

Bulgaria Property Investment | Q3 2009

ECONOMIC OVERVIEW

While some of the major economies in Western Europe have already announced the end of the recession, the effects of the global crisis in Bulgaria intensified further in Q2 2009. This is primarily as a result of the dependency of Bulgarian economy on foreign trade and investment. GDP contracted by 4.8% on an annual basis and industrial output also shrank by more than 20% compared to Q2 2008; on a q-on-q basis however the latter exhibited a 3.7% growth which is promising. The unemployment rate also continued rising to reach 7.6% in July 2009.

Inflow of Foreign Direct Investments (FDI) which was a major driver of the rapid economic growth in the last years has plummeted since Q4 2008 and the total amount for the first half of 2009 is more than 50% down on H1 2008 – a value comparable to the level of 2005. In order to stimulate the economy and in line with global trends Bulgaria' Central Bank (BNB) has lowered the base interest rate to its lowest value ever – 1.57% in September.

SECTOR BRIEFING

The increasing yield levels and downward pressure on rents which came as a result of the global financial crisis produce rewarding opportunities for equity rich investors. Current market conditions have lowered capital values by as much as 25% and assets previously deemed overpriced are becoming more appealing to opportunistic funds.

Transaction data from the first nine months is showing a trend of slow but steady recovery. The number and average size of concluded deals is still far below the record volumes of 2007 and 2008 but this can be explained with the fact that most players on the market currently are mainly local ones. In addition, banks are still restrictive in their lending policies creating an illiquid environment which is an obstacle to large acquisitions.

Unlike some of the more developed Central European markets, however, where recent data shows that large European funds have resumed their activities, foreign investors do not show great interest in Bulgarian real estate at the moment. Almost half of the transacted properties since the beginning of 2009 are development projects at different stages of planning and construction; owners of yielding assets do not feel pressed to sell because capital values have fallen considerably as a result of rising yields and the pressure on rental levels. With some minor exceptions, distressed sales are still not a

Key Economic Indicators 2005 – H1 2009

Macroeconomic Indicator	2006	2007	H1 2008	H2 2008	H1 2009*
GDP Growth (%)	6.3	6.2	7.1	3.5	-4.8
Annual Inflation (%)	6.5	12.5	15.0	7.8	4.1
Foreign Direct Investments – FDI (€ bln)	6.16	8.49	3.27	6.16	1.56
FDI (% of GDP)	24.4	29.4	9.6	18.1	4.6
Base Interest Rate (%)	2.69	3.93	4.91	5.12	2.35
Current Account (% of GDP)	-18.4	-25.1	-13.1	-25.3	-6.3
Trade Balance (% of GDP)	-22.0	-25.1	-12.5	-25.7	-7.0
Unemployment Rate (%)	9.1	6.9	6.0	6.3	7.3
Average Monthly Salary (€)	184	220	261	289	300

