DOCUMENT OF THE EUROPEAN BANK
FOR RECONSTRUCTION AND DEVELOPMENT

PROPERTY SECTOR STRATEGY

As approved by the Board of Directors on 9 March 2010

EXECUTIVE SUMMARY

Countries in the transition region inherited a commercial, logistics and residential infrastructure which suffered from decades of underinvestment and was not geared to the demands of a market economy.

As the provision of modern real estate infrastructure is essential to support the region's transition and economic expansion and diversification, the activities of the Bank in the property sector are aimed at complementing, enhancing and creating synergies with the core competencies of the Bank, in particular by building an efficient platform for enterprises and municipalities, whilst applying a high selectivity as far as sponsors and projects are concerned.

The key transition challenge in the property sector is to support the market-oriented development and renewal of real estate and the creation of the necessary institutional environment. Through its involvement in property and related markets, the Bank promotes the creation of market-based mechanisms to ensure that demand and supply for property are well balanced, the development of a liquid secondary property market, the strengthening of the legal framework for property as well as the application of international best practices in terms of integrity and environmental, social and energy efficiency standards.

Beyond the scope of the global crisis which affected severely the real estate sector in the Bank's countries of operations, the region remains fundamentally undersupplied with modern, high-quality commercial, logistics and residential real estate, particularly when such increasingly critical considerations as climate change and energy efficiency are included. Long-term demand in the sector is underpinned by two forces: the growing need to replace the region's existing, dilapidated real estate stock on the one hand and its positive, long-term economic growth dynamics on the other. These forces will continue to create strong demand for new, high-quality buildings across the region.

Over the strategy period, the Bank will aim at making a difference by initiating or increasing the range of its operations in countries where transition gaps remain large, achieving a presence in several property sub-sectors in countries with medium transition challenges, and selecting projects with a particularly high demonstration effect in the regions of Russia and Ukraine.

In the short-term, ***liquidity shortage*** (in both debt and equity) constitutes a key challenge to facilitate the completion of selected projects, provide support to situations of distress and allow commercially viable pipeline projects to be relaunched. The Bank's immediate priority is therefore to back financially viable projects whose development has been interrupted by a withdrawal of financing, particularly in regard to its existing clients. With the ultimate aim of restoring the region's real estate markets to activity and liquidity, the Bank is also seeking ways to support the emergence of distressed asset markets and investor restructuring.

Over the recovery period, the Bank will pursue financially sound investments with high transition impact and clear additionality, selecting sponsors with the highest integrity standards and products that better address the region's transition gaps, such as logistics centres, technoparks, regional hotels or the institutional strengthening of the construction industry, with an appropriate mix of direct financing and indirect investment activities through real estate funds. In so doing, it will continue to apply its project finance model at the forefront of real estate market transition, in cooperation with leading domestic and international developers, and supporting real estate projects with a visible demonstration effect. The carefully selected projects will need to address tangible supply and demand imbalances, and promote technology skills transfer as well as international business standards.

In pursuing the core operational objective mentioned above, the Bank will place special emphasis on ***sustainable market development*** and ***climate change mitigation***:

- ***Sustainable market development through institution building and innovation***

  High standards of integrity and **an adequate and enforceable legal and administrative framework** are vital for the healthy development of property markets. Although progress has been made, the level of development is unequal across the countries of operations. Complex administrative requirements, e.g., in the context of property registration, zoning and building permissions are often at the root of corruption, and legal gaps create significant uncertainty. By preventing the involvement of players unwilling or unable to bear the associated risks, supply of quality real estate assets does not meet demand, which in turns affects market-based pricing. The Bank will continue to use all its investments – whether direct or indirect – to promote the highest standards of business integrity. Furthermore, it will engage selectively in policy dialogue, mainly at the project level, with the real estate community, including investors, developers and authorities, to identify and address shortcomings in the institutional environment for property development.

  The **existence and depth of secondary markets** is an important investment consideration for real estate investors and developers, who would typically seek to realise their investment after a few years, especially in the case of a development. This in turn requires an increased participation of institutional investors, international but also domestic. The creation and deepening of secondary markets will continue to constitute a key element of the Bank's objectives. By participating mainly in sector specific equity funds but also in pre and post IPO property companies and real estate developers, the Bank can lead the expansion of secondary markets in the region and help create greater liquidity in real estate markets.

- ***Climate change mitigation through energy efficiency***

  At present, a number of the world's most energy intensive economies are located in the EBRD region. Within this context, the built environment is estimated to account for around 39 per cent of final energy consumption in the region, mostly through heat, and is thus the largest single opportunity for energy efficiency. To address this challenge, the Bank will assess systematically the scope for energy efficiency across all operations. By assisting in the dissemination of energy efficiency best practice, introducing/upgrading energy efficiency standards and transferring skills and know-how, the Bank will aim to act at the forefront of the region’s broader climate change mitigation efforts, employing commercially viable, available technology and practice to achieve major energy savings.

Throughout its operations in this sector, the Bank will focus on **geographical diversification**. The Bank will progress further into the Western Balkans, Eastern Europe & Caucasus, Central Asia and Russia and where possible and appropriate, into secondary cities with the aim of creating new, high-quality stock across all sub-sectors. In less developed countries, continued involvement in capital cities remains justified. Furthermore, especially in the ETC region, **small scale projects** will remain an important component of the Bank’s work and will be mostly carried out through dedicated vehicles.

In line with its mandate, the Bank will continue to support actively environmentally and socially sound and sustainable development in all its investments. Urban regeneration projects that revitalise dilapidated areas will constitute a particular area of interest in this context.

The attached Property Sector Strategy proposes overarching priorities that aim to address the remaining transition challenges in the sector. A level of flexibility will be needed to enable the Bank to respond effectively to the transition needs of each country in a context where the medium to long-term impact of the global crisis remains uncertain.

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Table of Country Groupings

Central-eastern Europe and the Baltic States	Croatia
	Estonia
	Hungary
	Latvia
	Lithuania
	Poland
	Slovak Republic
	Slovenia
South-eastern Europe	Bulgaria
	Romania
of which Western Balkans	*Albania*
	Bosnia & Herzegovina
	FYR Macedonia
	Montenegro
	Serbia
Turkey	Turkey
Eastern Europe & the Caucasus	Armenia
	Azerbaijan
	Belarus
	Georgia
	Moldova
	Ukraine
Russia	Russia
Central Asia	Kazakhstan
	Kyrgyz Republic
	Mongolia
	Tajikistan
	Turkmenistan
	Uzbekistan

Table of Abbreviations

3PL	Third Party Logistics
CBRE	CB Richard Ellis, a leading international real estate consultant
Class A	Top category in international real estate categorisation; precise definitions vary by country, source and sub-sector
DIF	Direct Investment Facility
DLF	Direct Lending Facility
E2C2	Energy Efficiency and Climate Change
EEC	Eastern Europe & the Caucasus
ETC	Early Transition Country
EU	European Union
EUR	Euro
FDI	Foreign Direct Investment
GDP	Gross Domestic Product
IFC	International Finance Corporation
IFI	International Financial Institution
IFRS	International Financial Reporting Standards
IPO	Initial Public Offering
JLL	Jones Lang LaSalle, a leading international real estate consultant
LEF	Local Enterprise Facility
MCFF	Medium-sized Co-Financing Facility
MEI	Municipal and Environmental Infrastructure
MSME	Micro-, Small- and Medium-sized Enterprise
OPIC	Overseas Private Investment Corporation
REIT	Real Estate Investment Trust
REVpar	Revenue per Available Room
SEFF	Sustainable Energy Financing Facility
SEI	Sustainable Energy Initiative
Sqm	Square metre
TIMS	Transition Impact Monitoring System
USD	United States Dollars

1. UPDATE ON DEVELOPMENTS IN THE REGION

1.1 Developments in the Region

The real estate sector has been severely affected by the current global financial and economic crisis. The halt in activity that this crisis has caused stands in stark contrast to the period 2001 –2008, which was characterised by the constantly rising volume of investment in projects and by the ambitious plans of developers active in the region. This resulted not only in a greater intensity of development in selected major cities, but also in geographical expansion towards smaller cities, which for the first time became subject to modern real estate development. However, these trends were reliant on the availability of financial capital from international markets, whose flows began to diminish in 2007 and came to a virtual halt from September 2008.

The activities of the Property and Tourism sector support the development and renewal of the real estate infrastructure in the Bank's countries of operation. For visitors to the region, new hotels provide suitable accommodation; for growing enterprises, new, international standard office space leads to increased productivity; for expanding retailers, modern logistics hubs and retail outlets facilitate entry into new markets, providing consumers with increased choice and lower prices; and in the tourism industry, new assets add directly to the service economy. Local communities benefit directly from the products, services and employment opportunities that this infrastructure facilitates.

From 2001 to 2008, development in the sector benefited from two trends in the region: strong GDP per capita and FDI growth. Both trends positively influenced demand for new, high quality real estate infrastructure to replace the remaining Soviet-era stock that was marked by poor quality and design and falls short of modern business requirements.

GDP Per Capita and Net FDI, all Countries of Operation

Measure / Year	2000	2001	2002	2003	2004	2005	2006	2007	2008
GDP per capita (constant USD)	2,331	2,300	2,615	3,234	4,113	5,075	6,050	7,674	9,575
(% change y-o-y)	-	*3%*	*14%*	*24%*	*27%*	*23%*	*19%*	*27%*	*25%*
Net FDI (USD millions)	25,589	29,445	31,318	24,409	51,734	66,559	98,837	115,373	124,374
(% change y-o-y)	-	*15%*	*6%*	*-22%*	*112%*	*29%*	*48%*	*17%*	*8%*

Source: Office of the Chief Economist.

The dynamics of demand led to the following generalised trends in the sector:

- A high growth rate in real estate assets of all types. In isolated cities, this led to instances of temporary oversupply, such as high-end hotels in the Budapest market, but mostly, unsatisfied demand was tangible across all sub-sectors and real estate stock per capita remained well below Western European averages.
- Increased activity from international property developers and financiers, whose projects were initially focussed in Central Europe & the Baltic States but had

begun to enter Russian and South-eastern Europe markets as the crisis took hold. Some capital cities experienced near exponential supply growth before 2008.

- The creation in Central Europe & the Baltic States of limited secondary markets thanks to the activity of sector-specific equity funds and, from 2004 onwards, vehicles that allow individual investors to benefit from investment in commercial real estate, like pension funds. This helped market yields, which closely reflect investors' risk perceptions, to fall across the region. In their turn, secondary markets act as a catalyst for further primary market activity because they serve to reassure developers of an exit through sale of the assets they deliver.
- Despite these positive developments, supply growth remained uneven, both amongst countries and within their regions. Whilst some new EU members attained a measure of self-sustainability, other countries of operation continued to suffer from structural impediments that prevent transition from taking root in the sector. Consequently, these countries received minimal attention from sophisticated commercial real estate professionals. Transition across the region became more uneven.

