Ukraine Property Investment

H2 2009

Quick Stats

	Change from H1 '09	Change from H2 0'8
Investment volume	↑	↓
Number of deals	↑	↓

Hot Topics

- Investment activity picked up in H2 2009, albeit from a very depressed level, bringing total annual turnover to only ca. $18 million (€12.5 million)
- While direct turnover was meager compared to previous years, the market has seen a proliferation of other activities, most notably that of debt settlements by non-cash trading of distressed projects
- As in H1 2009, cross-border investors' appetite for local real estate remained diminished and the market was driven almost entirely by small local parties acquiring non-prime properties for opportunistic rather than strategic reasons
- Key measures of Ukrainian real estate market should improve in 2010, but for as long as major investors continue to chase defensive properties, the growth in the number of completed transactions will be restricted

EXECUTIVE SUMMARY

As expected, investment activity has increased in the latter part of 2009, yet the transactions that have been completed so far are insignificant and therefore indicate that the market is not yet out of the doldrums. That said, CRE is definitely, if slowly, getting back on the radar screens of investors. However, it is mostly local investors that remain active, while foreigners continue to shun the marketplace given the risks and the uncertainties involved. Cross-border transactions therefore almost equaled nil in 2009, although some deals on the development side – specifically involving players from Russia – were finalized in the last months of 2009.

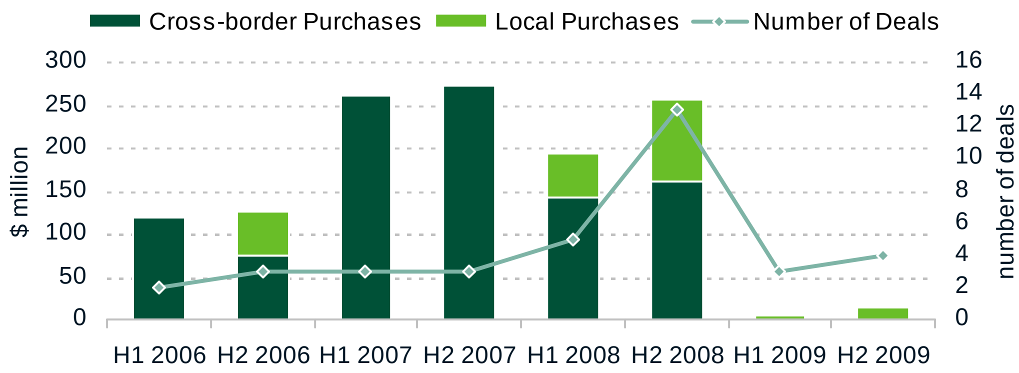
A meaningful recovery of investment market is unlikely to commence before election-induced uncertainties fully subside in Q2 2010 and tenant demand shows noticeable improvements. Prime yields, it seems, have more or less reached the point where further increases look unjustified, but general risks to that outlook remain elevated, given Ukraine's history of troubled post-election periods and acute fiscal pressures.

MARKET OVERVIEW

Turnover

Total property investment turnover (net of debt settlements and development deals) over H2 2009 amounted to ca. $14 million in 4 transactions, three times as much as in H1 2009, but still some 94% down in y-o-y terms. While the upturn in activity has been evident throughout CEE, in case of Ukraine it does not demonstrates rising investor confidence in the local commercial property. This increased turnover in the latter part of 2009 is rather a result of several less upbeat factors, including seasonal effects (the fall is, traditionally, the busiest period), financially stretched government disposing of surplus property assets and pure low-base effects. Nevertheless growing turnover does appear to indicate that the gap between vendor and purchaser perceptions of value is leveling off, albeit not for institutional property.

Semi-annual Property Investment Volume and Number of Deals



Source: CB Richard Ellis

Note: local investment market is extremely small and opaque, so CBRE data on investment volumes does not claim exhaustiveness and is subject to constant revisions. Calculation methodologies were changed in 2008 to take account of share deals. Previously, only asset transactions were recorded. Please see definitions on p. 5

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Investors

The market was driven entirely by small (equity-based) local parties, acquiring non-prime properties for opportunistic rather than strategic reasons. The complete retreat of international investors in 2009 meant that locals are having an increased market share on purchaser side after being net sellers in every year since records began. The proliferation of unnamed private individuals, whose activities nobody would have noticed in a booming market, indicates just how severely the market has shrunk and how endogenous it has become.