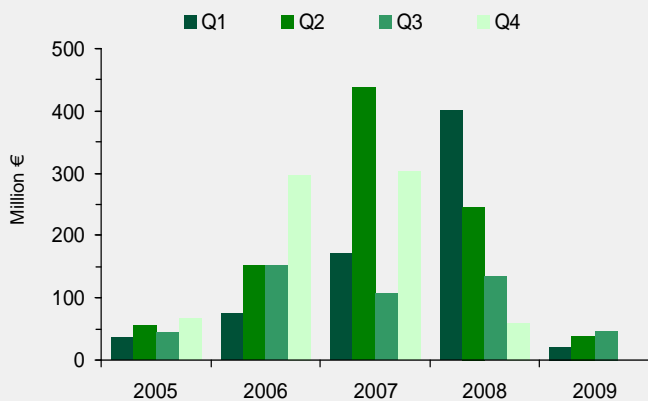
Source: NSI, BNB

* preliminary data for 2009

Market Trends

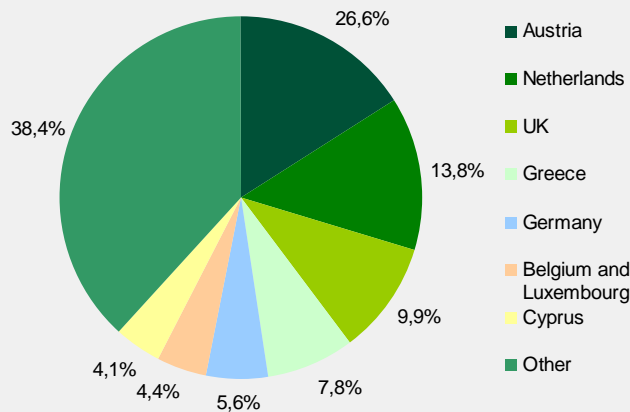
- *The economic downturn has had a sobering impact on commercial property markets thus creating lucrative possibilities for opportunistic and equity rich investors*
- *After a slow start investment activity increased as the year progressed*
- *Over 55% of the total turnover since the beginning of 2009 belongs to office transactions compared to less than 10% in 2008*
- *Prime yields have stabilized at levels of ca. 300 bps since their lowest point in mid-2008*

Total Investment Volume 2005 – Q3 2009



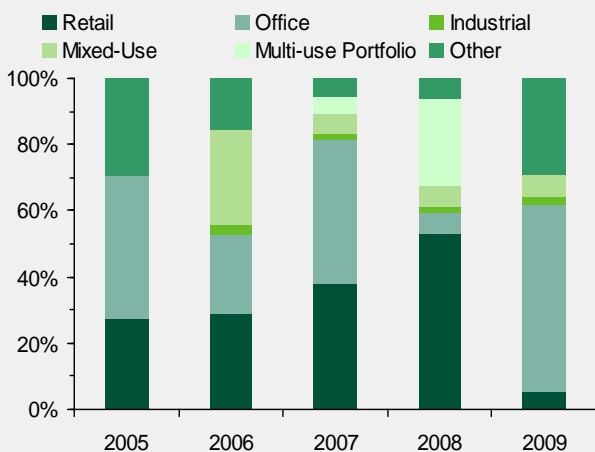
Source: Elta consult

Foreign Direct Investment by Country 2005 – H1 2009



Source: BNB

Share of Investments by Sector 2005 – Q3 2009



Source: Elta consult

SECTOR BRIEFING cont.

feature of the investment market in Bulgaria, despite the interest of many opportunistic local and international investors.

We have estimated that over the last year prime yields have moved out by ca. 300 bps on average across all commercial segments. On a quarterly basis, however, there is a considerable slowdown of yield movement and a possible sign that real estate price corrections have reached a level at which capital values will become appealing to major investors again.

OFFICE

As some movement is observed on the capital markets office properties, including development projects, tend to be most actively traded – they comprise over 55% of the entire volume since the beginning of the year. Except for a couple of minor transactions all deals involve assets located in the capital city. A growing tendency towards sale-and-leaseback transactions can also be observed as businesses are trying to cope with the weakening demand for goods and services. Yields have moved out by ca. 300 bps over the last year and quality office buildings coming to the market create lucrative opportunities for equity buyers.

The office market in Sofia at the moment is characterized by a growing vacancy rate and a large development pipeline which will put additional strain on take-up levels upon its delivery. This creates pressure on rental levels in the short term, especially for lower quality properties. Since yields have slowed their outward movement we expect that market activity will pick up in the beginning of 2010. A positive trend is that a large percentage of development pipeline for the next 1.5 years is announced as Class A offices, which amount to only 25% of the total at the moment.

With the return of the market to property fundamentals the yield spread between prime and secondary property will increase further. As the gap in rental levels between Class A and Class B space expands further prime office buildings with good letting potential will retain the interest of potential purchasers looking for quality assets.

RETAIL

Shopping centres which accounted for a significant portion of the total investment volume since 2006 have somewhat lost their appeal. As banks have become increasingly cautious in their lending policies, it has proven difficult to find the necessary financing for deals of such magnitude. In addition, modern mall schemes in Bulgaria are still a rather scarce commodity, plus the economic downturn has created further complications, so that not all shopping centres may turn out to be as profitable in the short term as previously expected.