The increasing availability of financial capital fuelled real estate investment growth. However, the trajectory of this growth remained reliant on the availability of this financial capital from international markets, whose flows began to diminish in 2007 and shrank at a higher rate from September 2008. As Western financial institutions sought to reduce their overall risk profile, they withdrew from the region and its real estate markets. The motivation for this withdrawal is manifold and includes the deleveraging of the financial system, the retrenchment by Western banks towards their domestic markets as well as growing concern over macroeconomic and currency stability. As the financial crisis progressed into a global economic one, the pressure on the region's economies depressed rental rates and demand for real estate space across the board, as existing and potential tenants become exposed to the negative impact of the crisis. The combined financial and economic elements of the crisis have affected all aspects of the commercial real estate market, with the following main effects:

- **Standing Assets** are challenged by the creditworthiness of their tenants. The risk of tenant default has risen significantly, forcing downward rent negotiations, restructuring/delay of rental payments, and non-payment. Funds that invest in income producing real estate assets in the region have suffered discounts on their book value as a result of the devaluation of their core assets. Such assets become vulnerable to default and discount sales.
- **Recently Completed Assets** are challenged by potential tenants' unwillingness to commit to long-term rental contracts. These potential tenants, which are often businesses moving into new geographical areas for the first time, are unwilling to commit to rental agreements, most of which are denominated in a Western currency rather than a local currency, until they have a reliable view of the length and depth of the current recession. As a consequence, recently completed assets are experiencing much longer lease-up periods and lower rental levels.
- **Assets Under Construction** face not only the prospect of a problematic lease-up, but also more immediate difficulty of securing adequate financing. Many projects across the region were commenced without having secured full construction financing, in the expectation (realistic in the pre-liquidity crisis environment) that sufficient funding could be found after construction had been launched. The principal risks at this stage are either that a funding gap emerges or that the

construction loan used to finance the project up to building completion cannot be rolled over or re-financed to maintain the project's leverage.

- **Pipeline Assets** have been drastically reduced – up to 80% in certain reported instances. Starting towards the end of 2008, as developers and investors took stock of their current financing liabilities against a severely restricted financing environment, pipeline projects were either postponed or cancelled outright. The decline in activity caused by these postponements/cancellations has caused construction costs to fall dramatically, up to 50% in some areas.

New development activity has fallen practically to zero across the region as all interested parties have chosen to focus exclusively on completing projects that had already begun. Where necessary, developers are using cash reserves to avoid distress, and though many projects are breaking some debt covenants, lending banks have largely avoided calling loans for the time being. Distressed market activity is bound to follow, however, once either of these temporary responses reaches an end. Real estate professionals predict distressed asset sales to increase in 2010.

The asset value write-downs and impairments that have already begun are certain to continue. Their full extent is unknown because since October 2008, there have been very few real estate transactions in the region. Without such activity, the market has not produced the sector-specific yield rates[1] relied upon to arrive at asset pricing. Consequently, current asset value estimates in the region have been reduced to a comparison against Western European rates combined with a political/financial risk assessment, which remains at best an inaccurate measure. Currently quoted yields for Moscow, for example, are around 13% (depending on the sub-sector in question), but could rise as high as 20%[2] once transactions re-emerge in the marketplace. 13%[3] nevertheless represents a rise of between 2% and 4% on 2008, indicating a severe market reversal.

The conditions created by the crisis are forcing, and will continue to force, significant changes in the form and behaviour of the region's real estate markets. In doing so, they will create commercial opportunities for those market participants that have retained sufficient financial strength. Beyond the defaults and distressed asset sales outlined above, considerable market consolidation is anticipated amongst construction companies and developers. There will also be an opportunity, once financial institutions begin to unravel their exposure to the sector, to assume a still unquantified volume of non-performing loans. As with any critical economic change, new behavioural norms and markets processes may be introduced to the region. The Bank has an opportunity to act as a leading force in the region as it emerges from this recession.

To return to a long-term perspective, the region remains fundamentally undersupplied with modern, high-quality commercial and residential real estate, particularly when such critical considerations such as climate change and energy efficiency are taken into account. Long-term demand is secured by two opposing forces: on the one hand, the stock of existing real estate is becoming increasingly dilapidated and requires

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[1] A yield rate in real estate is similar to a discount rate in corporate finance: it is a measure of the risks associated with a given asset. The higher the yield, the higher the associated risk of the asset.
[2] Colliers International 2009.
[3] CBRE 2009.

replacement – new construction has kept pace with expiry only in the most dynamic locations and Soviet-era construction is reaching the end of its intended life. Much of this construction was completed between 1960 and 1980, with an economic life of 30 – 40 years. On the other hand, the region's positive growth dynamics, highlighted above and interrupted but not extinguished by the current crisis, will continue to create a strong demand for new buildings of every sort, all across the region.

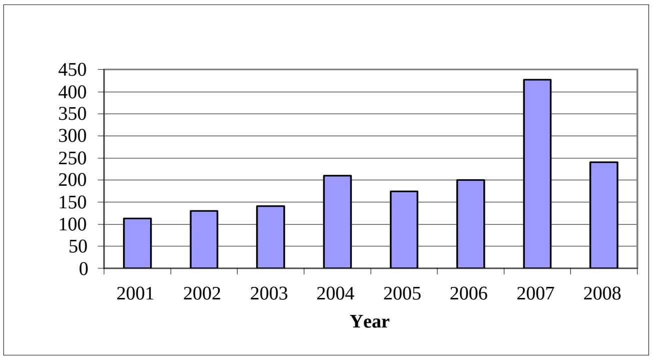
The long-term prospects for the sector thus depend largely on the liquidity conditions that follow economic recovery. It is estimated that some EUR 3.5 billion in equity was committed to Central & Eastern European real estate in 2009[4], less than half of the amount available at the market's peak in 2007, and approximately equivalent to the 2005 volume. The rate and way in which this equity will be spent will depend on liquidity in the debt financing market, which remains all but closed at present and is not anticipated to return to former levels even in the medium- to long-term. Future activity, therefore, will be a balance between the continued demand for new, high-quality real estate in the region and the prevailing financing conditions. Future projects will have to accept a new set of operating norms, including a reduced loan-to-value ratio, higher margins and fees, more stringent financing conditions and a period of lower rental levels.

For in-depth analysis of critical sub-sectors within commercial real estate, please refer to **Annex 1**.

1.2 EBRD Activity over the Period

In line with the Bank's mandate to sponsor financially viable projects on terms not readily available from commercial sources, the Bank's activity over the period responded to the considerable changes in the region's real estate financing environment – notably the rise in financing accessible on Western and domestic capital markets, and then the sharp reduction in this financing as the global crisis took hold. Overall, annual commitments more than doubled from 2001 to 2008.

Annual Commitments in the Property & Tourism Sector, EUR million



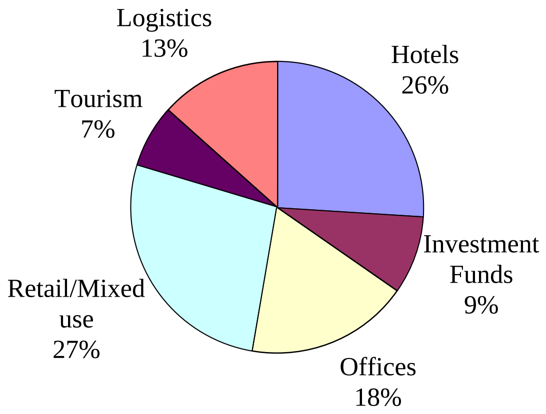
Source: Bank statistics. (Note: the figure for 2007 is unusually high due to the Bank's commitment to two large equity fund projects, both of which have been scaled down. These also affect the tables below.)

[4] CBRE 2009.

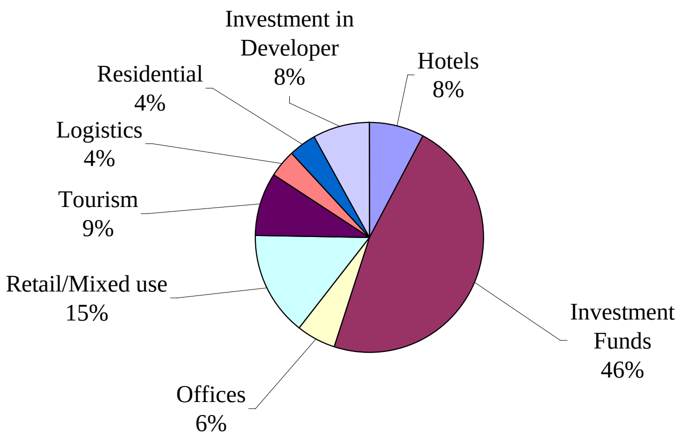
1.2.1 Distribution across Sub-sectors

The distribution of projects across sub-sectors evolved markedly towards investment funds. Experience in the countries of operation shows that such investment vehicles can offer the dual advantage of developing high-quality assets and thus setting new standards in terms of quality, whilst also contributing liquidity to the market. In doing so, they render real estate markets more efficient and contribute to the extension of property markets in the Bank's countries of operation. From the Bank's perspective, funds are an effective way of reaching and influencing a large number of counterparts and entities as well as an efficient tool due to their high mobilisation ratio, mobilising more commercial capital relative to direct investments over the period. Because the majority of institutional investors lack the sector and/or geography specific expertise, for them indirect investments through funds is the only way of deploying substantial commitment amounts in the property sector in the region. The figures below show cumulative share of volume *committed* per sub-sector:

Cumulative Commitments by Project Type, end 2000



Cumulative Commitments by Project Type, end 2008



Source: Bank Statistics.

The break-down by sub-sector of the equity committed by the investment funds in which EBRD has invested in is as follows: offices - 50%, logistics – 17%, mixed use developments - 14%, retail - 11%, residential – 5%, developers – 2%, hotels – less than 1%.

1.2.2 Distribution across Geographical Regions

The geographical focus over the period began in Central Europe & the Baltic States but later progressed both south and east into Russia and South-eastern Europe and Eastern Europe & the Caucasus. Commitments in the Western Balkans and Central Asia, modest in the early part of the period, began in earnest in 2005, and the relatively modest volume invested belies the fact that a large number of small transactions were completed under the Bank's dedicated schemes. This evolution reflects not only the Bank's overall strategic shift south and east, but also the natural movement of commercial real estate projects deeper into the region.

Annual Commitments by Geographical Area, EUR million

Country Group	2001	2002	2003	2004	2005	2006	2007	2008	TOTAL
Central Asia	0	0	0	0	10	5	74	2	**92**
Central Europe and Baltics	30	29	85	125	21	6	52	49	**397**
Eastern Europe & Caucasus	26	1	8	15	25	11	80	36	**202**
Russia	5	0	2	5	0	26	54	27	**119**
South-eastern Europe	53	100	46	65	117	152	167	122	**822**
Of which Western Balkans	0	0	7	11	21	20	28	17	**104**

Source: Bank Statistics. (Note: for the purpose of this table, equity funds are distributed according to guidelines drawn up ex ante*, before the funds are deployed. The regional distribution of equity funds* ex poste*, once the funds have been deployed, differs somewhat from the original guidelines.)*

1.2.3 Distribution across Financial Instruments

Just as the geographical focus progressed, so a trend towards equity emerged. This evolution can be explained by two main factors: firstly, the Bank's investments in real estate equity funds, described above. Whilst remaining a minority partner, such funds proved keen to secure the Bank's participation as an anchor investor in order the better to attract other investors. Secondly, the increased availability of debt from commercial banks reduced the Bank's additionality for this instrument. However, the Bank returned in 2008 towards debt as an instrument of choice.

Annual Commitments by Financial Instrument, EUR million

Annual investments by instrument	2002	2003	2004	2005	2006	2007	2008
Debt (million euro)	95	99	12	94	45	77	129
Equity (million euro)	35	39	111	42	102	270	107
Debt and Equity (million euro)	0	3	87	38	53	80	0

Source: Bank Statistics.