It should be noted, however, that cross-border investors did not complete any serious acquisitions not only because of increased risk-aversion but also because of their very tight buying parameters. Indeed, most players with good capital positions, who in theory could revitalize the market, have been primarily focused on defensive product – i.e. prime buildings in core locations with long and secure lease contracts. With very few (if any) vendors offering such product [at transactable price] and even fewer still likely to appear in the nearest future (the motives to sell in a bottomed-out market are disappearing), investors looking for direct real estate exposure should consider broadening their choice of options. Development market in particular is full of distressed sellers with opportunities across the board, but only a handful of properties are in the prime tier of the market.

Transactions

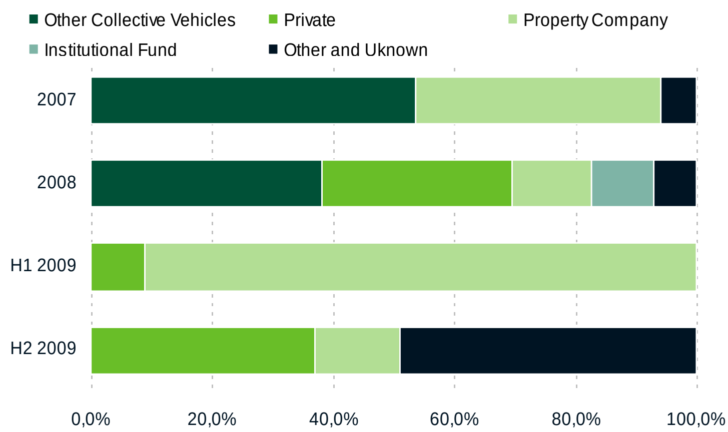
As before, the majority of sell offers in H2 2009 was confined to the most illiquid types of real estate – land holdings, unfinished construction, etc., while prime income-generating assets remained outside of the marketplace. The reason for their absence is twofold. Firstly, the owners were unwilling to part with cash-flow and instead preferred to advertise riskier assets. Secondly, they were in no immediate need to realize value from existing properties, because banks never seriously forced them to. Indeed, one of the main reasons for the lack of transactions (development deals aside) is a very small number of genuinely distressed sellers, which is a rather perplexing aspect in a bearish market when impaired debt situations should, supposedly, be rising. However, because banks have been inclined to turn a blind eye on breached LTV covenants for the sake of avoiding foreclosures (read: bringing assets to the market) and potentially depressing values even further, owners were in no hurry to sell.

Taxation

	Rate, %
Personal income tax	15 (flat)
Corporate tax	25
Value-added tax	20
Social insurance tax	30.8

Buyers with their narrow search criteria also helped quiet the market and if it wasn't for the State Property Fund auctioning off some of its most decent (yet not completely professional) real estate assets – notably, TsUM (Central Department Store) and Bratislava, a 327-room, 3-star hotel – total annual turnover may have been near zero. State Property Fund in general and Kyiv City Council in particular are expected to remain active sellers of real estate in 2010. Although the vast majority of assets that they are going to dispose off will not get reflected in the total investment turnover because of their poor quality, some – like high-street retail premises on Khreshchatyk St, which are proposed for privatization in 2010 – definitely will be.

