

Ukraine Property Investment

8M 2010

Quick Stats

	Change from	
	8M '09	8M '08
Investment volume	↑	↓
Number of deals	↑	↓

Hot Topics

- Investment activity gathered pace in 2010 but remained below historical average, even though average deal size tripled
- As throughout 2009, foreigners shunned the local marketplace, with turnover being driven almost entirely by local players
- Ascertaining the level of yields in the current market environment remains problematic, but we have lowered our estimations by 100 basis points for all segments, in view of general decline of Ukraine country's risks

EXECUTIVE SUMMARY

Whether judged by the number of completed transactions, news stories or buyers' profiles, Ukrainian CRE investment market has been a sad place for most of the last 24 months. Reduced to the state of inertia when debt financing became unreachable and hitherto pricey assets turned worthless, the market of 2009 was a complete reversal from (and the result of) the go-go years of 2006-2008.

In our very first Market View back in 2008 we said that 2009 would be a year of intense treatment, which it was. Now, eight months into 2010, the question is whether the treatment is still ongoing or are we moving into the recovery phase?

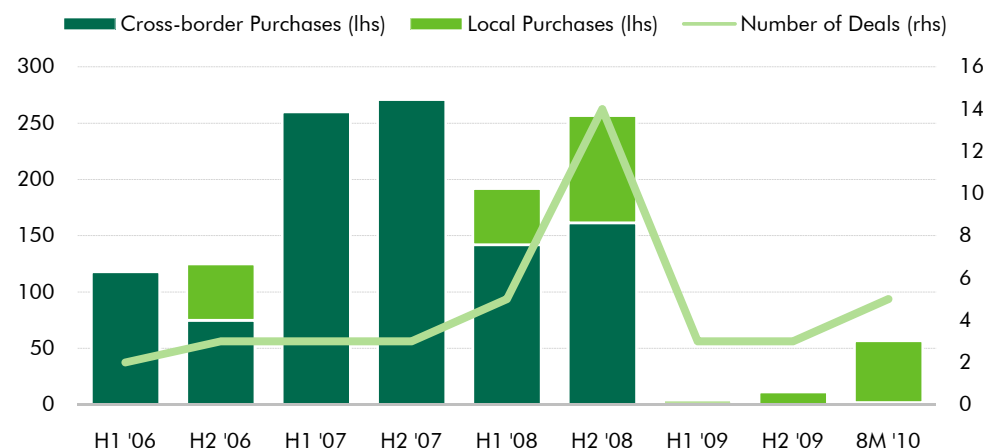
The picture is mixed. Although the market became crowdier this year, the current activity pales in comparison with historical performance. Financing remains in a deadlock, rents are flat and assessing current yields still requires a good deal of guesswork. The resurfaced uncertainty over short-term economic outlook and increased fears of double-dip recession add to the concern of a possible relapse. Still, we take an optimistic view and believe the market is moving into the recovery phase, albeit one which is bound to be slow. We take comfort in an impressive +3.9% q-o-q rebound in GDP in Q2, successful initiation of a new lending program with IMF and in what appears to be a reform-focused ruling elite, which is less prone to internal strife and political chaos. We remain anxious, however, about the health of Ukraine's banking system and possible sovereign defaults elsewhere in the world, which could have a negative spillover effect on emerging markets, including Ukraine.

MARKET OVERVIEW

Turnover

Total property investment turnover (net of debt settlements and development deals) in eight months to the end of August amounted to ca. \$57 million in 5 transactions, almost three times as much as in the whole of 2009, but still some 20% below 4-year historical average. The trajectory is clearly upwards (see graph), but the degree of increase depends on calculation methodology. This year's activity was boosted by the sale of a single property – 50% stake in Sky Mall shopping center – which, in the strictest of terms, cannot be regarded as a pure investment transaction. Once it is excluded, total investment turnover comes to a more modest sum. Still, the results clearly confirm that the market has at least bottomed out.

Semi-annual Property Investment Volume (USD, million) 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. 6

Buyers and Vendors

The recent growth in investment turnover is mainly the result of activity by domestic buyers. If previously international players were an important driver for the market, today it is the locals who are making the weather. Unsurprisingly, therefore, purchasers' profile turned shadowy. During 2009, in particular, the market has witnessed a proliferation of anonymous private individuals and unidentified entities whose acquisitions would barely have turned heads in a booming period. Over the first eight months of this year, however, the array of active investors has widened but still remained predominantly within domestic pool of players.