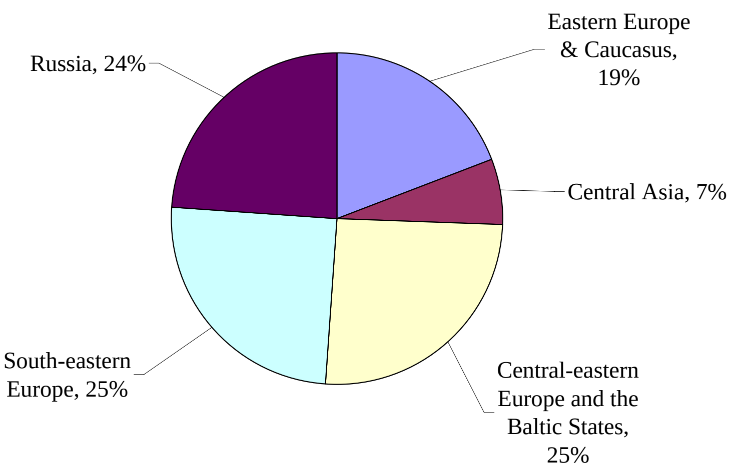
As outlined in the Section 1.1, commercial real estate activity has been effectively stymied since the fourth quarter of 2008. In this context, with commercial banks retrenching drastically and liquidity draining from the market, the Bank has already stepped in to secure several projects impacted by the crisis. As of the end of 2009, by deploying a range of senior debt, mezzanine loans and straight equity, it has already committed EUR 223 million across eight crisis response projects, covering a range of sub-sectors, geography and stages of completion.

1.2.4 The Bank's Portfolio in the Current Climate

As of end 2008, the Bank's portfolio in the Property and Tourism sector amounted to EUR 1.24 billion against EUR 413 million at the end of 2001, representing a threefold increase over the period.

In terms of geographic breakdown, the portfolio is well-diversified amongst the country groups, with Central Asia still representing a small portion of the portfolio.

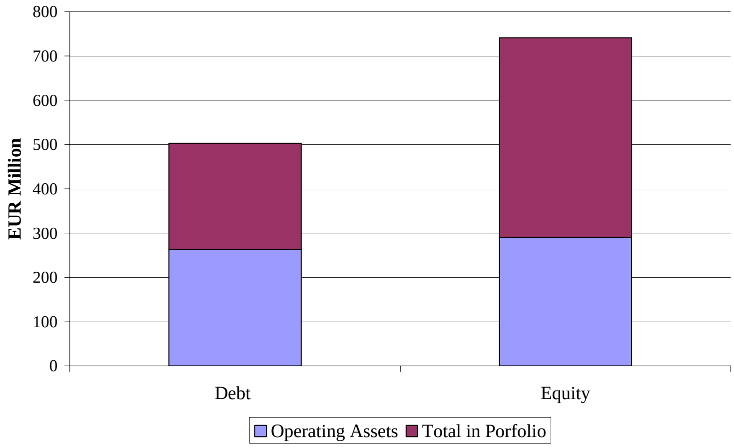
Portfolio broken down by Region, End 2008



Source: Bank Statistics.

With operating assets at end 2008 amounting to EUR 554 million, a large portion of the portfolio is undrawn (see graphic below). This is explained by the fact that over 50% of the portfolio is composed of real estate funds, where disbursements are spread over an investment period ranging between three to five years from commitment. Another explanation for the gap between portfolio and outstanding assets is the fact that disbursements of loans follow construction progress (typically over 18 months) and are subject to conditions precedent, reflecting the prudent approach of the Bank.

Debt, Equity and Operating Assets in the Portfolio, end 2008



Source: Bank Statistics.

Equity investments, which represent approximately 60% of the Bank's current portfolio, are mainly composed of investments in real estate equity funds. The performance of the equity portfolio, which was strong up to 2008, has been negatively impacted by the recent turmoil.

Listed investments dropped close to 60% between Year End 2007 and Year End 2008. The non-listed equity portfolio also suffered a drop in valuation for investments made in 2007 and before, albeit less severe. A further drop in valuation as of the end of 2009 is anticipated.

The situation for **real estate funds** depends largely on their vintage and stage of investment. *Funds which are at an early stage* of their investment period will suffer from a decrease in the value of their portfolio, but are unlikely to face immediate liquidity constraints due to their ability to call on capital. However, they are likely to have invested at or near the peak of the market, which will drag the overall return of the portfolio. *Funds which are close to or fully invested* risk, in addition to a reduction in their portfolio value, to face liquidity problems. Breaches of loan covenants might lead the banks financing sub-projects to suspend drawdowns or request full or partial repayment of loans which could potentially wipe out the value of the fund's equity in the respective sub-project. Furthermore, these funds will see their exit horizon postponed for the foreseeable future. On the other hand, these funds are likely to have invested the bulk of their capital before the peak of the market, and if they are able to overcome the liquidity problems, they might produce an acceptable return.

As for direct equity investments, the Bank is witnessing a clear deterioration in its portfolio, especially for those investments made in 2007 (Ukraine, Georgia and Croatia).

The debt portfolio has so far benefited from the disciplined approach adopted by the Bank, even when commercial lenders were loosening their lending criteria. However, as the economic aspect of the recession reaches a wider number of consumers and companies, tenant defaults are expected to increase, which will jeopardise the ability of the borrowers to service the debt. The first signs of this trend are being felt in Ukraine and Russia.

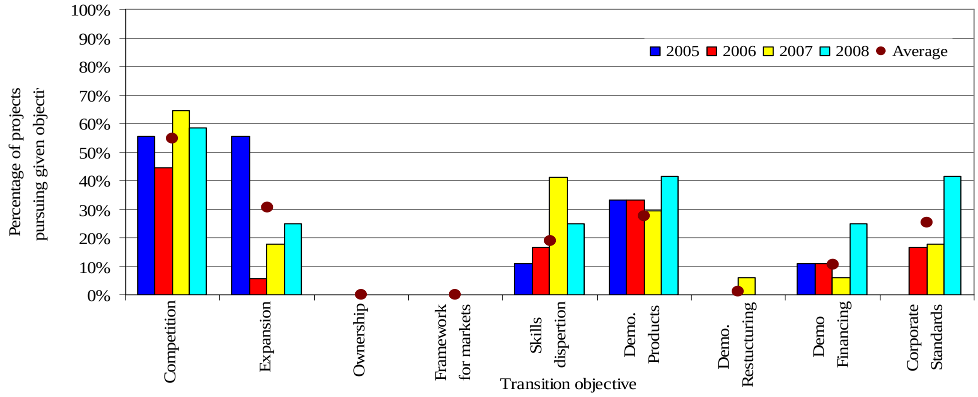
1.2.5 Transition Impact Review of Property and Tourism portfolio

Analysis of the typical monitoring cycle of operations shows that projects in the Property and Tourism sector carried above average transition impact potential at signing (95% of approved operations were rated either "Excellent" or "Good" at signing from 2005 to 2008). The analysis also shows that transition impact takes slightly more time to materialise than those of average EBRD projects. Overall, the transition impact of Property and Tourism projects across the Bank's countries of operation has suffered from the crisis, since a number of transition impact benchmarks have been negatively affected as the financial and economic crisis has taken effect.

For TIMS-monitored projects signed at the beginning of the review period (2005), above average cancellation rate is visible. This is explained in the analysis undertaken in Section 1.1 on standing assets (challenged by the creditworthiness of their tenants), recently completed assets (challenged by potential tenants' unwillingness to commit to long-term rental contracts) or assets under construction (which face not only the prospect of a problematic lease-up, but also more immediate difficulty of securing adequate financing). For projects signed more recently, there have been relatively more rank downgrades than for projects signed in 2005-2006, reflecting the increasingly challenging market environment. An indicator of this state is the fact that the average rank of projects at signing across all signed projects over 2005 to 2008 is marginally better than the average rank of the same projects as of mid-2009. This is mainly driven by higher risks.

Investment funds have been the most important vehicles for achieving transition impact, not least because they enhance market efficiency by developing high-quality assets whilst also contributing liquidity to the market. Activities of such funds in regions such as South-eastern Europe were still relatively new at the beginning of the review period. Through investments of regional scope, transition impact was achieved as developments increased competitive pressures in the respective property market niches (office, warehouse, retail, residential) while activities of the funds supported some development of secondary real estate markets. By sharing best-in-class asset management techniques with their local partners, real estate funds have also contributed to the transfer and dispersion of skills in areas such as building operation and management, tenant customer service, rollover risk mitigation and leasing best practice. In the past year however, attractive opportunities have become more rare and difficult to process due to the impact of the crisis.

Transition Objectives Pursued by Property and Tourism Projects, 2005-2008



Source: Office of the Chief Economist.

As seen in chart above, throughout 2005 to 2008, *Competition* has been the channel through which most transition impact has been pursued, followed by *Market Expansion* and *Demonstration effects of new products*, which have increased over time. To some extent, this is in line with Bank geographical diversification as depicted in Section 1.2.2. This also applies to other demonstration effects and improvements in *Corporate Governance*. On average *Expansion* seems to be a key channel for achieving transition impact. However, the average shown on the chart above is biased by the large number of projects signed in 2005 which pursued this objective. These projects were primarily undertaken in less advanced countries with larger transition gaps. In segments such as *Real Estate*, transition impact related to the expansion of markets typically emanated from linkages to the support companies in the construction and property sector, while in *Hotels/Accommodation*, it came from backward linkages to local suppliers of auxiliary services.

Overall, the analysis shows that the later the project signing date, the less transition impact materialised, but also the higher the related risk. In fact, since 2005, there have been as many upgrades as downgrades: most upgrades occurred for projects signed at the beginning of the review period, while most downgrades towards the end, indicating that the environment in which the Bank operates has become more complex as the crisis began. On the other hand, as demonstrated by the projects signed in 2009, the Bank can have a significant transition impact by designing adequate crisis-response projects that respond to the region's immediate liquidity shortage and help to bring the region's real estate markets back to activity.

1.2.6 Lessons Learned Since the Last Sector Strategy

The Bank has collected more than 100 Lessons Learned in the sector, relating to all aspects of the projects in which it participates. It routinely follows these lessons, adopting them as an important guide, particularly during economically challenging periods. For the Evaluation Department's own synopsis of these lessons, please see below:

- Project sponsor should be committed and creditworthy.

