

Dream and reality: the commercial property market

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A growing gap between buyer's and seller's expectations is obscuring Ukraine's real estate market.

Due to its strategic location, large population, big territory and huge potential for development, Ukraine offers unique opportunities for foreigners. The size and potential of the market attract many investors and developers, who regard Western European markets oversaturated with intense competition and limited capacity for income-producing investments. Higher yields than in the Western and Central European markets are yet another spur to look into the Ukrainian real estate market.

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However, many of the investors, who initially show an interest in commercial property in Ukraine, end up not actually investing. How can this be?

An investor's dream

On the buyer side, for some years now, investors have been seeking to optimize their information, practices and aware-

ness by applying to real estate brokers, agents and consulting companies for advice and assistance in acquiring an income-generating asset.

Improvements on the market, reduced risks, growing economy, ever increasing purchasing power, very high yields, good potential for development, huge undersupply in the market, short payback periods and no significant challenges – these are the typical responses that interested parties receive from their brokers, agents and consultants. However, these expectations are sometimes greatly overestimated and hide some big puzzles that investors may face when coming to Ukraine.

A seller's dream

Turning to the seller side, a rental rate growth averaging at least 15% for all segments and big demand for real estate resulted in an increase in property prices. In fact, checking recent transactions in Ukraine's office segment, one can observe that sold properties are overpriced and have rather low capitalization rates. Thus, the yield of 8-9% does not match the early established market yield of 10-11%.

This gap may stop the deal becoming reality as investors turn away the interest.

Evidently, the real estate mar-

ket is booming. Given this situation, it should come as no surprise that owners of income-producing properties - bearing in mind the analogue prices of recent transactions - are not willing to sell on a yield basis. Frequently, they set the price on a cost per square meter basis instead.

A gap between dreams and reality

The combination of too high expectations on both the investor's and the sellers' side have the unfortunate effect of creating a gap between investor expectations and vendor requirements. This gap may stop the deal becoming reality as investors turn away the interest.

These discrepancies are a key explanation as to why action on Ukraine's real estate market is slower than could be expected when looking only at the hard facts.

The hard facts

A few years ago analysts and real estate consultants in Ukraine were convincing investment companies that it was the right time for making investments. Predictions were that the market would mature (supply would meet demand) in 2008-2009.

Today, however, the Ukrainian commercial real estate market is not yet established - the number of qualitative projects ready for

sale is too small and a number of the projects that should have been delivered already are still in pipeline.

Bottom line and actual fact: investors' demand cannot be satisfied at the moment.

At the current low level of supply or vacancy in all segments, it is difficult to foresee when supply will match demand.

The current undersupply and big demand for all segments of commercial property has created favorable conditions for vendors in sale-purchase deals. Skyrocketing prices and shortage of projects with high capitalization rates resulted in a limited number of deals on the real estate investment market.

Predictions

At the current low level of supply or vacancy in all segments, it is difficult to foresee when supply will match demand. Even those same experienced brokers, agents and consultants, who have been giving optimistic advice for years, are at loss to guess what will come in the future.

It is almost certain though, that no crucial changes will take place within the next two-three years. A forecast based on past experience and today's practice

Stages of commercial property market development

- 1  Short-term, high risk and opportunity driven, local and foreign investments
- 2  Mostly locals doing renovation and offering higher quality projects
- 3  Longer-term developers doing larger projects and adding value by renting
- 4  Property funds and wealthy individuals managing the asset and optimizing the investment portfolio
- 5  Institutional investors managing the portfolio together with shares and bonds

At the moment, the Ukrainian real estate market is between phase 2 and 3, indicating that the market is immature and not yet established.

of projects delivery delays for 1-3 years is that the current rate of vacancy will be preserved on the same level for the next two years, and that the rate of rents will continue to grow.

Adjusting the approach

Of course, not all potential investors actually engage in negotiations. Many others are eager to invest in Ukraine, but do not do so because of risk perception and lack of understanding of the market conditions. Essentially, the foreign investors usually apply a "western" approach. They look only on capitalization rates and do not consider other options like growth options and positive dynamics of income flow.

However, if you are dreaming of high return on investment

in Ukraine, it is not as simple as just investing in income-generating asset. It has to be an investment plus "knowledge".

Given the market trends and growth opportunities, there is plenty of room for maneuvering and thus raising the yield once one has been established

Indeed, what may put an investor in a well-off position is the application of the same "western" approach and professionalism to leading the business and to establishment of professional property management. Also, it should be considered that given the market trends and growth opportunities, there is plenty room for maneuvering and thus raising the yield once one has been established.

The Free Trade promises

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Ukraine's successful bid for WTO accession has quickly opened up new opportunities for economic integration with the EU. On February 18th - less than two weeks after the WTO approved Ukraine membership application - EU Trade Commissioner Peter Mandelson and Ukrainian President Viktor Yushchenko launched negotiations on creating a Deep Free Trade Area (FTA+).

Perspectives

An FTA+ will provide new opportunities and chances to enhance the long-term competitiveness of the Ukrainian economy. Besides eliminating trade barriers, an FTA+ will bring legislative harmonization with the EU, as

Ukraine must adopt and make changes to numerous laws. This includes very important changes to legislative acts in the areas of corporate governance, taxation, real estate and land legislation. The legislative harmonization will transform Ukraine's heavily corrupted business environment into a business environment of European standards.

The FTA+ also means liberalization of services, capital and labor force movement between Ukraine and the EU, and new opportunities will be created as markets access is simplified. For example, accession to markets on the principles of 'single passport' can be realized in the banking sector.

Impacts

But the rewards of an FTA+ do not come for free, and in the short run the FTA+ impact on the Ukrainian Economy

will be controversial. Positive effects of the FTA+ will be offset to some extent by tougher competition on the internal market, and this will force some Ukrainian businesses to close down.

There is no doubt, however, that the overall long-term impact on Ukraine will be positive. An FTA+ will help the country build up a modern and competitive economy and have a positive effect on doing business in Ukraine - for foreign investors, as well as for local businesses.

Bottom Line

Of course the terms and forms of the FTA+ creation depend highly on the results of the newly opened negotiation process between Ukraine and the European Commission. There is reason to hope for a speedy and successful process, as we believe that the benefits of an FTA+ will outpace expenses many times, both in

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the EU and in Ukraine. The creation of an FTA+ would thus become a very significant step in the integration process between the EU and Ukraine.

Expected impact on the Ukrainian economy of an FTA+ with the EU

- ↑ **GDP**
Increase in investments, interest rate reductions and stimulation of consumption
- ↑ **Price Control**
A more open economy absorbs pressure on prices from increasing consumption. Integration adjusts the inflation level on the domestic market to the EU level, where CPI growth is traditionally low.
- ↑ **Exchange Rate**
Transformation to inflation targeting monetary model with freely convertible currencies. Foreign investments will support hryvnya currency.
- ↑ **Investments**
Improved access of the Ukrainian corporate sector to EU investment resources will have positive impact on growth of FDI and external borrowings.
- ↓ **Currency Account of Balance of Payments**
Rise in imports of consumer and investment goods. Growth in imports and current account deficit will be financed in full by investments.
- ↓ **Employment level**
A growing number of jobs will be offset by reductions due to increased labor productivity and tougher conditions.