Purchaser Activity by Purchaser Type



Source: CB Richard Ellis

Major Transactions in 2009

Name	Segment	Region/ Submarket	Type
Druzhba	hotel	Uzhgorod	development; asset
Ekonom+	office	Kharkiv	investment; asset
Leipzig	hotel	Kyiv / CBD	development; debt settlement; asset
Visak	hotel	Kyiv / NC-WB	investment; forward; asset
Bratislava	hotel	Kyiv /NC-EB	investment; shares
Sosnovaya Rosha (Pine Grove)	hotel	Yalta	debt settlement; asset
Mirax Plaza	mixed-use	Kyiv / c-CBD	distressed development; asset
TsuM	retail	Kyiv / CBD	investment; shares

Source: CB Richards Ellis

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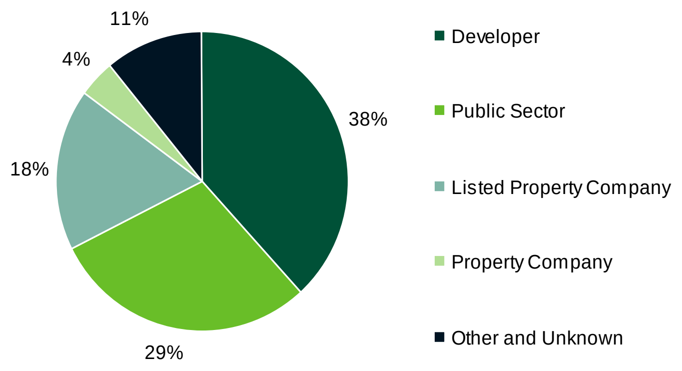
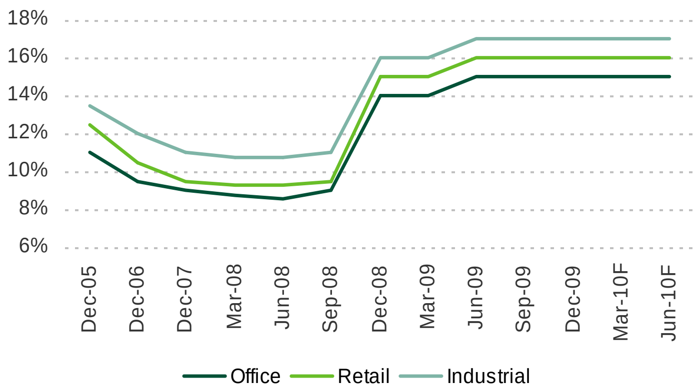
Vendor Activity by Vendor Type, 2009



Source: CB Richard Ellis

Kyiv Prime Yields



Source: CB Richard Ellis

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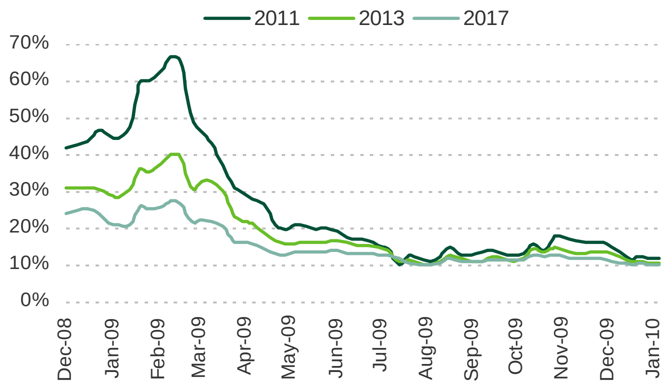
Ukrainian Eurobonds Yields to Maturity



Source: Dragon Capital

Note: USD denominated sovereign paper, by year of maturity; yields are based on bid prices.

[1]The peak for offices and retail was reached in Q2 2008, while for warehouse it was in Q1 of the same year.

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Capital Values

Kyiv capital value trends have been highly synchronized across all CRE sectors because of the universal downward drivers of devalued currency, reduced occupier demand, tightened liquidity and increased risk aversion. CBRE estimates that by the end of 2009 prime capital values were on average some 70% below their peak levels reached in H1 2008 and some 40% down in y-o-y terms. Prime offices sank deepest (80% from peak and 56% y-o-y); warehouse came second with the decline of 66% and 35% respectively, while prime retail shed the least – 62% and 22% respectively.[1] Pushed down by both rising yields and declining rents, valuations returned to the levels last seen no less than five years ago.