- Risk mitigation measures should be tailored to market circumstances and sponsor strength.
- Contracting and procurement should be carefully managed to control conflicting interests. Potential contractor/sponsor conflicts of interest managed by contracts (sponsor's equity kept at risk into operational phase through controlling value of turnkey contracts and monitoring contractor's profit potential). The contractor should be fully tied to the project through contractual and bonding arrangements.
- Property projects should seek trimming of administration costs upon completion.
- The role of the lender's supervisor is an important one in risk mitigation and should be appointed, to oversee construction work, to review the initial budget presented by the sponsor, to advise on implementation issues and provide good quality, regular monitoring reports.
- The introduction of Western-style leases can be an important risk-mitigating factor for the Bank.
- High quality property management can significantly reduce rollover risk.
- Conservative assumptions should be adopted when the capacity of the hotel represents a sizeable share of the local market, since demand for high-end space can "thin" such that temporary oversupply will add to lease-up risk/cost.
- The hotel management company should be at risk for something other than the management contract.
- The loan amount per room is the key determinant of timely repayment of the Bank's loans… the Bank has changed its focus when analysing hotel projects from loan-to-cost measures to loan-per-room measures.
- A significant level of equity (at least 40%-50%) is required to support any possible under-performance in the crucial early years.
- In any partial finance of a property project, ensure that financing commitments are in place for the balance of the funds needed to complete the project.
- The Bank should seek, whenever possible, to pursue multiple projects in sectors where it has gained experience, although beware of saturating small markets with any particular project type.
- Whenever possible, project monitoring, particularly during the implementation phase, should be handled by bankers with sector specific expertise. For projects with a substantial construction element, the wider use of a lender's supervisors by the Bank should be considered.
- The Bank should seek, whenever possible, to specify prepayment penalty fee in the loan agreement. Prepayment penalties are justified for pioneering operations with high initial transaction costs and risks.
- Implementation and completion of commercial property development projects should be timely since delays will add not only to direct completion cost but also to market risk.

The Bank has also benefited from the *Property Sector Policies – September 2006*, conducted by the Evaluation Department which provided an evaluation of the Bank's property sector policies of 1994 and 2001 and an in-depth review of the Team's activities between 1992 and 2004. While the *Property Sector Policies – September 2006* referred to above rates the Property and Tourism projects evaluated by the Evaluation Department generally positively ("…slightly better than the Bank as a whole"), it assesses the impact of the Bank in the property sector as a whole as marginal. The report suggested that the Bank's performance could be improved by (i) initial operations in countries where the impact was judged to be "none" as a result of there having been no Bank projects in the property sector and where large challenges were still present; (ii) increasing the range of property project types in those countries where there was minimal impact and large challenges remained; and (iii) increasing the range and number of property project types in those countries where there had been minimal impact and where there was still a medium transition challenge. Since the study was published and demonstrating a commitment to overcome these challenges, the Bank has conducted operations in four of the nine countries where there had been no activity and increased the number and range of property project types in six of nine countries where it was considered that there was minimal impact but still a large or medium challenge remaining.

By actively pursuing opportunities in the other countries, the Bank will continue to improve the impact of the Property sector. Furthermore, the Bank has been adapting its model by placing a special emphasis on ETC countries, and making extensive use of the instruments and frameworks which have been put in place to promote further investments in countries with large transition challenges.

2. TRANSITION CHALLENGES

Transition in the sector requires not only the development of real estate markets, but also of the institutions, business formats and behaviours that accompany market development. Countries first encounter fundamental challenges, such as how best to implement land registration; as they progress, they face more advanced challenges, such as how best to optimise land collateralisation laws for efficiency. To arrive at an efficient, market-based real estate sector, each country must move through the full range of these challenges.

Though real estate sub-sectors (hotel, office, retail, logistics, investment and residential) differ in their individual characteristics, the same generalised challenges apply to the sector as a whole. On the basis of the transition challenges detailed below, operational priorities are presented in Section 3.

Immediate challenges created by the financial and economic crisis: *Mobilise financing structures and entities capable of responding to the region's current liquidity shortage (in both debt and equity), in order to facilitate the completion of selected projects, provide support to distressed situations and allow pipeline projects to be relaunched over the medium- and long-term. For this response to take place, innovative financing structures and market segments must take root in the region, which has only limited experience of this to date.*

The immediate challenge in relation to the financial and economic crisis is to return the market to activity. As described above, the market has fallen to a practical standstill at all levels, with construction halted where finance is lacking, tenants delaying their rental decisions or withdrawing from existing commitments, developers starkly reducing their project pipeline and investors hesitating to commit to transactions. This situation will persist until such a time that these parties gain a realistic view of the length and depth of the recession, and a sense that a "floor" has been put in place to limit the downside risk. They are presently operating with survival in mind, though impairments and asset write-downs have begun to cause considerable harm. Vulnerability to standing asset defaults is heightened by frequent currency mismatches between loans extended by Western financial institutions and tenants' local currency revenue streams. The EU member states of Central Europe & the Baltic States and, in particular, the Baltic States have been worst affected by the crisis so far, along with individual sub-sectors of major cities in the region – such, for example, as residential developments in Moscow and Almaty. However, the whole region is affected, and will continue to be so as its economic aspect takes full effect.

Thus the challenge in the short-term is to facilitate activity in the market, in order to re-establish market pricing for assets and provide all parties the short- and medium-term perspective they require in order to make strategic decisions.

Development of an adequate institutional framework for property: *This refers to the development of the legal and administrative basis for private property ownership, development and trading – including the privatisation of state-owned property assets, legal basis for private property rights, establishment of property/land registries, collateral legislation, etc. It also covers improvements in the enforceability of legislation concerning the real estate sector, to improve enterprises' predictability in decision making, and to reduce bureaucratic interference and the scope for corruption.*

Ill-functioning, unpredictable institutional frameworks and policies represent major constraints to development in the property sector in many of the Bank's countries of operation. Countries whose fundamental institutions and policies, in particular legal frameworks, need further strengthening are concentrated around Central Asia (except Kazakhstan), Eastern Europe & the Caucasus (in particular Belarus, Azerbaijan and Moldova) as well as the Western Balkans (Bosnia & Herzegovina, Montenegro and, to a lesser extent, Albania, FYR Macedonia and Serbia). Russia also belongs to this group. In the most basic case, insufficient ownership laws create risk perceptions that reduce or erase investors' willingness to invest. The ensuing challenge is to establish a legal basis for ownership of immovable property (including clear land registration), in order to create satisfactory conditions for high quality real estate investment. Notably, Georgia achieved this with a new land registration law in the wake of the Rose Revolution, and thus provided impetus for a commercial property market to emerge.

In countries with somewhat efficient institutions and policies, the remaining challenges are concentrated around improving enforcement of the legal framework – since basic legal frameworks only allow basic real estate markets to develop, considerable refinement is necessary to allow more sophisticated markets to develop, including secondary markets. As a region, Central Europe & the Baltic States has advanced the furthest in efficiency terms, so that for the majority of these countries the remaining transition gaps in this arena are negligible. Besides this, only individual countries can claim to have laid the groundwork for sophisticated real estate markets (i.e., Bulgaria, Romania, Georgia, Kazakhstan). By way of example, new legislation in Russia increased residential buyers' protection vis-à-vis developers but its complexity also created a barrier to entry for international investors. In a number of countries, privatisation laws are not universally enforced, a situation that preserves the system of state land leasing by municipalities and unduly rewards developers that are able to maintain close relations with granting municipalities. Similarly, in the construction stage, increased predictability in zoning and construction permit schemes would contribute significantly to reduced risk perceptions throughout the region.

Adequacy of property-related business environment and conduct: *In order to reduce the scope for bureaucratic corruption associated with the sector and improve its integrity performance, the principle challenge is to introduce internationally recognised, standard practices in business conduct. Critically, it also refers to simplification of administrative requirements e.g. in the context of property registration, zoning and planning permissions, in order to eliminate risks associated with entering construction phases without permissions.*

Whilst many local developers and operators in the region are technically capable, their corporate governance, integrity, contracting, accounting or even language standards prevent international investors from entering into contracts with them. The limited use of international accounting standards in many less advanced transition countries provides one example of this. Such issues are relevant particularly in Central Asia, the Western Balkans and regional Russia. Inefficiencies linked to the property-related business environment, such as costly and lengthy property registration procedures or high bureaucratic hurdles to obtain a construction permit, are other important obstacles for local and international investors to enter the property market in the region, and create opportunities for bureaucratic interference. Related transition challenges are most pronounced in Central Asia (Turkmenistan and Uzbekistan), Ukraine and the Western Balkans (Albania, FYR Macedonia, Montenegro). Often, the creation of a one-stop shop has led to significant efficiency gains, as exemplified in Belarus, where since 2007 the time needed to register property in Minsk has fallen from 231 to 21 days. Even in more advanced countries such as Bulgaria, Romania, Poland and Slovenia, problems remain with regard to, for example, the checking of land titles, dealing with property restitution cases or inefficient legal frameworks for obtaining mortgages.

Market penetration of standard international techniques in property development: *This concerns incremental innovation in building practices, technology, financing and contracting, resulting in best-in-class standards in the region. It also includes the renewal of dilapidated urban and post-industrial areas through private development, rezoning and municipal cooperation, including brown field and city centre redevelopments.*

Local participants in the real estate sector, from construction companies to developers and operators, are often unaccustomed to standard international techniques and practices. They lack the technical expertise to build best-in-class developments. The majority have minimal experience in developing and managing high quality assets, and market penetration of innovative construction/building service technologies (building materials, insulation, building management systems, renewable energy use, etc.) remains low. The related transition challenges are most pronounced in Central Asia, Eastern Europe & Caucasus and the Western Balkans. In more advanced property markets, i.e. in Central Europe & the Baltic States, the challenge is to mainstream the use of innovative construction technologies in the market in order to further improve the sustainability of the building stock, including in the context of brown field and city centre redevelopments.

Availability of property-related financing products and entities: *This relates to the availability of long-term debt financing for commercial property development, as well as access to mortgage finance and buyer protection to expand the residential market. It also concerns the development of liquid secondary property markets through the emergence of different types of property businesses, including domestic and international institutional investors and equity funds. It also comprises – principally for residential developments – a strengthening of the use of local currency in real estate financing in countries where significant risk from unhedged currency exposure emerges.*

Secondary markets are essential to the efficiency of the real estate market as a whole. But their development remains a principal transition challenge in the sector for almost the entire EBRD region. Even the most advanced secondary markets of Central Europe & the Baltic States are still impaired by a lack of liquidity and a scarcity of market players capable of providing depth, such as large-scale institutional investors or sector-specific real estate funds. For this reason, the secondary markets comprise only a small portion of total European activity and compare unfavourably on a per capita basis. This is not only the case for commercial property but also for residential property. In Russia, new instruments such as real estate funds and other investment vehicles targeting both domestic and international investors have started to emerge in the last three years, but are still relatively scarce and need to be further promoted. In South-eastern Europe, Central Asia, Turkey and Eastern Europe & the Caucasus, the challenge refers to creating the first secondary market activity. An important corollary of international investors' participation in the region's real estate markets also is their contribution to raising integrity standards in the sector, since any entity which relies on raising funds on international capital markets is reliant on its reputation and subject to greater regulation, so much more likely to reject projects with questionable origins or practices.