Cross-border buyers stayed inactive for the same old reasons of risk aversion. By remaining focused on defensive product – i.e. prime buildings with strong covenants and minimal voids in cash flow projections – international investors essentially have nothing to choose from. Their tight buying parameters mean that they remain outside of “transactional territory” – i.e. the market for opportunistic, development-like investments such as unfinished constructions and for value-add, second tier products such as inferior properties with potentially upgradeable capacities – where most deals are taking place today and which local players have been successfully exploring.

The mismatch between the demand and supply is equally ensured by surprisingly resilient vendors, whose positions were strengthened as a result of banks' unwillingness to foreclose on properties secured against NPLs. In fact, during the crisis not one bank completed a major sale of a toxic asset or portfolio. Instead, developers and property companies remained the primary vendors of real estate, accounting for some 63% of the market since the crisis began.

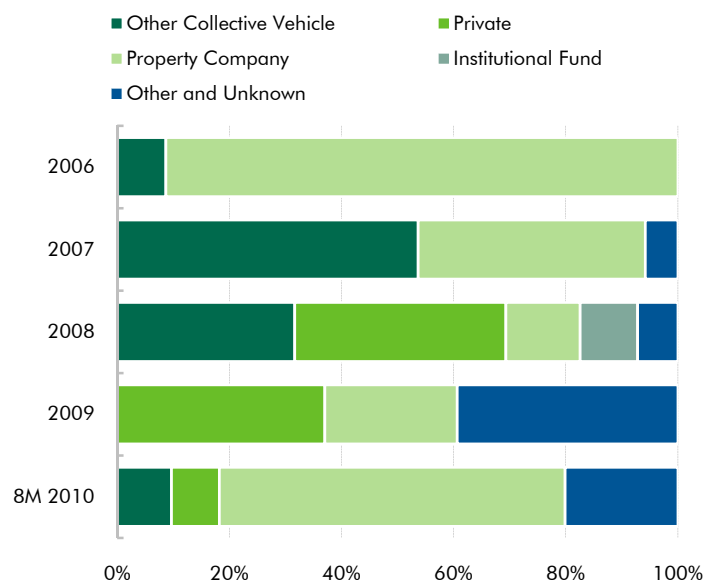
The most notable, however, was the emergence of State Property Fund as an active seller. Although the government has been auctioning off its surplus property assets for years, it was not until recently that it sold some of its most decent (yet not completely professional) properties such as *Tsum* (Central Department Store) and *Bratislava* hotel. Precarious finances combined with the high share of state ownership (estimated at 37% of GDP including social infrastructure) means that the government could remain an important player on real estate investment market in the future, as privatizations become an importance source of deficit financing.

Transactions

Market participants meet rarely and when they do, they agree on little. That is the major reason why transactions are few and uncommon. The majority of sell offers is confined to the most illiquid types of real estate – land holdings, unfinished construction, etc. Quality income generating assets have not changed hands for 20 straight months as owners remain loath to part with their cash-flow.

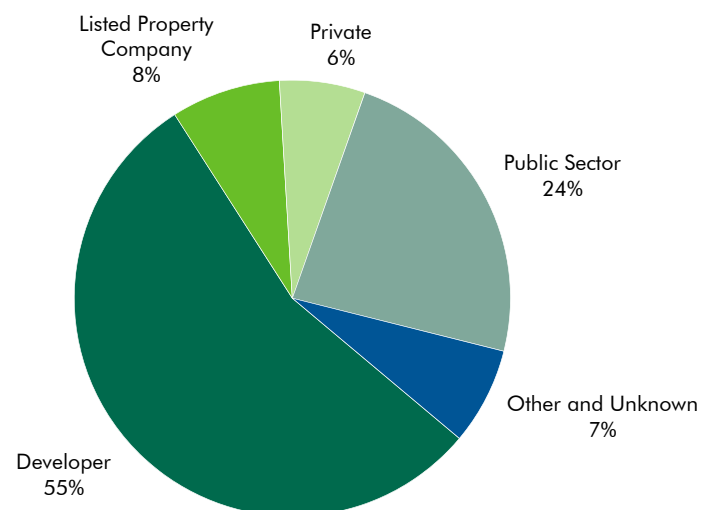
The most prominent transaction was the acquisition of a 50+% stake in Sky Mall shopping center (semi-finished retail scheme) by OLEDO Group, a local privately-owned property company. The vendor, Panorama Group, has been trying to attract financing by offering an equality stake in the project ever since it halted its construction in early 2009. It took more than 10 months, an end to the presidential campaign and the coming out of a competing bid from EBRD for the deal to materialize. The purchase of Sky Mall represents the largest retail property investment transaction since H1 2008 and is in effect the largest deal recorded for the last 23 months.

