



Analytical Bulletin of the Ukrainian Real Estate Market

Issue #2, July 2009

Dear Ladies and Gentlemen,

We would like to present you the second issue of the Analytical Bulletin of the Ukrainian real estate market drafted by the members of Ernst and Young Real Estate Advisory Services.

Working in close co-operation with the major real estate companies in the CIS (developers, investors and real estate consumers) we have become a part of the industry through monitoring its development in transaction and legislative aspects and conducting our own analysis of all market segments inclusive office, retail, industrial and hotel.

We would like to offer you our view of current market condition which is based on our practical experience and accumulated professional knowledge. We hope that it will provide a better understanding of current events and will help to develop practical solutions to mitigate the crisis effects.

Sincerely yours,
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Current condition of global economy and investment markets



The world economy has entered some new and insecure phase of its development and there is no market fully immune from the current downturn. Fears about rising default rates and declining property values, which overwhelmed the home mortgage market at the start of the credit crisis has spread to the commercial real estate market and presumably the worst is yet

to come with respect to all sectors of commercial property. There is no question that the global impact of the subprime meltdown exceeds most expectations.

Debt structures and investment vehicles have become increasingly complex creating an environment of uncertainty, which has virtually brought lending to a stand still. The restriction on the availability of credit and the short-term inability to deploy capital at acceptable levels of return has completely paralyzed the transaction sector of real estate.

Global Economic Trends

- ▶ The stresses in U.S. financial markets that first emerged in the summer of 2007 and transformed themselves into a full-scale global financial crisis in the fall of 2008 are evidently deepening in 2009
- ▶ IMF expects global GDP to decrease by 1.3 percent in 2009, while economists from the World Trade Organization forecast a 9 percent decline for global trade in the same year, both the largest drops on record since World War II
- ▶ The World Bank forecast recessions in Europe and Central Asia (negative 2.0 per cent), and Latin America and the Caribbean (negative 0.6 per cent) while Japan's economy has already contracted by 3.3% in the fourth quarter of 2008
- ▶ Developing countries have been hit harder and lack the means to withstand the pressure
- ▶ Emerging economies are directly hit because what came along with the crisis was a reversal of capital flows to the developing economies

Investment and Capital Markets

- ▶ Debt for real estate industry will be in short supply as banks rebuilt their balance sheets. Conservative debt coverage ratio (1:2, 1:3) and tighter underwriting are expected to be back on the market
- ▶ Banks are now heavily exposed to their local property markets, having financed investors, developers and contractors during the boom of the last couple of years
- ▶ Morgan Stanley estimates that £41 billion of commercial real estate loans will be in negative equity by the end of 2009
- ▶ Direct real estate is still reckoned to be a better prospect in 2009 than investment-grade bonds or equities
- ▶ Mergers and acquisitions activity and Initial Public Offerings of venture-backed companies are on pace this year to hit their lowest point this decade.
- ▶ Asia is supposed to be the favorite for direct investment followed by Western Europe and USA

Global Real Estate

- ▶ The global financial crisis has hit world economies, questioning the prospects for real estate
- ▶ In Summer 2007 it was the property sector that brought the banks down, in Fall 2008 it is the banks bringing the property sector down
- ▶ The indirect impact of the financial crisis is just starting to flow into the real estate economy through deflating consumer spending, business confidence, rising unemployment and corporate bankruptcies
- ▶ Being a heavy user of debt, the performance of RE industry is in direct correlation with the liquidity crisis
- ▶ A massive reprising of European real estate is underway. (e.g. the values in UK are 31% off their 2007 peak and another 24% fall is being predicted in 2009)
- ▶ Publicly traded RE companies' shares are trading at historically large discounts to their net asset values
- ▶ Pre-crunch 80% loan-to-value ratios have already been slashed to 50% or 55% maximum for senior debt
- ▶ Investors start looking beyond the mainstream property sectors. Alternative asset classes are very attractive from a defensive point of view. Players are getting involved in student housing, self-storage, car parking, data centres, and infrastructure



