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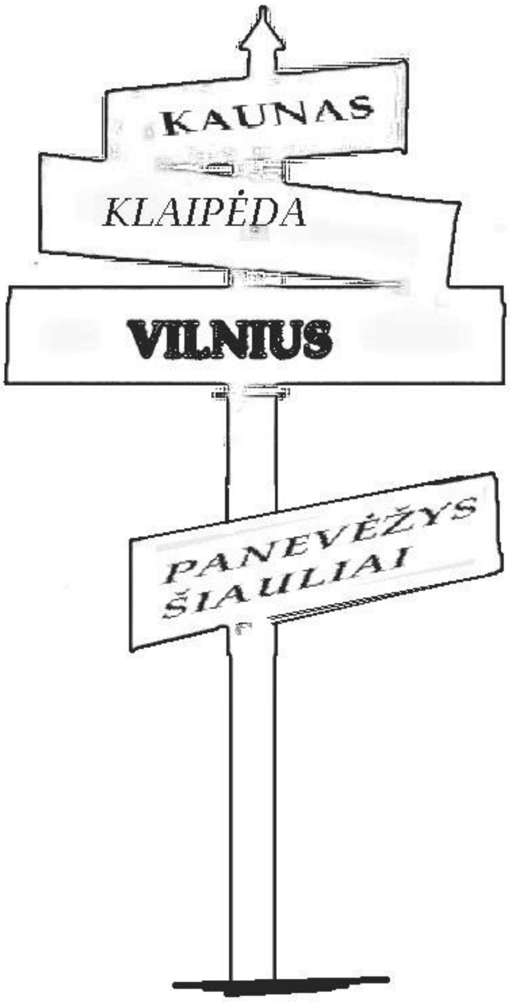
RE MARKET TRENDS February 2014



RE MARKET TRENDS:

INVESTMENT POTENTIAL DECLINES IN VILNIUS AND GROWS IN OTHER CITIES OF LITHUANIA

- Due to the increasing activeness in the RE market, more and more residents and enterprises seek to invest in the RE. Vilnius remains the most attractive among investors as the least risky RE market.
- Since the activeness in Vilnius market is rapidly growing, it becomes less attractive for long-term investors and more attractive for short-term investors, who expect to earn from the price increase, but not from the lease return on investment.
- Currently the lowest lease return is in Vilnius (4-8 percent), and the highest – in Šiauliai and Panevėžys (5-11 percent).
- It is especially important for an investor to to secure the ability to accurately forecast cash flows and manage the risks arising from leasing arrangements.

RAIDLA LEJINS & NORCOUS

LEASE RETURN GEOGRAPHY

Due to the increasing activeness in the Real Estate (RE) market, more and more residents and enterprises in Lithuania seek to invest in the RE. One of the key indicators helping to make investment decisions is the investment return, which is usually expressed by the ratio of the annual net income flow and the purchase price.

The analysis of the lease return from various types of RE has showed that the current investment yields in different cities and segments are different. Currently, the lowest lease return on investment is in the capital city - it ranges from 4 percent to 8 percent per year depending on the segment. The highest return is in Šiauliai and Panevėžys, where the lease return ranges from 5 percent up to 11 percent per year depending on the segment. In spite of the lowest lease return indicators, Vilnius remains the most attractive among investors, as they take into account not only the rate of return, but also to the safety, liquidity of the acquired RE and the overall market prospects. In this respect, Vilnius is far ahead of all other cities. In addition, it is most likely that both the lease and the sales rates will grow in the capital city and it additionally motivates the potential investors.

Nevertheless, because of rapidly increasing activeness in the capital market, it transforms and becomes less attractive for long-term investors and more attractive for short-term attractiveness, who expect to earn from the price increase in the future, rather than from the lease return on investment. Meanwhile, the ratio of annual net lease income and the purchase price is more favourable to a purchaser in other cities, where there are much less potential investors/competitors. Thus, at the improving economic climate of the country, the investment potential is growing in other cities and declining in the capital city.

Expected average lease return in the main Lithuanian cities in different sectors*:

	Vilnius	Kaunas	Klaipėda	Šiauliai/ Panevėžys
Apartments	4-5%	5-6%	5-6%	6%
Houses	4-5%	5-6%	5-6%	5-7%
Offices	4-5%	6-7%	6-7%	9-10%
Commercial	5-6%	6-7%	6-7%	9-10%
Warehousing	7-8%	7-8%	7-8%	10-11%

Source: Inreal

** When calculating the lease return, it was assumed that the vacancy rate would be minimum and the RE costs would comprise not more than 15 percent of the gross income.*

Due to the greater activity and liquidity, the RE lease market in the capital city is considered to be more secure, however, it also offers a lower lease return on investment compared to the markets of other cities. Today there is an opportunity to invest in other cities more profitably, however, it should be borne in mind that the higher returns are generally associated with the higher risk, which lies in possibly lower occupation and liquidity of an object than in more secure markets, the potential reduction in prices or stagnation, more complex search for tenants, etc.

Kaunas, Klaipėda, Šiauliai and Panevėžys markets can be identified as more risky because they have more "weak" tenants and the lease period in the housing segment usually does not exceed one year, in commercial segment – 1-3 years. This means that a greater change of tenants can be expected, which would lead to a greater vacancy of premises because of the search for new tenants. In order to achieve a higher lease return on investment in these markets, more knowledge and expertise may be required in both choosing the investment RE and searching for tenants.

INVESTMENT IN RENTAL PROPERTY: WHAT HELPS SECURE DESIRED RETURN?