Purchaser Activity by Purchaser Type



Source: CB Richard Ellis

Vendor Activity by Vendor Type (October 2008- August 2010)



Source: CB Richards Ellis

Name	Segment	Region/ Submarket	Type	Purchaser Type
Yalta-Intourist	Hotel	Yalta	investment; shares	Other collective vehicle
TsuM**	Retail	Kharkiv	investment; shares	Private
Sky Mall	Retail	Kyiv / NC-EB	investment; shares	Property Company
<i>XI Century projects portfolio</i>	Industrial and retail	nationwide	development; shares	unknown
<i>Valmi portfolio</i>	Retail and other	nationwide	debt settlement; assets repossession	Bank
H-Tower	Mixed-use (hotel)	Kyiv / CBD	development; shares	Private
<i>confidential</i>	Retail	Kharkiv	investment; asset	Other collective vehicle
Kyiv	Hotel	Donetsk	development; asset	Developer
Europolis Park	Industrial	cross-border (Europe)	development (part of 42-property portfolio)	Listed property company
Ultra	Residential	Kharkiv	development; asset	Listed property company
Sofitel	Hotel	Kyiv / CBD	development; shares	unknown
Astoriya	Hotel	Lviv	development; asset	Corporate
TsuM**	Retail	Kyiv / CBD	investment; shares	unknown

The risks associated with investments in income-producing retail assets were always higher than for offices but lower than for warehouses. Professional office market emerged in the late 1990s, while first modern non-central retail scheme was only built in 2003. Unsurprisingly, it was not before three years later – when more quality properties entered the market – that the first retail investment transaction was completed. Historically retail was the second (after offices) most popular sector among investors. Out of ca. \$1.3 billion directly invested into Ukrainian CRE market over 2003-2007, some 39% (\$500 million) ended up in retail property.

Today retail property is actually becoming more popular, attracting some 70% of all investment into CRE over first eight months of 2010. While stronger market fundamentals are clearly making the segment more attractive, the major reason for this upturn is purely technical. Firstly, because the market is so small, one deal (in this case, Sky Mall) can seriously impact the turnover on the whole market. Secondly, retail sector was left with the biggest chances to achieve large turnover because quality warehouse product saw no investment demand and quality office assets were simply not on offer.

* net of owner-occupier transactions

** department store

Source: CB Richard Ellis

The Relevance of Public Debt

Stress factors that emerged in the broader capital markets in the form sovereign debt crisis in Europe refocused the attention on the sustainability of government deficits. As one of the most volatile sovereign debt issuers with mediocre ratings and relatively high probability of default in the next five years (calculated at 31%), Ukraine is particularly vulnerable to an abrupt loss of investors' confidence. Crudely put, if Ukraine is perceived as less creditworthy than its peers, it will likely face higher borrowing costs. Apart from slowing the economy, higher borrowing costs would make property yields stickier on the downside. So how well placed is Ukraine to face the potential jittery in the bond markets?

Looking at the size of public debt as a benchmark, Ukraine is clearly in a much better position than others. Its public debt (direct and conditional) stands at \$45.9 billion (33% of estimated 2010 GDP) – a quite acceptable level by international standards. The deficit, however, is primarily funded by borrowing from external (foreign) lenders, resulting in a net capital outflow. The proportion of debt held by non-residents was nearing 65% in July, but some 49% of that (32% of the total) is attributable to IMF loans issued at a rather generous rate. Ukrainian Eurobonds spreads over US Treasuries eased to around 400-550 bps (depending on maturity), but remain uncomfortably high. That said, even with the projected increase in both internal and external borrowing, end-2010 debt is expected to be around 39% of GDP², hardly the level that would alert investors.

Ukraine's debt position, therefore, does not look dangerous in itself. What is disturbing, however, is the fact that Ukraine appears to be disappearing from the radar screens of investors as seen from the continuing decline in the inflows of FDI. Ukraine received only \$496 million of FDI in six months to the end of June 2010, which was 78% below the amount invested over the same period a year ago and some 93% down on 2008 results. Although global economic downturn did play a part in this savage reduction, Ukraine's cumbersome bureaucracy and pervasive corruption also act as significant obstacles to progress. Thankfully, the authorities are taking necessary steps to improve the business climate – specifically, by presenting new Tax Code and laying out plans for a comprehensive economic reform.