Forecasts and trends



- ▶ Unprecedented declines in global economic output and trade volumes are anticipated in 2009, warning that growth would also slow sharply in the vulnerable developing world
- ▶ GDP growth in 2009 in developing countries is expected to slow to 2.1 per cent from 5.8 per cent in 2008
- ▶ Securitization of commercial loans is effectively dead, thus large deals will be difficult to finance
- ▶ The main sources of property investment will be private property vehicles and conservative institutions like sovereign wealth funds, insurance companies and pension funds. However all of them will be waiting for property prices to stabilize before starting active investment
- ▶ There will be tighter controls on the capital markets with global regulation being mooted
- ▶ For the next three years there will be a stronger focus on higher-quality assets, long leases, good locations, low leverage, and more stable markets
- ▶ Yields for prime properties on developed markets will weather the storm better than secondary real estate however are expected to rise further between 42 and 62 basis points
- ▶ Capitalization rates in all sectors are expected to move up in 2009
- ▶ A significant amount of distressed property is expected to come onto the market, however the anticipated flood of distressed properties has not materialized yet in a full scale
- ▶ The restoration of confidence in the developed world should start emerging some time in 2010, however positive impact on business might not be felt until 2011 especially in emerging markets
- ▶ Industry will be observing an unprecedented acceleration from opportunistic to systematic strategies for emerging markets

Top business risks associated with current downturn

The credit crunch

The credit crunch ranks as one of the top risks because of its extraordinary and direct impact as well as its unpredictable evolution. The credit crunch and attendant crises in property and financial markets have posed existential threats to firms in asset management, insurance and banking, forcing some of the global companies in these sectors into insolvency. At the time of writing this newsletter, the chain of escalating crisis that had threatened to cause a systemic collapse in the global financial system appears to have been interrupted, however it is still expected to continue to pose a serious threat, as banks continue to reduce lending.

Regulation and compliance

Regulation and compliance encompasses many issues: the increasing political restrictions that prevent oil and gas firms from gaining access to proven reserves, regulatory intervention into pricing in power and utilities and telecoms, and the regulatory response to the current banking crisis, which will affect the operational and competitive environment for the financial services industry.

Deepening recession

Many developed economies have entered recession, and some forecasters are projecting recession for the world economy in 2009. This is of greatest concern in cyclical industries, such as automotive and media, and industries with direct exposure to the global financial crisis, including banking, asset management, and real estate.

Radical greening

The reason for the rise of this risk is probably the exceptional surge in oil prices that occurred in 2008. Oil prices have now fallen, though they remain high by historical norms. But few analysts expected the pressure for radical greening to disappear. Surging oil prices accelerated long-anticipated structural shifts and raised political and consumer pressure on carbon-intensive sectors such as automotive, oil and gas, power and utilities, and real estate.

Climate and environmental concerns also pose a direct challenge to firms' reputations and brands. Failure to be seen to be responding to climate change could have huge reputation risks for companies in high-carbon sectors and elsewhere.

Managing Talent

Talent management includes not only the competition for top talent, which continues in many sectors, but also perhaps surprisingly the struggle to retain key competencies during an economic downturn, and the escalating debate on misaligned compensation structures. The fact is that the talent war remains but the resources available to fight it have been reduced.

Executing alliances and transactions

The high pressure, time-constrained environment in which many strategic transactions are now conducted can create execution risks. The “rescue” transactions that have taken place in the financial services sector have happened almost by definition without adequate due diligence and planning; hence there is an increased challenge to carry out the required level of analysis to optimize integration.

Emerging markets

Emerging markets are an increasingly important competitive battleground, and can pose a novel set of risk management challenges. At the same time emerging markets represent the majority of the growth opportunity for the majority of industries. However, success in emerging markets is far from guaranteed. Differences in culture, wealth, market structures and politics create pitfalls for companies that do not adapt their strategies to local conditions. Emerging markets also pose a different risk profile. Labor costs can rise more quickly than expected; it is easy to underestimate the time required to set up production, distribution channels, and sales outlets, and the war for talent in these markets can be particularly fierce.