In substance, investing in rental property is based on expected future cash flows from rent. As this type of investment involves buying future rental income, ability to forecast and estimate accurately both income and expenses and to safeguard against risks prior to and after the acquisition is essential.

Responsible attitude to the RE acquisition process and transaction documents

In order to secure safe investment in RE and protect against potential risks, it is necessary to perform due diligence and determine the value and quality of and identify potential risks to the property and activities intended to be carried out, select appropriate structure for the transaction and be sure to invest in a flawless transaction process and well-drafted contracts to provide adequate risk diversification and equal protection for both parties to the transaction.

For those who consider buying real estate an important step is to perform comprehensive due diligence on the property to be acquired and evaluate potential risks inherent in the transaction they intend to form and the nature of activities they intend to pursue in the future. Due diligence may be undertaken to look at different facets of the matter, which include technical, legal, tax or other aspects, as needed, and is crucially important for the buyer both from the legal and practical perspective. As the buyer has a general duty to carry out a comprehensive due diligence review of the property he plans to acquire and assumes full risk related to the condition of the property, so he needs to make proper evaluation of the property. By doing so the buyer obtains sufficient information about the property he intends to buy, which helps him decide on the most appropriate structure of the transaction and the final value and price of the property or shares to be acquired.

Due diligence mainly focuses on the core issues, such as the seller's title to the real estate and the right to sell it, lawful or disputable (disputed) rights of third parties to the real estate. Due diligence also involves identification of other existing encumbrances on real estate, any flaws, defects, etc. It should be noted that due diligence is conducted by a team of professional advisers, who provide conclusions and proposals for risk elimination or, respectively, diminution.

Due diligence enables proper identification and evaluation of any existing and threatened risks and ensuring that proper protection for the buyer's interests is secured under contracts and other transactional documents. In certain cases due diligence may also facilitate property management following acquisition.

Well-drafted contracts afford protection against risks

Taking into account that in rental property investing return is not created by a RE property as such, but by the income they generate, it is essential for an investor to be able to make accurate forecasts of cash flows and manage risks arising from the lease relationship. An important aspect of investing in commercial real estate is a clear and attractive concept of a RE property, good location, tenant structure, rent which is appropriate given market conditions and trends, and long-term and legally and commercially well-structured lease agreements.

An investor should give sufficient attention to existing lease contracts in respect of the RE they acquire. The Civil Code (CC) provides for the right of a tenant to terminate a lease upon the change of the property owner; accordingly, unless additional agreements are executed with the tenants, even a fully leased property can become vacant and unprofitable at any time after its acquisition.

There is also another aspect to the above-mentioned risk, i.e. upon taking over of a property together with the tenants the investor inherits existing contracts. Unless consistent legal due diligence is carried out at the time of RE acquisition, the investor acquires RE without being precisely aware of all contracts in place between the owner and the tenants, and it can later appear that these same contracts are not only disadvantageous, but also detrimental to the investor. It is worth noting that some contracts or an established long-term business practice, even if not reduced to writing, is valid and binding on the contractual parties.

For the reasons specified above, it is fundamental securing continuity of the existing leases on the terms favourable to the investor before taking-over possession of the property, i.e. by concluding relevant agreements with the tenants, covering all issues pertaining to the periods of lease, the rent and indexation, the terms and conditions of extension and termination of the agreements, liability and other issues.

The above-mentioned risk of inheriting vacant RE or unfavourable terms of lease become extremely relevant in a "tenant's market" situation, i.e. when there is excess supply of commercial space, with tenants being unable to occupy all available vacant space, because then the investor risks the success of the project as a whole.

Professional RE management provides investment return guarantee

The relationship between the investor as landlord and the tenants does not cease to exist upon formation of lease agreements with the tenants on favourable terms.

In order to retain or even increase RE value, persistent professional management of the agreements and the RE property itself must be ensured. The meaning behind RE management can include rational exercise of the rights to RE, income generating efficient operation of RE, maintenance or improvement of the condition of RE in order to keep it fit for its intended use.

Only professional RE management makes it possible to determine a use of RE which produces maximum effects, because RE management is generally a complicated process involving different issues requiring special expertise: control over the use of RE (budget management and optimisation, coordination of services, reputation building, etc.); accounting management; transactional management; recruitment of supporting staff, etc.

Frequently, an investor does not have enough capacity and competence to make full use of and maintain the RE acquired, while recruitment and professional development of new employees is a costly, risky and time-consuming process. An investor needs to properly evaluate his own capabilities, and if it appears that he may be unable to cope with all issues that may arise, he should consider hiring a RE management company.

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INREAL GROUP

Inreal Group, consisting of JSC "Inreal GEO", JSC "Inreal valdymas" and JSC "Inreal", provides probably the widest spectrum of services in Lithuania, related to real estate. Inreal group companies belong to SC "Invalda privatus kapitalas". About 90 employees are currently working in Inreal group; mediations in lease or sale of more than 550 thousand sq. m. of commercial premises, over 1000 residential housing objects, and over 200 land plots. The company mediates in 40 residential housing projects, 22 investment projects, and 2 investment RE portfolios. More than 2000 valuation reports and about 80 consultations (feasibility studies, investment memorandums, and market research) are being drawn up annually. The value of asset of valuation is above 2 milliard Litas. Company offices or representations are operating in Vilnius, Kaunas, Klaipėda, Šiauliai, Panevėžys, Mažeikiai, Alytus, Plungė and Utena. Currently JSC "Inreal Valdymas" develops two real estate projects: houses in Nida "Kopų vėtrungės" ("Dunes weathervanes") and apartments and comercial premises in Klaipeda oldtown "Danės užutėkis" ("Danes Bay").

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