Presence and effectiveness of energy, environmental and social support mechanisms: *This includes the integration of energy, environmental and social management systems into real estate projects in the region, as well as the need to respond to climate change through mitigation and adaptation measures. In the built environment, the dissemination of energy efficiency best practice, along with creating a market for energy efficiency technologies and promoting the use of energy from renewable sources represent critical mitigation techniques. It also includes the introduction and upgrading of the energy efficiency regulatory framework in the building sector.*

With regard to global climate change, the entire region's challenge is to effect a broad systemic transformation towards a low carbon economy. Also at stake for individual countries are energy security and economic competitiveness and efficiency. Given the long-term horizons of many energy technologies (such, for instance, as carbon capture and storage), the implementation of energy efficiency measures, including the development of renewable energy sources, is the most direct route forward for the region. At present, a number of the world's most energy intensive economies are located in the EBRD region. Within this context, the built environment is estimated to account for around 39 per cent of final energy consumption in the region, mostly through heat, and thus the largest single opportunity for energy efficiency. The majority of the building stock in the region was constructed between 1960 and 1990 with little or no regard to efficient energy performance. The stock of public and commercial buildings in the region is still not able to meet the needs of the service sector - in spite of considerable construction growth during recent years. As a result of these deficiencies the annual energy consumption of the average building in the region is about 2.5 to 3 times higher than the average energy performance in EU countries under similar climatic conditions. Around a third of the business-as-usual emissions projected for 2020 in the region of operations could be saved through building sector mitigation measures, and the region's main challenge under the banner of climate change mitigation is to implement these measures. Without addressing the building sector, ambitious targets for climate change mitigation as set for EU member states cannot be met. For a thorough discussion of the transition challenges in regard to climate change, please see the Bank's publication *Sustainable Energy Initiative* (May 2009) and refer to **Annex 2**.

With regard to environmental and social issues, real estate entities must consider and respond inter alia to impacts on habitats and biodiversity, issues of waste water treatment and solid waste management, resettlement and economic displacement, land use planning and approval process and associated public information disclosure and consultation practices, cultural heritage and sustainable tourism. For a thorough discussion of the transition challenges in regard to environmental and social issues, please see the Bank's publication *Sustainability Report 2008* (May 2009) and refer to **Annex 3**.

Support for market-based mechanisms to ensure that demand and supply are well balanced: *This refers to the creation of competitive markets for real estate construction and development open to both domestic and foreign enterprises, resulting in the addition of new developments built to appropriate standards in response to demand, and leading to market-based rent setting. It also includes the development/refurbishment of tourism assets with high growth potential and capable of attaining an increase in quality and attractiveness.*

The principal challenge for countries with an underdeveloped real estate market is to create the market conditions necessary to support the development of buildings across all sub-sectors in response to demand: hotels and offices to accommodate business expansion, retail and logistics in response to gains in consumer spending, and residential buildings to reflect inhabitants' living aspirations. Such primary market demand is most visible in Central Asia, Eastern Europe & the Caucasus and the Western Balkans. The key challenge for countries with more developed real estate markets is to address under-supply in regional cities. Regional cities have less sophisticated markets in terms of product and players, more shallow demand and a less liquid asset pool than primary cities, which make their market structure more vulnerable than the region's capital and primary cities. While such regional imbalances can be observed throughout the countries of operation, they are most pronounced in Russia, Ukraine, Turkey, Romania, Bulgaria and Croatia. However, the degree of regional under-supply varies by sub-sector. For instance, in the regional cities of Russia, Ukraine and South-eastern Europe, retail facilities are most developed (but remain low in square metre per capita terms), whilst office, hotel and logistics facilities require more extensive development. Another challenge is to promote effective outsourcing of construction and maintenance of property by public authorities to the private sector through competitive process, for example, in the context of public-private partnerships, which remain scarce even in the most advanced of the Bank's countries of operation, i.e. the EU member states.

The region's tourism assets are typified by poor surrounding infrastructure and poor quality of stock. The challenge for the coming period is to translate positive trends in tourism into sustainable, high quality development not only in major centres, but also in regional cities and areas with high growth potential, to be achieved through the development of mixed business and tourism hotels, the redevelopment of existing tourism areas and the development of new, international-standard assets in high potential areas. The Bank has played a substantial role in encouraging the development of city centre hotels in capitals and has initiated a process of supporting international quality, medium-range hotels in regional cities, for instance in Russia. The challenge is to translate this process into projects not only in Russia but also further east and south, particularly towards lesser developed regions in Central Asia, Ukraine and South-eastern Europe.

The following table shows the Office of the Chief Economist's view of the region's remaining transition challenges on a country-by-country basis and serves as a useful summary of the above analysis. Its basis is an in-depth study of the steps required to complete transition in the sector, based on a quantitative and qualitative analysis of the data from commercial sources, other international institutions and the Bank's own resources. The two sub-headings, **Structure and Extent of Markets** and **Market-supporting Institutions and Policies**, refer to the Bank's official Transition Impact Categories.

2009 Transition Gap Ratings

	Market Structure	Institutions / Policies	Overall Transition gap
Central-eastern Europe and the Baltic states			
Croatia	Medium	Small	Medium
Estonia	Small	Negligible	Small
Hungary	Small	Negligible	Small
Latvia	Small	Negligible	Small
Lithuania	Small	Negligible	Small
Poland	Small	Small	Small
Slovak Republic	Small	Negligible	Small
Slovenia	Small	Small	Small
South-eastern Europe			
Albania	Large	Medium	Medium
Bosnia & Herzegovina	Large	Large	Large
Bulgaria	Medium	Small	Medium
FYR Macedonia	Large	Medium	Medium
Montenegro	Large	Large	Large
Romania	Medium	Small	Medium
Serbia	Large	Medium	Medium
Turkey			
Turkey	Small	Medium	Small
Eastern Europe and Caucasus			
Armenia	Large	Medium	Medium
Azerbaijan	Large	Large	Large
Belarus	Large	Large	Large
Georgia	Large	Small	Medium
Moldova	Large	Large	Large
Ukraine	Large	Medium	Large
Russia			
Russia	Medium	Large	Medium
Central Asia			
Kazakhstan	Medium	Small	Medium
Kyrgyz Republic	Large	Medium	Large
Mongolia	Large	Large	Large
Tajikistan	Large	Large	Large
Turkmenistan	Large	Large	Large
Uzbekistan	Large	Large	Large

Source: Office of the Chief Economist.

3. OPERATIONAL PRIORITIES

3.1 Operational Priorities

The Bank's priorities over the coming period take account of the changed circumstances brought about by the global financial and economic crisis. Though the length and depth of its impact remain unknown, the best analysis to date for the sector suggests a recovery that balances unsatisfied demand for real estate in the region on the one hand with diminished activity in the sector as a result of this crisis on the other. The Bank will work to address the steep decline in financing availability and the repricing of risk across the region, in the knowledge that the resources it has available, though limited, have become markedly more additional than they were at the peak of the market. Whilst its short-term strategy will be tailored to the specific conditions created by the crisis, the Bank will continue to pursue a selective approach towards financially sound investments with high transition impact and clear additionality over the medium- and long-term, selecting sponsors and products that are capable of responding to the region's transition challenges in both primary and secondary markets. It will seek to finance projects that address tangible supply and demand imbalances in areas with long-term growth potential, complementing and enhancing the core competencies of the Bank by building an efficient and modern real estate infrastructure to support the region's transition and economic expansion and diversification. It will promote skills transfer and international business standards, favouring projects with a high demonstration effect related to the transfer of new behaviour and activities; and it will continue to demand the highest integrity standards in all its transactions. Its choice of financial instruments will be flexible, replicable and designed to improve the markets' structure and depth.

Over the strategy period, the Bank will aim at initiating or increasing the range of its operations in the countries where transition gaps remain large, such as Azerbaijan, Belarus, Bosnia & Herzegovina, Moldova, Montenegro and most of Central Asia, at achieving a presence in several property sub-sectors in countries with medium transition challenges, such as Albania, Armenia, Bulgaria, Croatia, Georgia, Kazakhstan, Macedonia, Romania and Serbia, and selecting projects with a particularly high demonstration effect in the regions of Russia and Ukraine.

The Bank's operational priorities for the period run along the following major themes designed to respond to the transition challenges identified in the previous section:

Robust Crisis Response. Throughout the countries of operation, the Bank's priority is to support financially viable projects whose development has been interrupted by a deficit in financing. Debt, mezzanine and equity are appropriate in these instances. In particular, the Bank will seek to support its existing clients in providing crisis-related financing of this type. With the ultimate aim of restoring the region's real estate markets to activity and liquidity, the Bank will also support the emergence of distressed asset transactions, be they for troubled standing assets, completed assets that have failed to attract the necessary tenants, assets under construction or pipeline projects. Distressed asset transactions could be made on an individual or a portfolio basis, and executed directly or indirectly via real estate funds. Real estate equity funds are key to leveraging the Bank's limited resources in returning as much liquidity as possible to the market.

Sustainable Market Development through Institution Building and Innovation. The Bank will use its investments – whether direct or indirect – together with technical cooperation and policy dialogue, to contribute to the strengthening of the institutional environment, improve business conduct and governance standards, and support the transfer of skills and innovation in property markets. This will be done using the following channels:

- When investing in real estate funds and developers, the Bank will support those fund managers and real estate companies who have either developed or have agreed to adopt integrity standards satisfactory to the Bank: the introduction of rigorous integrity standards is a condition of its participation in funds to ensure their implementation.
- The Bank will utilise their ability to interact with many different partners and sub-contractors across the range of their projects to introduce and enforce the highest standards of corporate governance and business practice, including but not limited to international accounting standards, reporting practices, auditing and the use of professional consultants.
- The Bank will invest in pre- and post-IPO property development companies that have the ability to transfer knowledge, promote standard international expertise and support the transfer of skills to local developers.
- The Bank will seek opportunities, principally at project level, to engage in policy dialogue with the real estate community, including investors, developers and local authorities, to promote the need to improve integrity standards and business practice in the sector, and to contribute to the strengthening of the institutional environment for property development.
- Throughout the project cycle, the Bank will apply strict integrity standards in order to reduce the scope for bureaucratic interference and other non-market behaviour. These standards will be applied in conjunction with the Bank's Office of the Chief Compliance Officer.

Creation and Deepening of Secondary Markets. The existence and depth of secondary markets is a critical investment consideration for developers and real estate investors, who would typically seek to realise their investment after a few years, especially in the case of a development. The creation and deepening of secondary markets will therefore continue to constitute a key component of the Bank's objectives. This in turn will require an increased participation of institutional investors, international but also domestic. By participating mainly in sector specific equity funds but also in pre- and post-IPO property companies and real estate developers, the Bank can lead the expansion of secondary markets in the region and help create greater liquidity in real estate markets, providing additional exit opportunities and thus enhancing the primary market. Furthermore, as mentioned above, the Bank's participation in such funds represents an important and effective means of spreading international standards in corporate governance and expertise.

- In Russia, Central Asia, Eastern Europe & Caucasus, Turkey and South-eastern Europe, the Bank will support real estate vehicles that add liquidity to the market by providing long-term capital.

- The Bank will promote investment activity that originates within the region, for instance an equity fund originating in one country of operation and investing in other countries of operation.
- The Bank will strongly engage funds that attract participation from local institutional investors, for instance from local pension funds.

Climate Change Mitigation through Energy Efficiency. The built environment (under which the Team's activities fall) is included under Phase II of the Bank's Sustainable Energy Initiative[5]. Within the context of the region's energy security, competitiveness and transition towards a low carbon economy, energy efficiency and renewable energy in the built environment will play a major role. Energy loss in the building sector could be reduced by 40 to 60 percent from current usage levels in an economically viable way. By assisting in the dissemination of energy efficiency best practice, introducing/upgrading energy efficiency standards and transferring skills and know-how, the Bank aims to act at the forefront of the region's response, employing commercially viable, available technology and practice to achieve these energy savings.