The yields the county pays to attract foreign capital are ultimately conditioned on the underlying economic fundamentals so fixing the economy by improving regulatory environment is currently a much more pressing issue for Ukraine than trying to maintain adequate levels of government debt.

¹ According to CMA, financial information services company

² According to Dragon Capital, an investment bank

Capital Values

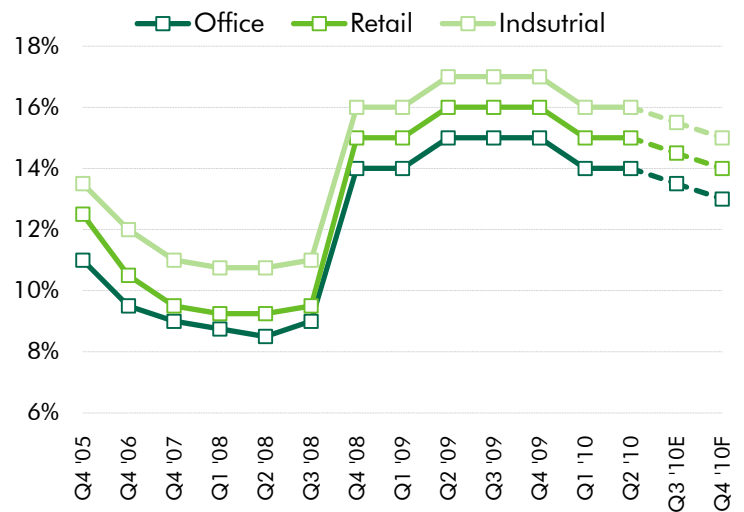
At the height of the crisis – when cash was king and cost-cutting became the norm – rising yields and falling rents pushed capital values deep into the red. By Q4 2009 Kyiv prime capital values were on average 72% below their peak levels recorded in H1 2008. Values started to level off in 2010 thanks to favorable base effects and sentiment-driven compression in yields.

Occupier market situation in each segment is different, but it is clear that rental rates are no longer having a negative impact on valuations. Indeed, in prime offices the prospect for rents has recently brightened and current outlook is for prime capital growth to turn positive in y-o-y terms by October with possible acceleration in H1 2011 (see graph).

Kyiv prime yields have been highly synchronized across all CRE sectors because of the universal factors that drive them. Whereas during the crisis the key upward factor has been tightened liquidity, a major cause for declining yields today is predominantly sentimental. As the global commotion has receded, Ukraine's country risks have lessened and especially so given that power transition period following presidential elections proved to be relatively mild. Despite this increased confidence, there is still a lack of transaction evidence available, and in the absence of reliable benchmarks pricing is still being compromised. It should be noted, therefore, that yields currently serve as an indication only and are not based on any relevant transactions.