Retail parks are becoming more popular due to their lower development costs and the shorter time needed for construction. Tenants, mainly hypermarkets and major retail chains, also find them suitable to their needs because of their lower rents and maintenance costs. Last but not least consumers which have become more price conscious in recent months consider these schemes to offer a good variety of shopping and amusement services in one place. Several such developments have announced in the last year, both in Sofia (Black Gold Park, Retail Park Capital) and in the country (Trakia Retail Park, City Point).

The majority of transactions in the retail segment in the last year involve the acquisition of development plots by international hypermarket and supermarket chains in regional cities. Companies

RETAIL cont.

such as Rewe Group, Tengelmann and Schwartz Group, which continue the expansion of existing brands and are considering introducing new ones, are the most active foreign investors in Bulgaria at present. Vendors in many of these transactions are local governments which are looking for ways to reduce budget deficits, as well as encourage more investments in their regions.

Unlike the office sector retail assets transacted over the years are more evenly divided between the capital and regional markets. As regional shopping center development intensified in the last few years we expect this trend to continue. Among the modern shopping centres that have changed ownership in recent years are Mall of Sofia, Sofia City Centre, Mall Varna, Mall of Plovdiv, Burgas Plaza Mall, Central Mall Veliko Tarnovo and others.

INDUSTRIAL

Similar to retail, though at a much smaller scale, transactions in industrial property has been chiefly confined to development projects. As the investment market slumped in Q1 2009, however, the share of industrial deals has become even more negligible. In addition to being the least developed commercial segment, some of the large-scale projects which were supposed to happen sooner have been delayed for economic reasons. Further obstacles are the inadequate infrastructure both on regional and national level.

Nonetheless, there are other factors that are conducive to the further development and modernization of the country's industrial sector. Bulgaria's geographic location is favorable to its becoming a regional hub on the Balkans – all Transport Corridors that are planned for the peninsula and the shortest surface route to the Middle East pass through here. Also, the rapid growth of the retail segment, and the economy in general, in the last few years has created a healthy demand for modern logistics space that still has to be adequately met. Some owner occupiers for example have begun renting out extra space due to reduced production capacity. Developers offer flexible build-to-suit and long-term lease solutions, which coupled with the lower construction and labour costs are making these projects very attractive investment opportunities. Banks though still careful about giving out credit for real estate investment have started reconsidering their policies regarding schemes they deem viable.

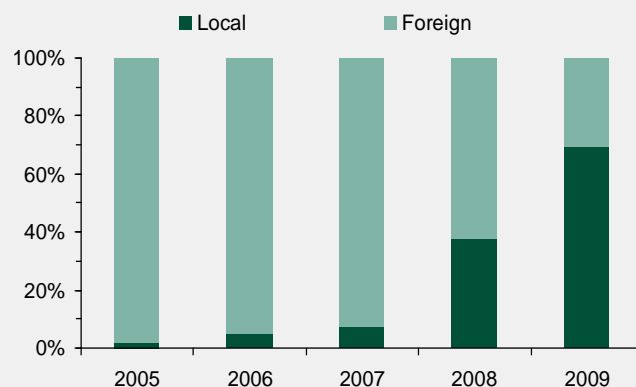
YIELDS AND CAPITAL VALUES

Prime yields have stabilized in Q3 at levels last seen at the end of 2005 and the beginning of 2006. Decline in capital values however is not over yet as further decrease in rental levels is anticipated. Rising vacancy and a large pipeline will be the main cause for future downward pressure on rents in all commercial sectors.

Another tendency that can be observed is the wider spread between prime and secondary yields, especially in the office segment. This is also valid for regional divisions with assets in the capital and the large cities enjoying a lower risk premium than other markets.