- The Bank will support projects with substantial sustainable energy potential, ideally those which have a strong demonstration effect and high replication potential within the region. The Bank will seek technical cooperation funds or co-financing grants to support these activities where appropriate.
- Projects in commercial buildings and their associated energy efficiency refurbishment will have recourse to finance under the Sustainable Energy Financing Facility (SEFF) model.
- The Bank will also engage in policy dialogue at all levels to assist in the development of appropriate institutions and regulatory standards.
- For additional details of the Bank's strategy for energy efficiency in the built environment, please refer to **Annex 2**.

Geographical Diversification. The Bank will continue to apply its project finance model at the forefront of real estate markets in its countries of operation, in cooperation with leading domestic and international developers. This implies a progression further into the Western Balkans, Eastern Europe & Caucasus, Central Asia and Russia. The Bank will also support investments in Turkey over the coming period. Furthermore, projects in regional cities will constitute an increased focus, with the aim of creating new, high quality stock across all sub-sectors – particularly when under-supply in the market has created abnormal pricing that cannot be justified by economic fundamentals. In less developed countries the dual criteria of demand and supply imbalances and long-term growth potential justify a continued involvement in capital cities. The countries whose capital cities are considered to have reached a level of self-sustainability in their real estate market, and thus to be beyond the long-term scope of this strategy, are those of Central Europe & the Baltic States, Russia and Turkey, and, depending on the pace and extent of market recovery, Romania, Bulgaria, Croatia, Ukraine and Kazakhstan. In the Western Balkans, Caucasus & Eastern Europe and Central Asia, where development has been limited, the Bank will sponsor projects that both demonstrate strong transition potential and demand. In doing so, the Bank will expand the extent of real estate markets in the

[5] For more information on this initiative, including its priorities and objectives, please see the Bank publication *Sustainable Energy Initiative* (May 2009).

region and open new cities to economic development. The sub-sectoral focus will include (but is not limited to):

- Making regional cities more accessible to both domestic and international travellers on limited budgets (such as SME business travel and leisure tourism) by promoting regional hotel chains, particularly in the economy and mid-range categories.
- Supporting projects that expand regional logistics networks along the region's strategic transport routes. It will also support projects that respond to increasing demand from retailers for quality logistics space that is likely to occur in cities with rapidly expanding retail consumption.
- Promoting the expansion of retail facilities to match the expansion of consumer purchasing power in the region, in order to provide an outlet for a full range of high-quality domestic and international retailers in surroundings of an appropriate standard.

In reaching its operational priorities, the Bank will continue to support small scale investments and co-financing across all sub-sectors with a particular focus on countries at an earlier stage of transition. It will seek ETC funding opportunities to MSMEs through its dedicated vehicles (e.g., DIF, DLF, MCFF and LEF facilities). Such projects often serve smaller markets and provide a full range of benefits in terms of promoting private ownership, building competitive markets and transferring skills.

The Bank will consider selective tourism investments that offer strong backward linkages and economic benefit towards the local economy, that have potential to transfer skills with the aim of absorbing international standard practices, and/or those that introduce new forms of tourism to the local area. In regard to resorts and related projects, it will restrict its participation to instances in which experienced sponsors are coordinating with strong operators, in regions with proven tourism demand such as Western Balkans, Croatia, selected parts of Russia and the Black Sea.

As part of the Bank's commitment to introducing new financial products to the region and strengthening public and private institutions that support the efficiency of markets, the Bank will consider projects that constitute public-private partnerships. In this context, urban regeneration projects that revitalise dilapidated areas could constitute a particular area of interest.

3.2 Policy Dialogue

Targeted policy dialogue promotes institution building and refinement. It is relevant not just to market foundations such as land cadastration (which is still not complete throughout the region) but also to issues that arise at a much later stage of market development, such as secondary market legislation associated with new investment vehicles like real estate investment trusts (REITs). In 2007, for example, the Bank published a study of mortgages in transition countries. Besides a thorough review of current mortgage practice in the region, it provided a normative view of mortgage legislation, with directive legal prescriptions and executable suggestions aimed at policymakers.

Each stage in policy dialogue requires specific expertise and access to stakeholders. The Team’s ability to exert significant influence in the policy shaping process is limited by two factors: firstly, by the modest size of its operations in the perspective of the region as a whole; and secondly, by the fact that its participation in projects typically commences after the purchase and zoning of land, leaving a more limited range of issues for which policy dialogue would prove effective. Nevertheless, the Bank will seek to engage in selective policy dialogue initiatives linked to its project financing. In this regard, the Bank will seek usefully to engage the real estate community, including investors, developers and local authorities, to:

- promote the need to improve integrity standards and business practice in the sector. Such dialogue is habitually conducted in the course of the Team’s negotiations and regular interactions with its counterparts;
- assist in the dissemination of energy efficiency best practice, introducing/upgrading energy efficiency standards, including the use of renewable energy technologies, and transferring skills and know-how. This dialogue will be conducted in close cooperation with the Energy Efficiency team.

Furthermore, the Bank will seek a dialogue on the increased involvement of domestic institutional investors in real estate investment vehicles. And finally, it may engage with city planning authorities when the Bank assesses its involvement in a project involving the regeneration of city centre areas. At the project level, the Bank, in association with the MEI team, could have a voice in public transport provision or traffic flow planning.

In areas where other international institutions have well-established programmes and projects – often in fundamental sector issues like cadastration and land management – the Bank is willing to offer its expertise where appropriate, as a strong supporter and advocate of progressive dialogue. Please see Section 4 for a summary of such work.

3.3 Environment and Social Policy

New property and tourism projects will be subject to the Bank's 2008 Environmental and Social Policy and incorporate, where appropriate, Environmental and Social Action Plans (ESAP) into the legal documentation in order to address issues raised during due diligence, in line with the Bank's mandate actively to support environmentally sound and sustainable development through its investment projects.

- For each project, national and EU environmental standards are required to be met and where EU environmental standards do not exist, the client will be required to apply other good international practice such as the World Bank Group Environmental, Health and Safety Guidelines. Projects are also required to comply, at a minimum, with national labour, social security and occupational health and safety laws, and the principles and standards embodied in the International Labour Organisation (ILO) convention related to the abolition of child labour, the elimination of forced labour, the elimination of discrimination related to employment and the freedom of association and collective bargaining.
- The Bank will require its clients to develop a systematic approach, tailored to the nature of their activities, to managing environmental and social risks and opportunities that will enable the client to comply with the Bank’s Environmental and Social Policy. Bank staff will work with clients to assist them in meeting these

requirements. In addition, when feasible the Bank will also encourage clients to incorporate environmental and social considerations in strategic planning within the project. This may be supported through technical co-operation initiatives where necessary and appropriate[6].

3.4 Co-financing

Co-financing over the period was mobilised in cooperation with commercial banks and primarily accomplished on a participation basis with an A/B or parallel loan structure. The majority of commercial bank partners were Austrian – following the norm for both the sector and the region – with French and Italian banks also participating. Their co-financing reached EUR 344 million over the period. Several projects were also executed in partnership with the IFC.

As regards funds, the Bank's co-investment partners showed a greater diversity, including a wider base of European and North American participants. The house banks of active funds often contribute debt to projects in which funds invest equity. Their mobilisation ratio of 3.6 to 1 (commercial capital committed per unit of Bank capital committed), is also higher than that of the rest of the portfolio, at 2.9 to 1[7].

The success of co-financing efforts on the part of the Bank depends on liquidity in the market, which reached its peak in 2007. The Bank cannot expect to syndicate the same relative volume of deals in the current or future environments, since they will be marked by a significant reduction in liquidity, along with lower project loan-to-value expectations. In the absence of commercial co-financing options, and until this financing returns to the region, the Bank will seek closer cooperation with other International Financial Institutions and government agencies. Where appropriate, it will also consider sponsoring projects without syndication.

3.5 Technical Cooperation

The characteristics of the Bank's projects in the sector create selective opportunities for technical cooperation. Since almost all projects focus on the stages subsequent to land acquisition, the Team has only limited opportunity to offer assistance in areas such as land registration and cadastration. It views other international institutions as being better-equipped in this arena, and follows their activity on a regular basis. However, in the case of Montenegro, two technical cooperation projects in 2007 aided the Montenegrin Ministry of Tourism and Environmental Protection to develop transparent, dynamic and sustainable mechanisms for the implementation of major tourism projects in partnership with private investors, including how best to manage tenders for tourism assets.

Under the E2C2 Programme, the Bank will provide active technical assistance through a set of services that aim to foster energy efficiency and the use of energy

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[6] For complete details of the Bank's Environmental and Social Policy, please refer to **Annex 3** and the 2008 publication *Sustainability Report 2008* (May 2009).

[7] Figures refer to all projects signed since January 2001.

from renewable sources in built environment projects. Measures include project screening of all the Bank's pipeline projects in the sector, energy performance assessments for projects with substantial sustainable energy investments, energy audits and corporate policy support, and are provided by the Bank's own Energy Efficiency Team. The Bank has launched a number of technical cooperation projects that address the improvement policy and regulation in the building sector: energy efficiency is addressed in Sustainable Energy Action Plans signed with Bulgaria, Kazakhstan and Ukraine. Technical cooperation projects concerning assistance on the development of national building energy efficiency standards for Kyrgyzstan and Moldova are in place - these projects have the benefit of applying the European Directive on Energy Performance of Buildings EC 91/2002 to the region.

4. COOPERATION WITH OTHER INTERNATIONAL INSTITUTIONS

Over the 2001-2008 period, commercial financing for real estate projects became increasingly available and accessible. Although the Bank maintained a cooperative relationship with the International Finance Corporation in particular, opportunities to co-finance with international financial institutions remained limited. Therefore, the Bank co-invested with the International Finance Corporation only in a handful of occasions over the period.

However, cooperation with international financial institutions intensified as the crisis emerged. The quasi-absence of commercial bank financing resulted in the impossibility to syndicate, and prompted these international financial institutions to assess joint financing opportunities. One of the first crisis response projects in the sector, signed in early 2009, was conducted in parallel with the International Finance Corporation; and it is anticipated that a number of projects in the pipeline will be co-financed by the International Finance Corporation and bilateral government agencies like DEG (Deutsche Investitions- und Entwicklungsgesellschaft).

Beyond cooperation with international financial institutions for co-financing projects, the Bank closely monitors the activities of other international institutions active in the sector as a whole and, where appropriate, complements and supports these activities, which can be summarised as follows:

- The European Commission promotes the improvement of energy performance of the built environment as well as the use of energy from renewable sources in several countries of operation of the EBRD, in particular the new EU member states. The Bank closely monitors the development of the EU policy framework in this area. Beyond the compliance by the new EU member states to the European Directive on Energy Performance of Buildings and Renewable Energy Directive, through its investments in the property sector, the Bank also promotes the adoption of EU standards in its countries of operation outside of the EU. Furthermore, the Bank uses technical cooperation funds to facilitate the upgrading of regulatory framework of non-EU countries to be aligned with the EU best practice. The Bank maintains a close dialogue with the relevant EU programmes, such as INOGATE, and utilises the EU funds for projects targeting energy efficiency in the residential sector. The assessment of energy performance in the EBRD property projects is likewise based on the methodology and standards mandated by the EU and aligned with provisions of the European Directive on Energy Performance of Buildings.