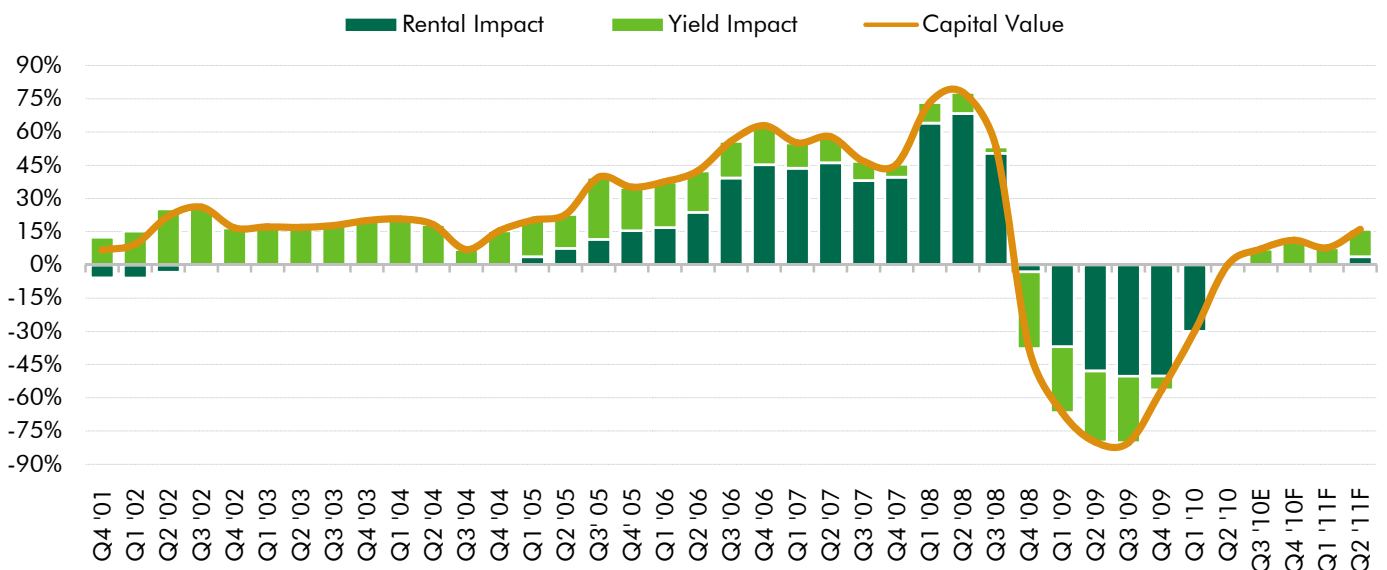
Looking forward, we are certain that prime yields will trend downwards. Given the lack of prime product and the fact that the majority of investors are showing strong willingness to transact only in the top tier of the market, upward pressure on prices is increasing. The trajectory for capital values outside of prime segment is less clear. Secondary rents are likely to remain flat for an extended period of time, and yields will continue to reflect the elevated risk of short-term movements in the occupier markets. However, buyer competition in this lower tier of the market is less intense and the chances of making good value-added investments are considerable.

Kyiv Prime Yields



Source: CB Richard Ellis
E – CBRE estimates; F – CBRE forecast

Prime Capital Value Growth - Office Market (% change, y-o-y)



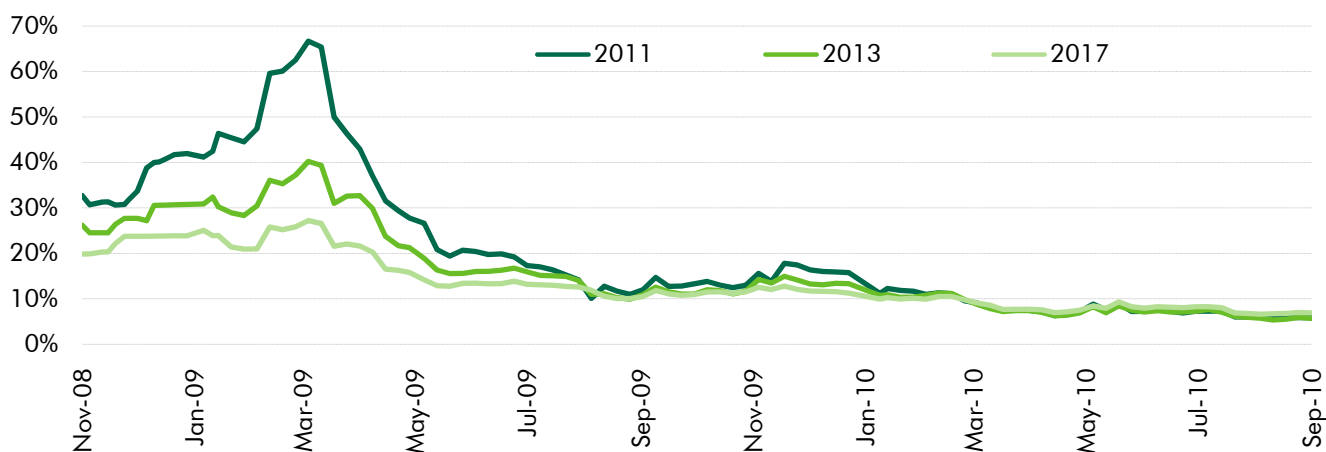
Source: CB Richard Ellis
E – CBRE estimates; F – CBRE forecast

Outlook

The most likely outcome is for the market to slowly drift away from the distressed state it is in today towards a more comfortable period of freer lending and stronger occupier market. It is unlikely to be a debt-driven recovery, however, with leverage-backed deals being rare and cash-rich investors dominating purchasers' lot. Cross-border investors are expected to steer clear of Ukraine, but mostly for benign reasons of lack of quality product, rather than for plain risk avoidance. Provided investors do not relax their criteria and banks continue holding onto to the repossessed collaterals, the number of transactions will be severely restricted, a fact that will contribute to the anemic pace of market recovery. We, therefore, forecast a protracted period of slow sentiment-driven growth of capital values until market fundamentals (distinct for each segment) will clear the way for an upward trend in rental values.