Prime yields were unchanged for three straight quarters, but in the absence of notable and revealing transactions remain purely hypothetical. Thanks to prime yields falling in certain Western European markets, there is a widespread belief that further increases in local capitalization rates look unjustified – a view, supported by the fact that Kyiv prime property yields already stand above those for long-term government bonds. Still, however, cash returns in the local market are high enough to dissuade internationals from investing in RE, let alone engaging in ground zero development. No bargain is possible so far unless a project can return 30-35% on leveraged funds or some 20% on equity.

Ukraine's Credit Rating

Agency	Rating	Date
Standard & Poor's	CCC+/stable	October, 2009
Moody's Investors Service	B2/negative	May, 2009
Fitch Ratings	B-/negative	November, 2009
Rating and Investment Information	B+/negative	December, 2009

Source: Reuters Financial

Selected Monetary Indicators

	2008	2009	2010*
Domestic credit growth (%)	76.9	4.3	8.0
Commercial banks' prime rate (av; %)	17.5	20.5	17.0
€ 3-month interbank rate	4.6	1.2	1.0

Source: Economist Intelligence Unit (EIU)

* - EIU forecasts

OUTLOOK

The prospects for 2010 are brighter – hardly unexpected, given how terrible 2009 was. Notwithstanding the prolonged period of discomfort that usually proceeds, complements and follows any significant political event in Ukraine – not least presidential elections – we remain certain that Q2-Q3 of 2010 will be a turning point in terms of investment turnover, as several investment transactions initiated earlier get finalized.

It should also be noted that there exists a possibility of a less positive scenario. With sovereign ratings standing next to the junk category, Ukraine is still perceived as a rather risky country to invest in. The probability of default (as measured in 5Y CDS spreads) was near 50% immediately after the first round of presidential elections (although it has declined since), and serious fiscal challenges are still to be tackled. Particularly detrimental to values therefore could be further devaluation of UAH and rising bond yields.

EMBI+Ukraine

Source: JP Morgan

We believe, however, that capital values are likely to start growing again in 2010, albeit slowly and totally on account of yield compression, as macroeconomic risks start declining and occupier market prospects improve. Indeed, now that rental rates have bottomed out, the expectations of a recovery in values can take hold as early as in Q2 2010. In the early 2011, capital value growth – particularly in prime segment – could actually accelerate, as the combination of subdued development cycle and reactivated demand signal forthcoming rise in rents.

However, the much anticipated upturn in key market measures in 2010 does not necessarily need to translate into increased investment turnover. Should investors continue to focus exclusively on prime, well-let assets, the overall market activity will be moderate at best. With banks showing no interest in exposing negative price evidence and forced sales of properties therefore not occurring, the fastest and perhaps the only way for turnover to rise is for investors to adopt less strict search criteria that would include secondary as well as unfinished assets. That approach would require an enduring period of stability, stronger leasing numbers and lower bond yields, and all three are unlikely to happen this year. In other worlds, even though market activity is bound to pick up in 2010, it is still expected to remain low by historical standards.

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DEFINITIONS

CBD – central business district

c-CBD – "*close to CBD*"; a notional submarket created to identify properties within 2km distance off CBD

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

CRE – abbr. from *commercial real estate*

NC-EB – "*non-central location on the east bank*"; a notional submarket created to identify properties outside of **CBD** and **c-CBD** areas on the east (left) bank of the Dnipro river

NC-WB – "*non-central location on the west bank*"; a notional submarket created to identify properties outside of **CBD** and **c-CBD** areas on the west (right) bank of the Dnipro river

Prime Rent – represents the top open-market tier of rent that could be expected for a unit of standard size commensurate with demand, of highest quality and specification and in the best location in a market at the survey date. **Prime Rent** 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, the quoted figure is more hypothetical, based on expert opinion of market conditions, but the same criteria on building size and specification will still apply.

Prime Yield – represents the yield which an investor would receive when acquiring a grade/class A building in a prime location (CBD, for example), which is fully let at current market value rents. **Prime yield** should reflect 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 the light of market conditions, but the same criteria on building location and specification still apply.

Property Investment Volume: 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. **Property investment volume** includes sale & leaseback transactions, but excludes corporate transactions in which real estate is only (a necessary) part of the transaction of the total business. Owner occupier transactions, land/development deals 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.