- Other international institutions, most notably the World Bank and United Nations Economic Commission for Europe conduct programmes to promote basic property rights – for the real estate sector, cadastration projects are critical. The World Bank has deployed such foundational projects in Azerbaijan, Bulgaria, Former Yugoslav Republic of Macedonia, Kyrgyz Republic, Moldova, Russia and Serbia since 2001 (amongst other places).The UNECE's Housing and Land Management Committee, and its Real Estate Advisory Group, provide support for policymakers.
- Country-specific agencies such as United States Agency for International Development and the Gesellschaft fuer technische Zusammenarbeit (GtZ) have also developed projects in the real estate sector, mostly in areas of property legislation. For example, GtZ have conducted land management programmes in Albania, Bosnia and Herzegovina, Georgia, Kosovo, Montenegro and Mongolia.

ANNEXES TO THE DOCUMENT

Annex 1: Developments in the Region: Sub-sector Analysis

Annex 2: The Built Environment under the Sustainable Energy Initiative Phase II

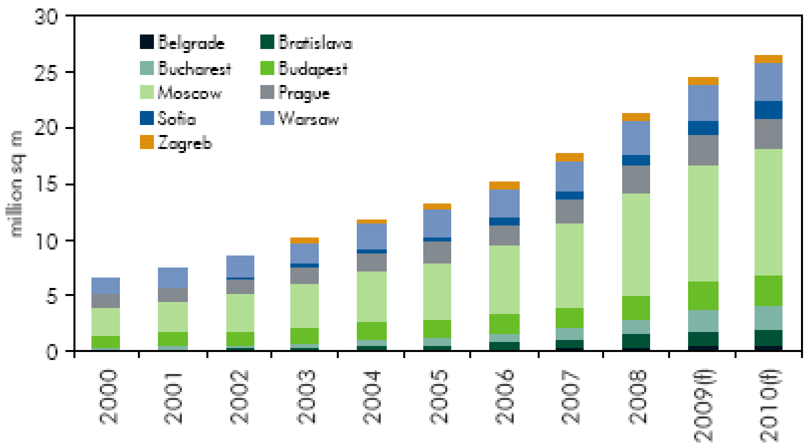
Annex 3: Environmental and Social Aspects of the Sector Strategy

Annex 1: Developments in the Region: Sub-sector Analysis

Office

High-quality office space is a key component of modern business infrastructure; it is also a leading indicator for the real estate market. As the 2001 Property and Tourism Operations Policy explained, office developments are typically the first to occur in a given city, reflecting the strategy of domestic and international businesses to enter the local market. They also act as a bellwether during periods of volatility, since fluctuations in occupancy and rental rates are more marked than in other sub-sectors. Capital cities of the Central-eastern Europe and the Baltic States moved towards maturity from 2001 to 2008 with unprecedented additions to office stock. Nevertheless, even Warsaw, one of the region's most developed cities, currently has an office density of 160 sqm. per 100 inhabitants, against a Western European average of 380 sqm.

Prime Office Stock, nine Central and Eastern European[8] Capitals



Source: CBRE.

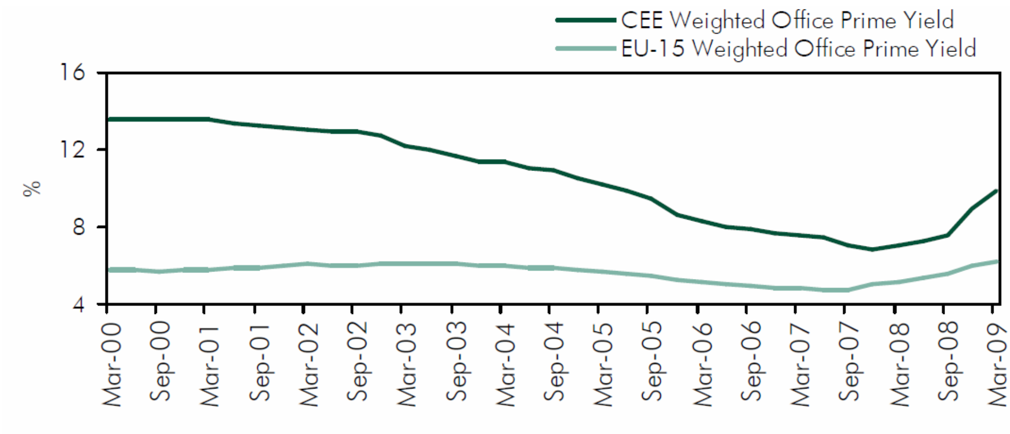
Over the period 2003 to 2007, the Bank successfully financed the first Class A office projects in some major cities in the countries of operation, including the first international standard projects in Belgrade, Serbia (GTC House Belgrade (BDS 03-66)), Baku, Azerbaijan (Landmark I (Neptun) and Landmark II (Libra) (BDS 03-132)) and later the Green Building in Tbilisi, Georgia, as part of the Georgian Property Debt Facility (BDS 07- 002).

Since the last sector strategy, yields continued to compress towards Western European levels in the largest cities, particularly after EU accession reduced investors' risk perceptions. Office assets were the first to be traded as investment assets, first individually then bundled into sub-portfolios. For example, Europolis I (BDS 01-14),

[8] Central and Eastern Europe is the country grouping most often applied by several international real estate consultants. It comprises Bulgaria, Czech Rep., Croatia, Hungary, Poland, Romania, Russia, Serbia and Slovakia.

a fund in which the Bank participated, span off and sold two sub-portfolios of Polish office assets to two large international insurance enterprises.

Office Yield Evolution, Central and Eastern Europe vs. EU15

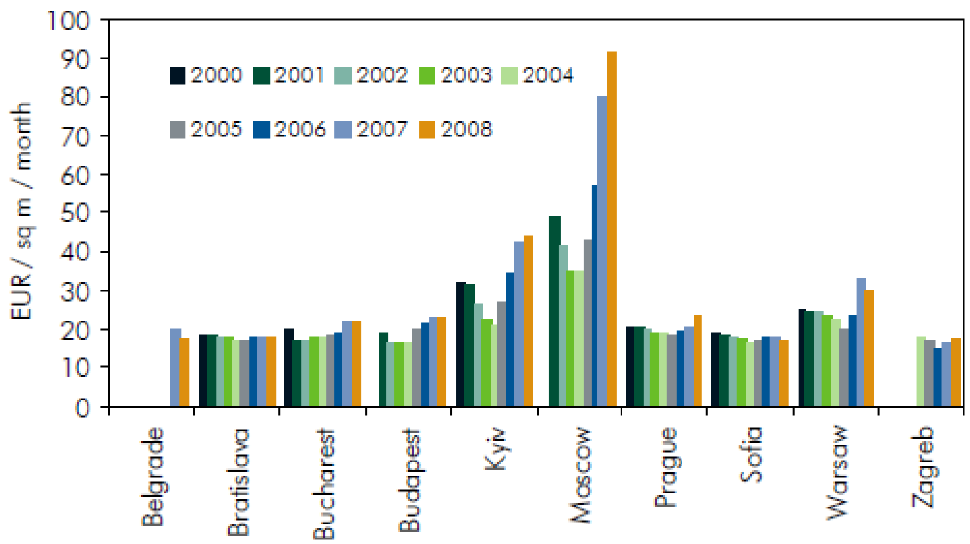


Source: CBRE.

As yields compressed over the period, rents began to stabilise and vacancy rates rose above low single digits – reflecting a growing stability in the market place, and a balance between supply and demand for space. Investors began to look outside capital cities in Central-eastern Europe and the Baltic States, and towards capital cities of Romania, Bulgaria and Serbia. These projects benefited investors targeting high yield projects as well as enterprises hoping to engage economical labour alternatives.

Other major cities in the region experienced strong demand-driven growth, and as a result of acute supply constraints, rental rates in Moscow, Kiev and St. Petersburg ranked amongst the highest in Europe, a position that could not be justified by the cities' economic fundamentals. Undersupply and artificially high rental rates both act as an economic drag.

Central and Eastern Europe Prime Rent Evolution



Source: CBRE.

The continued challenges for less developed economies include a scarcity of investment capital, vague and inconsistent planning regulations and a lack of local expertise in construction finance, management and operation. Addressing these challenges by supporting projects with positive demonstration effects will be critical in encouraging growth.

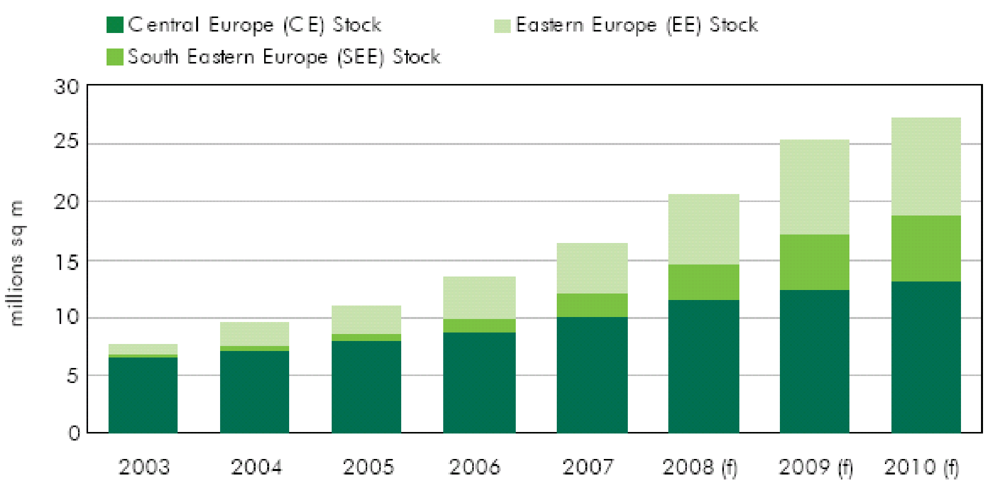
The office markets, like other real estate sub-sectors which are discussed below, have been adversely affected by the global financial crisis. Decreasing FDI and illiquid market conditions have severely affected both developers' and investors' ability to fund pipeline projects. Vacancy levels on average have risen from around 6% to above 10% which is just above the natural vacancy rates. Demand has slowed as occupiers review their options and expansion plans are placed on hold.

In the period Q1 2008 to Q1 2009, yields in the office sector have increased by between 125 basis points in Warsaw to 400 basis points in St Petersburg[9].

Retail

Retail development was closely aligned with consumer spending growth over the period, as retailers implemented long-term expansion strategies. Strong growth throughout the region led to record investment levels in modern retail facilities. Whilst the leading nations of Central-eastern Europe and the Baltic States have the largest consumer income per capita of all countries of operation at approximately EUR 2000 annually, this figure remains over EUR 1000 below Portugal, the lowest on the list of Western European consumer spending.

Total Shopping Centre Stock, Central and Eastern Europe (Gross Leasable Area)



Source: CBRE.

High-quality developments throughout the region were driven by international real estate companies capable of bringing to market third generation space. Supported by

[9] CBRE data.

strong occupier demand and extremely low vacancy rates, certain countries of operation were able to leapfrog second generation space, instead concentrating on state of the art provision. South-eastern Europe provides a strong example, with a capital city and regional pipeline that would assure up-to-date space in dedicated and mixed-use developments (though many such schemes will have been cancelled as a result of the crisis). Hypermarkets continued to dominate as anchor tenants, with 75% of new developments housing international grocery chains such as Carrefour (FR), Tesco (UK) or Metro (DE). DIY clients such as B&Q and IKEA likewise claimed anchor posts in purpose-built, out of town developments. The presence of a strong anchor remains key to successful retail developments.