In an industry as capital-intensive as real estate, prices cannot grow rapidly when credit is in short supply. Yet if set against other investment asset classes, real estate looks grossly undervalued. Prime office yields, for example, can be as high as 800 bps above Ukrainian Eurobonds. Equally, after hitting a bottom in November 2008, share prices³ have almost tripled and their appeal is now less obvious. Perhaps the sheer fact that the demand for other types of assets has escalated, indicates that the next on order is real estate.

Ukrainian Eurobonds Yields to Maturity



Source: Dragon Capital

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

An Alternative View on the Market: Listed Property Companies

One obvious way of measuring the health of an industry is to look at how much is being earned there. Companies' financial reports show both the "fair value" of their real estate and the actual profits or losses being made. As such, they shed additional light on the investment and, to a lesser degree, occupier markets. Unfortunately, the vast majority of Ukrainian developers and construction companies are not public and therefore do not need to divulge much to the financial markets. In fact, there are only five listed property companies (LPCs) active in Ukraine: *AISI Realty Public Ltd.*, *Dragon Ukrainian Properties & Development Plc.*, *KDD Group N.V.*, *TMM Real Estate Development Plc.* and *XXI Century Investments Public Ltd.* Other companies such as *Clubhouse Group Holdings Ltd.* and *Davento Plc.* went through private placements of GDRs and their internal goings-on remain essentially obscure.

On the face of it, most red ink was spilled in 2008. The combined losses of the above mentioned companies amounted to \$1.9 billion of which \$1.7 billion was lost on revaluations of investment properties. However, these huge losses came largely on the back of fat valuations awarded to companies during boom years. Indeed, some projects were soon sold with ca. 80-90% discount to their pre-crisis value. The decline in revenues came later and has been much less severe. Furthermore, the drop in incomes was offset by corresponding cuts in operating expenses, so the overall effect on gross profits has been manageable. Nevertheless, share prices plummeted and in 12 months to the end of June 2009 they declined by an average of 84% in local currency terms.

How unwell are LPCs today? Given the fact that some of them are yet to announce their FY2009 results, the answer may not be pretty, but it all depends on the company in question. Out of five LPCs, three have seen their shares roughly double in 12 months to the end of June 2010; the stock of another company fell 35% over the same period, while yet another one has been suspended from trading altogether. Overall, however, things are getting better. Companies' results that were announced show smaller losses and minor profits as well as significant slowdown in NAV depreciation. Average earning per share are expected to turn positive in 2010. Even if statisticians are not yet recording a turnaround (construction works were down 16.7% y-o-y in seven months to the end of July), shares rally of most LPCs suggest that investors are betting on the promise of bigger profits in future – a fact that will drive the recovery of broader CRE investment market.

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*

GDRs – abbr. from *global depository receipts*

NAV – abbr. from *net asset value*

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.

Disclaimer 2010 CB Richard Ellis

Information herein has been obtained from sources believed to be reliable. While we do not doubt its accuracy, we have not verified it and make no guarantee, warranty or representation about it. It is your responsibility to independently confirm its accuracy and completeness. Any projections, opinions, assumptions or estimates used are for example only and do not represent the current or future performance of the market. This information is designed exclusively for use by CB Richard Ellis clients, and cannot be reproduced without prior written permission of CB Richard Ellis.

© Copyright 2010CB Richard Ellis

CB Richard Ellis is the market leading commercial real estate adviser worldwide - an adviser strategically dedicated to providing cross-border advice to corporate and investment clients immediately and at the highest level. We have 400 offices in 58 countries across the globe, and employ 24,000 people worldwide. Our network of local expertise, combined with our international perspective, ensures that we are able to offer a consistently high standard of service across the world. For full list of CB Richard Ellis offices and details of services, visit www.cbre.com

For More information regarding the MarketView, please contact:

CBRE Ukraine Office

4 M. Hrinchenka St.,
Kyiv 03680
t: +38-044-390-00-00

Sergiy Sergiyenko

Managing Partner

e: sergiy.sergiyenko@cbre.com

Radomyr Tsurkan

Managing Partner

e: radomyr.tsurkan@cbre.com

Volodymyr Bezruchenko

Head of Research

e: volodymyr.bezruchenko@cbre.com