Ukrainian economy



- ▶ Ukraine's economic crisis is one of the worst in Europe. Industrial output plummeted by 32 percent in January and February compared with the same period a year ago, and output in the construction industry dropped by 57 percent during that period, according to the World Bank.
- ▶ The IMF revised its earlier forecast for Ukraine of a 6-percent contraction of economy, as the global economy continues to deteriorate, but predicted 1 percent growth next year.
- ▶ The World Bank forecasts Ukraine's economy will shrink by 9% this year, more than double its previous forecast.
- ▶ The IMF expects inflation to hit 16.8 percent this year and slow to 10 percent next year.
- ▶ The national currency, the hryvna, has lost about 40 percent of its value to the dollar since the crisis hit last fall.
- ▶ The IMF gave an approval to granting Ukraine a \$2.8 billion second installment of a \$16.4 billion loan to recapitalize top banks, prop up the national currency and fund the state budget.

Ukrainian property market

- ▶ A stable decline of prime yields over the recent years, reflecting positive growth and investors confidence has been sharply reversed with the beginning of global credit squeeze
- ▶ Comparatively high level of bankruptcies are predicted within small and mid-developers
- ▶ The commercial real estate market and office market particularly can now be determined as tenants market as opposed to the landlords' market that established during 2003 - Q3 2008.
- ▶ A considerable number of distressed assets are on the offer, with yet no large transactions recorded
- ▶ The majority of investments in 2009 are expected to flow in distressed assets with an emphasis on quality locations

Office market	Retail market
<ul style="list-style-type: none"> ▶ The majority of businesses are increasingly trying to minimize their operational costs and optimize business processes, consequently reducing the occupied office space and seeking to consolidate all their business units to a single building or smaller suites. ▶ As a part of cost reduction programs a significant number of tenants are seeking for relocation from Class A to Class B premises, while well performing firms have got the opportunity to improve their current office conditions without additional rental expenses ▶ Vacancy rates in Class A business centres reached 10-15% ▶ Rental rates for prime office premises in Kiev are down for 30%-40% and are expected to further decline to the levels of USD30 - USD40 per month per sq m for Class A and USD15 - USD30 for Class B ▶ The availability of sublease opportunities has further increased and today this stock has formed an additional significant offer for companies seeking space ▶ The new supply in 2009 is expected in the range of 70,000 - 120,000 square meters, however large scale projects remain suspended and are not expected to be recommenced until 2011-2013 ▶ Landlords show more flexibility in terms of offering fit out (ready for occupation) premises and not only core-and-shell structures 	<ul style="list-style-type: none"> ▶ Apparently the retail sector weathers the storm better than other segments of Ukrainian commercial real estate ▶ The credit squeeze however strongly affected the demand side of retail sector through weakening consumer purchasing capacity already plunged to the level of 2000 ▶ The total stock of retail premises in Kiev comprised about 850,000 square meters by the end of 2008, with the total new supply amounted to some 140,000 square meters ▶ The extension of existing stock will presumably be a momentous in the further growth of the stock in 2009 ▶ The threat of vacant spaces is forcing landlords to negotiate lower base fixed rents and introduce a turnover rent ▶ Vacancy rates continue their upward movement, with regions being affected the most ▶ An obsolete majority of the developers have revised and postponed their plans to enter small markets with the population of less than 700-800 thousand ▶ Recently the cabinet of ministers has passed a decree on the state regulation of rental rates in retail premises. The decree aims to fix the margins of rental rates as well as the profitability ratio at the level of 20%.
Industrial market	Land market
<ul style="list-style-type: none"> ▶ Production decline and shrinking retail turnover resulted in a weakening demand of warehouse facilities ▶ In 2009 the market is likely to observe the shift from speculative development to built-to-suit schemes as one of the ways to mitigate the risk of market uncertainty ▶ The warehouse market has been changed from landlord's to tenant's market resulting the occupiers requiring greater flexibility in lease terms, break options and rent ▶ Demand for a new quality warehouse space will be decreasing, and new supply in 2009-2010 may well exceed the demand for this period ▶ Historically minimal vacancy rates have been hardly affected by the economic downturn, eventually bringing it to the 15% by the end of 2008. ▶ In the light of declining demand, the vacancy will be increasing putting a downward pressure on rental rates in the short run 	<ul style="list-style-type: none"> ▶ The actual prices for commercial land plots have plummeted by 35-40% and are expected to decline by further 25-30% by the end of 2009 ▶ There is almost the total absence of medium/large land plot transactions on the market, consequently the dispersion of asking prices is considerable ▶ Only the limited number of small transactions for individual residential development can be currently observed on the market ▶ The land plots initially acquired by developers for speculative purposes is now put on the market, however sellers are suffering from the low liquidity and weak demand for the land ▶ The trade discounts reached their peak in 2009, amounting to 25-30% in particular cases ▶ The strong oversupply of both freehold and leasehold land is expected by the end of 2009 ▶ Land plots with prime location, adequate infrastructure and reasonable price will possibly be the only demanded product on the Ukrainian land market in 2009

