyers of course should not rush into snapping up all assets offered at below cost, but they should definitely consider a more long-term view as otherwise they risk missing out on some of the most rewarding opportunities on offer today.

Transactions

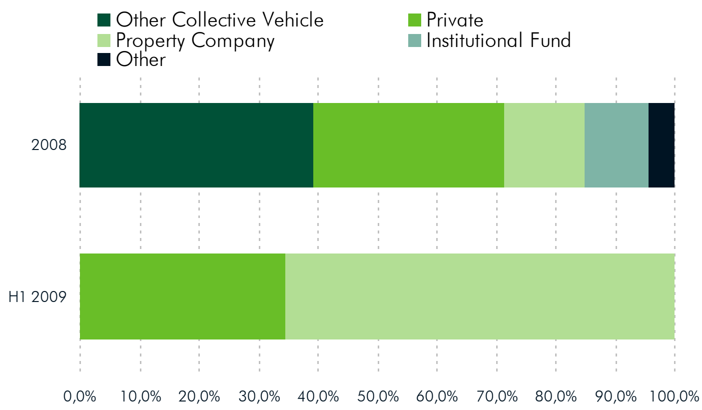
As difficulties with refinancing persisted, the inventory of distressed properties increased dramatically, leading to an outburst of sell offers. As expected, the vast majority of sell offers is confined to work-in-progress assets, such as land holdings, unfinished construction, etc., while quality income-generating properties remained outside the marketplace as owners preferred to hold onto the income and were unwilling to trade them at a large discount. Indeed more money went into projects by means of share purchases or land acquisitions than directly into CRE. This trend is indicative of local property companies succumbing to the pressure to sell their property holdings or share interest in real estate projects in order to recover funds to repay loans, increase liquidity, etc.

Yields

After a record 500 basis point (bp) jump in q4 2008, yields stabilized in q1 2009. However, with saleability showing no signs of meaningful improvement, yields inched upwards again in q2. The softening of prime yields was also fuelled by sustained weakness in the occupier markets as leasing transactions and rental values all declined steeply. Therefore, both yields and rents continued pushing capital values into the red.

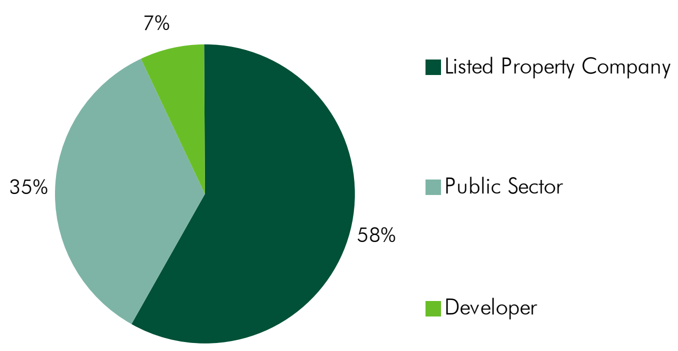
One must be cautious, however, when estimating yields during this volatile environment. Bid/offer standoff between participants is still ongoing, not least because of the disagreements about the current yield level. Therefore, it should be noted that yields currently serve as an indication only and are not based on relevant transactions.

Purchaser Activity by Purchaser Type



Source: CB Richard Ellis

Vendor Activity by Vendor Type – H1 2009



Source: CB Richard Ellis

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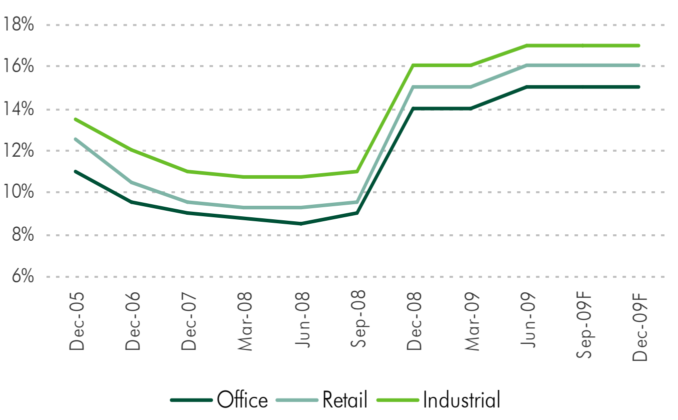
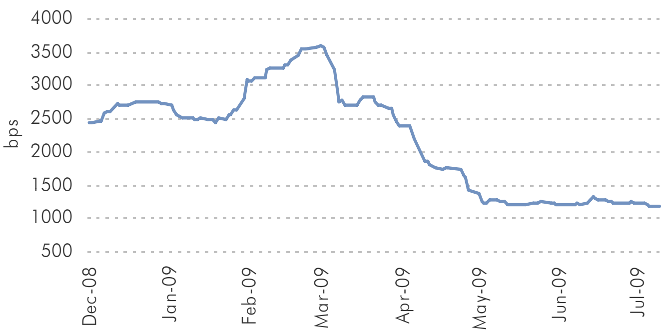
Kyiv Prime Yields