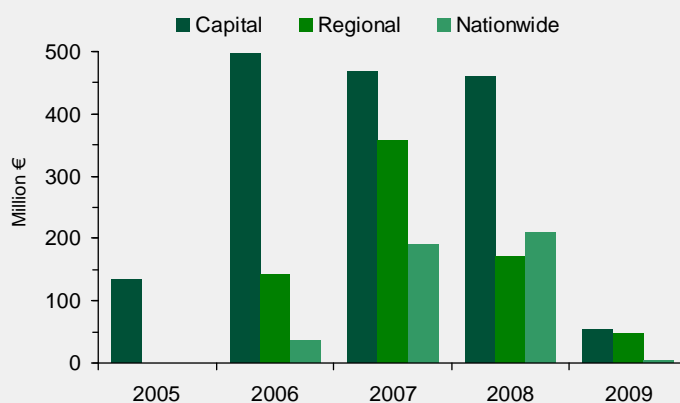
Due to the limited number of investment deals, especially ones involving yielding properties, and the general lack of transparency on the market, yields quoted represent the risk level attributed to the relevant asset class in the current market conditions. According to our estimates prime office and industrial yields in Q3 stand at ca. 10% and 11% respectively, while prime retail yields are in the range of 9.5% - 9.75%.

Local versus Foreign Purchasers 2005 – Q3 2009



Source: Elta consult

Total Investment Volume by Region 2005 – Q3 2009



Source: Elta consult

Local versus Foreign Vendors 2005 – Q3 2009



Source: Elta consult

MARKET OUTLOOK AND FORECAST

Investment activity in Bulgaria is sluggish with no major transaction over €20 million being concluded since the beginning of 2009. The number of deals is well below the one for the first three quarters of 2008 and the average size of transactions is down by 81%. As the economic slowdown and the rising vacancy levels are causing further uncertainty in the occupier markets we cannot expect any sustained growth in capital values over the next six months. New development starts in most segments have also dwindled in response to the challenging market conditions. There is a large pipeline already under construction but since Bulgaria is at one of the last positions in terms of modern commercial real estate stock we believe there is market potential to absorb this pipeline without creating substantial market imbalance.

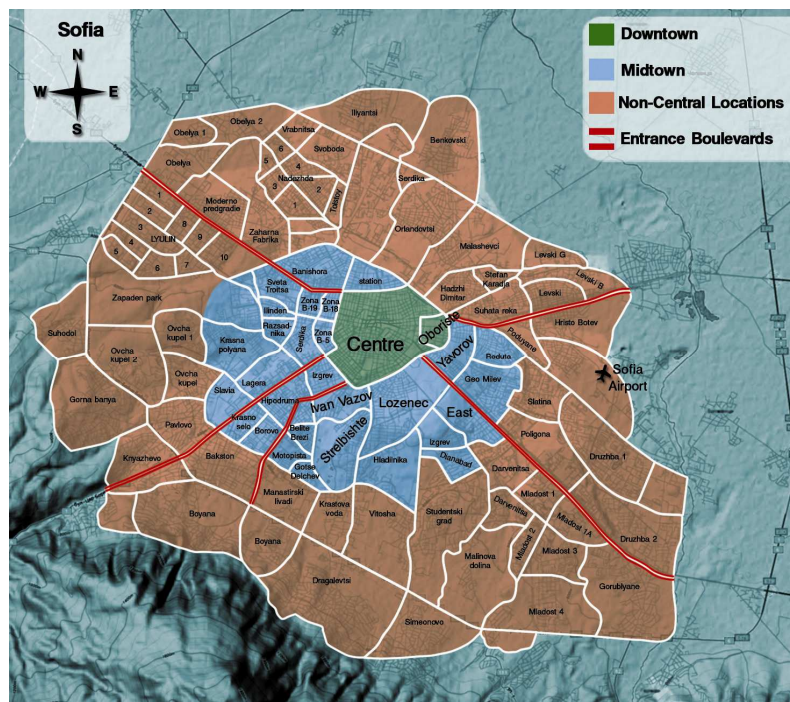
At present investors are in no hurry to buy assets as they feel that prices are still going to fall; there are sellers on the market but unless being pressed by credit obligations they are not willing to sell at any cost. We expect that the market will be reinforced when major international players believe that the bottom has been reached, although any hopes of swift recovery are groundless.

NOTES

The figures regarding the Bulgarian property market are tentative due to the lack of transparency on the market.

They represent only major transactions (over €1 mln); smaller ones are not subject of our analysis.

Sofia Sub Markets Map



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