Best practice during the crisis



During the crisis - downturn can not be avoided, the key is to be impacted less than competitors

- ▶ Maintain long-term strategy against multinational and local competitors and avoid knee-jerk reactions
 - ▶ Acquire competitors that are probably trading at a distressed discount
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- ▶ Acquire prime location land plots for future development as it gets cheaper
 - ▶ Be proactive and fast about acquisitions, but still careful about due diligence
 - ▶ Focus on building market share. Each point gained during the crises increases long-term profitability
 - ▶ Ultimately it is about focusing on long-term gain, by allowing a hit on short term profitability, but it only applies to those firms that can actually afford it and want to do it
 - ▶ The crisis should be considered as once-in-a-life time opportunity to improve market position, weaken competitors and take more control over business
 - ▶ Global companies should recognize that emerging markets need to be an equally important part of strategy as developed markets
 - ▶ Companies should get ready for unprecedented rise in competition once the crisis is over

Real estate advisory services provided by Ernst & Young

Real estate advisory services:

- ▶ Real estate appraisal
- ▶ Feasibility studies and concept development
- ▶ Due diligence investigation
- ▶ Consultations on the hospitality business and concept development for hotels
- ▶ Real estate financing and development of an optimal capital structure
- ▶ Corporate real estate services and optimization of real estate portfolios for business purposes
- ▶ Project development and management, budgeting, cost control, and monitoring of project deadlines
- ▶ Location advisory services (finding an optimal business location)
- ▶ Business advisory services for real estate companies: development of growth strategies, organizational design, performance management, business process re-engineering.

Hospitality and leisure advisory services:

Having a rich experience in rendering advisory services on financial, tax and legal aspects of hospitality business, Ernst & Young ensures optimization of all stages of proposed hotel projects - from initial concept of market positioning and operating projections to assistance in selecting hotel operators and negotiating hotel management contracts.

Transaction advisory services:

Our market insight, good contacts with leading investors and transaction support expertise facilitate effective decision making both with regard to financing individual projects and developing a long-term strategy to attract finance. Tax advisory services, financial and legal due diligence, as well as transaction structuring help reduce risks when executing transactions.

Tax services:

- ▶ Analysis and enhancement of developers' and investors' tax efficiency, recommendations for enhancing efficiency, including recommendations for improving tax accounting policy, and assistance with tax policy implementation
- ▶ Analysis and development of mechanisms for eliminating/minimizing tax risks in connection with various agreements frequently used in the area of real estate, including shared construction agreements and co-investment agreements
- ▶ Assistance in verifying the right to offset VAT on acquired/constructed real estate property and in obtaining a VAT refund, including an analysis of documents supporting VAT offsets
- ▶ Assistance in developing a VAT refund strategy
- ▶ Tax and legal due diligence
- ▶ Tax planning and support for upcoming transactions to acquire real estate assets.

Contacts

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