Source: CB Richard Ellis
F – CB Richard Ellis forecast

EMBI+Ukraine



Source: JP Morgan

Ukraine's Credit Rating

Agency	Rating	Date
Standard & Poor's	CCC+/negative	February, 2009
Moody's Investors Service	B2/stable	May, 2009
Fitch Rating	B/negative	February, 2009

Source: Reuters Financial

Selected Monetary Indicators

	2008	2009*	2010*
Real effective exchange rate (av)	87.8	75.9	80.4
Domestic credit growth (%)	76.9	8.4	17.8
Commercial banks' prime rate (av; %)	17.5	17.3	15.0

Source: Economist Intelligence Unit (EIU)
* - EIU forecasts

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OUTLOOK

The state of affairs on Ukraine's CRE investment market over H1 2009 can be summarized in one word: aftershock. While denoting largely negative feelings, it also implies that the worst is over. Indeed there are some indicators suggesting the decline is bottoming out.

Owing to the funding from International Monetary Fund, Ukraine's financial position has improved significantly over the last months. The probability of government defaulting on its obligations has decreased by half (the value of Ukrainian credit default swaps has narrowed from ca. 5,000 bps in March to less than 2,000 bps in June). Local risk free rate (EMBI+Ukraine) has consequently decreased to 12% – down from more than 35% in spring. While in theory these developments should make it easier for local players to obtain financing from abroad, there is little chance of that actually happening, at lease until Ukraine's credit ratings improve.

On the positive note, however, as the first half of the year drew to an end, the most dramatic aftershocks on the occupier market have mostly passed. Rents have adjusted significantly and at present on average stand at the level where they were no less than five years ago. It is thus tempting to conclude that the bottom in terms of rental movements has finally been reached. Still, however, negative absorption will persist in the mid-term, as development completions enter the market, while demand levels remain insufficient to prevent vacancy from further growth. Additional downward pressure on rents is therefore not impossible.

Nonetheless, investment activity is bound to increase in H2 2009. As before, however, transactions will largely be confined to distressed properties or work-in-progress assets. Just how soon we start seeing solid deals taking place will depend on how fast the availability of forced sales opportunities occurs. For the time being banks still remain unwilling to foreclose on a wide scale, thus preventing capital values from finally reaching rock bottom. This position from the banks allows asset holders – even in cases of frozen construction and outstanding debt - to hold onto their gems at sub cost levels, more for psychological than commercial reasons.

Notwithstanding the present impasse, we maintain our initial forecast for CRE investment market to start showing real signs of life in H1 2010. By that time the global economic crisis should abate, improving investor confidence and providing a much clearer view for future rental movements. Therefore, capital values are likely to start picking up slowly in H2 2010 on the back of yield compression. Conversely, due to the large stock of vacant space on the market, rental growth will not be impacting valuations for a longer period of time, resembling the situation after the Russian financial crisis of 1998, when rents were essentially flat for 60 months. This time around, however, given the more developed economic base, the recovery should come sooner. We estimate, rents starting to rise again in H2 2011-H1 2012.

Definitions

Central and Eastern Europe (CEE) includes the following countries: Bulgaria, Croatia, Czech Republic, Hungary, Poland, Romania, Russia, Serbia, Slovakia and Ukraine.

CRE – commercial real estate.

The **prime yield** represents the yield that an investor would receive when acquiring a grade/class A building in a prime location (for offices in the CBD, for example), which is fully let at current market value rents. Prime Yield reflects the level at which relevant transactions are being completed in the market at the time but need not be exactly identical to any of them, particularly if deal flow is very limited or made up of unusual one-off deals. If there are no relevant transactions during the survey period, a hypothetical yield is quoted, and is not a calculation based on particular transactions, but it is an expert opinion formed in light of market conditions, but the same criteria on building location and specification still apply.

Property Investment: all property transactions that are the result of a legally binding document between a purchaser and a vendor. All deals are recorded that CB Richard Ellis is aware of, both on the open market as well as off market deals. We include Sale & Leaseback transactions, but exclude corporate transactions in which real estate is only (a necessary) part of the transaction of the total business. Owner occupier transactions are also excluded. Forward purchases are taken into account in the year the binding purchase agreement is signed. The nationality of the purchaser is determined by the country where the money originates.

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