Central-eastern Europe and the Baltic States became the target of most developments, particularly between 2001 and 2005. A combination of rising consumption, EU accession and increasing market liquidity caused a steady decline in prime yields, from double to single digits. Russian retail expansion began in earnest in 2005. Focusing on Moscow and St. Petersburg, it rapidly became the top destination for international investment with more than EUR 1 billion committed to projects in 2007. As a consequence of a full pipeline in these cities and the rapid consumption expansion of smaller cities, regional expansion was initiated.

Central Asia and Eastern Europe & the Caucasus witnessed selective projects where the economic fundamentals supported modern facilities and brand name tenants.

Since 2000, the Bank supported IKEA's expansion into the Russian retail market with the financing of the first IKEA mega mall in Moscow (BDS 02-094); this was followed by the financing of IKEA's entry into the Ukraine in 2007 (BDS 07-088). The Bank also financed GTC's (one of the leading developers in EBRD's countries of operation) expansion into the regions of Romania, GTC Regional Retail (BDS 07-041) and Bulgaria, Galleria Stara Zagora (BDS 08-111). Other retail projects undertaken by the Bank included the first international quality shopping centre in Chisinau, Moldova (BDS 08-070).

The same corrections are visible in this sub-sector as elsewhere as a result of the global economic and financial crisis. A downward trend in rental rates, combined with much longer lease-up periods for empty space is exerting critical pressure on the sub-sector, particularly on developments whose design or location are not of the highest quality. In the short-term there is expected to be limited market penetration by international retailers and the rate of development is expected to slow across the region. In the medium-term investment opportunities should be relatively strong so long as investors invest in prime projects with good asset management. Growth in consumer spending will increase moderately in the medium-term as the region experiences stronger economic growth than Western Europe.

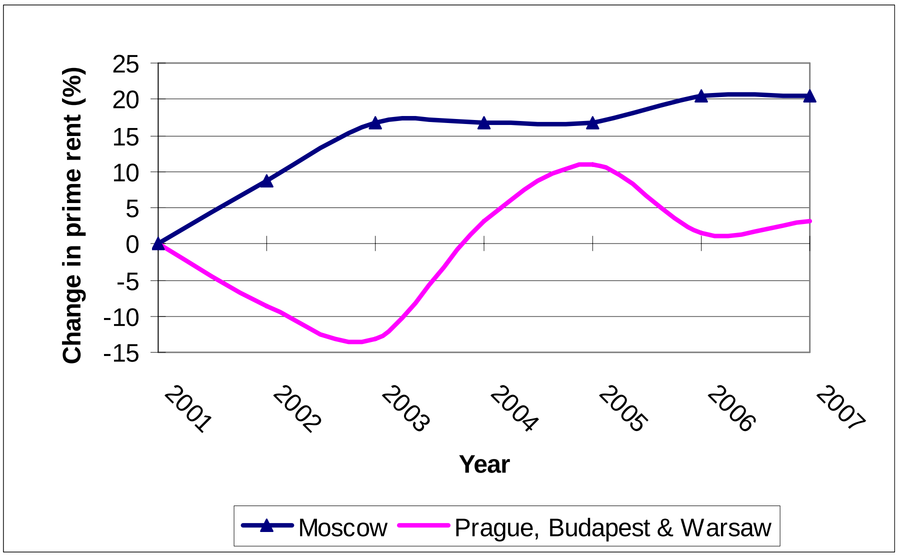
Logistics & Warehousing

Demand for modern warehousing space tends to follow the development of modern retail outlets and the activities of sophisticated retailers and 3PL providers. It is also demanded by local enterprises that seek efficiency gains in their supply chain management. Throughout the region, warehousing markets followed a similar pattern:

Soviet-era facilities, which are spacious but poorly fitted, with poor access to rail and road, were replaced by the owner-occupied facilities of large retailers (particularly hypermarkets such as Auchan in Poland); then followed built-to-suit developments (often for third party distribution "3PL" companies such as FM Logistics) before speculative projects were executed. At this stage, a secondary market for industrial space may emerge[10].

In Central-eastern Europe and the Baltic States, retailers targeting consumers with increasing spending power caused vacancy rates for modern facilities to remain below 1% for much of the period. This resulted initially in a rush to construct modern logistics sites in or near capital cities and along major transport highways. A remarkable volume of space added through new construction and site extensions eased the strain of under-capacity and led to the stabilisation of headline rents over the period. Pressure from sustained demand in Moscow led to an increase in headline rental rates despite significant new supply additions, both in the city and in the surrounding region. These results are shown below.

Change in Logistics Prime Rental Rates, Moscow vs. three Central-eastern European Capitals



Source: JLL.

As yields declined and suitable land plots became scarce, investors turned towards regional centres. By 2005, regional cities in Poland began to outstrip Warsaw in new supply provision. Russia, Ukraine and South-eastern Europe also evolved towards a more modern, efficient logistics market, with 100% plus absorption rates[11] echoing Central-eastern Europe and the Baltic States' earlier development. Yield compression, space constraint and the rising fortunes of regional centres caused expansion to spread into regional centres. Without strong demand from consumer-focused retailers,

[10] This progression line can be generalised and applied to other commercial sub-sectors: existing, low-quality facilities are followed by owner-occupied developments, then by built-to-suit developments, then a speculative market emerges; and in the final instance, these new assets can be traded in a secondary marketplace.

[11] An absorption rate is the amount of space that is taken up/leased out over a period compared the amount of space that is supplied. In a strongly growing market, absorption rates exceed 100%.

industrial real estate activity remained more modest in the Western Balkans, Eastern Europe & the Caucasus and Central Asia. Another significant constraint is infrastructure quality.

Nevertheless, certain cities continued to have headline rents well above the level economic fundamentals could justify: in Zagreb, EUR 6.5 per sqm per month in 2008 stood at double the Warsaw level[12]. One challenge for the upcoming period will be to sustain rent reductions through competition along the region's three emerging transport corridors: the first runs up through the Balkans from Istanbul towards Vienna; the second runs east – west along southern Russia; the third runs north from St. Petersburg – south through the west of Russia.

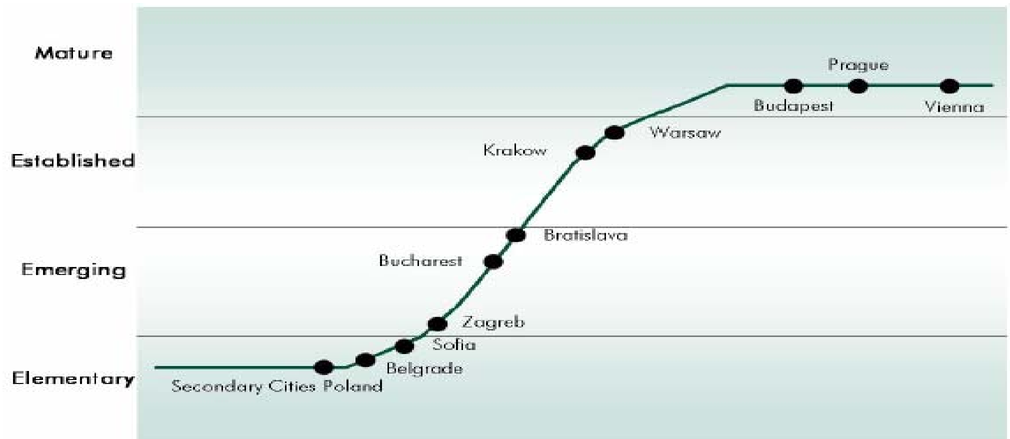
The Bank supported the development of the logistic sector in Poland (Europa Distribution Center in Poland – BDS 03-113); Russia (BD Logistics – BDS 05-071).; Volga Industrial Park – BDS 08-217) and Ukraine (Brovary Logistics Centre – BDS 08-171).

The logistics market is suffering from the liquidity crisis in the same way as retail and other sub-sectors, with rent accommodations for distressed clients, and reduced take-up for new space by potential tenants whose plans for expansion have been drawn back in the face of the crisis.

Hotels/Resorts

Central-eastern European and Baltic State cities whose demand for accommodation stemmed from both business and tourism alike approached maturity over the period. The dual metrics of price per room and REVpar placed Prague and Budapest on a par with Western European counterparts. Warsaw, whose demand is generated principally by business travellers, now offers over 10,000 international standard rooms – more than Moscow but half the number of Prague or Budapest.

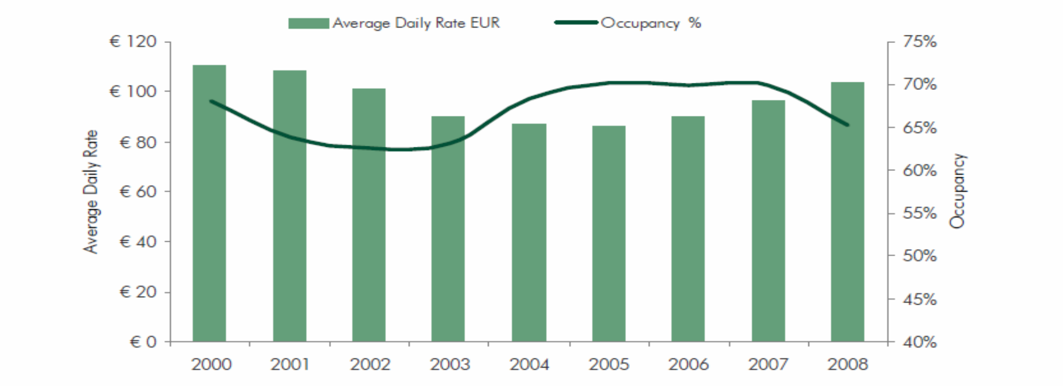
Market Maturity by city, Central and Eastern Europe



Source: CBRE.

12 Colliers, 2008.

Average Daily Rate and Occupancy, Hotels in Bratislava, Bucharest, Budapest, Prague, Vienna and Warsaw



Source: CBRE.

In some Central-eastern Europe and the Baltic State cities, rapid development led to temporary overcapacity – notably in Budapest and Warsaw – but this was remedied by both EU accession in 2005 and the increased arrivals of international visitors by low-cost airlines. Budapest, for example, received a 10% rise in bed nights following its accession to the EU.

Like office developments, hotel construction is a leading indicator in the sector, one which measures the attractiveness of a city to visiting business people. A similar development pattern emerged. When prime yields and rates fell in Central-eastern Europe and Baltic States cities, regional cities became the focus of investors' attention. Simultaneously, capital cities with marked under-capacity – like Kiev – became home to branded business hotels.

Regional City Hotels/Leisure

Regional city hotels continue to represent an area where the Bank can play a role of catalyst in the future. Regional centres of Poland, Russia and Ukraine will be the most attractive markets for such developments.

Since 2001, the Bank has financed hotel projects in Varna, Bulgaria (Hermitage Grand Hotel (BDS 05-007) and in Croatia through GS Hotels and Resorts (BDS 07-034) and Jadranka Hotels (BDS 08-5). Through dedicated MSME vehicles the Bank has reached the ETC with investments in hotels and resorts in Kyrgyzstan, Azerbaijan and Uzbekistan.

Smaller capital city markets such as Podgorica and Skopje currently show the very low week-day vacancy rates and high room rates that suggest an economic imbalance. Landmark developments both introduce competition to reduce headline rates and provide a strong demonstration effect; but where service standards are uncertain, most branded hotel operators still prefer direct management over franchise agreements in establishing new hotels.

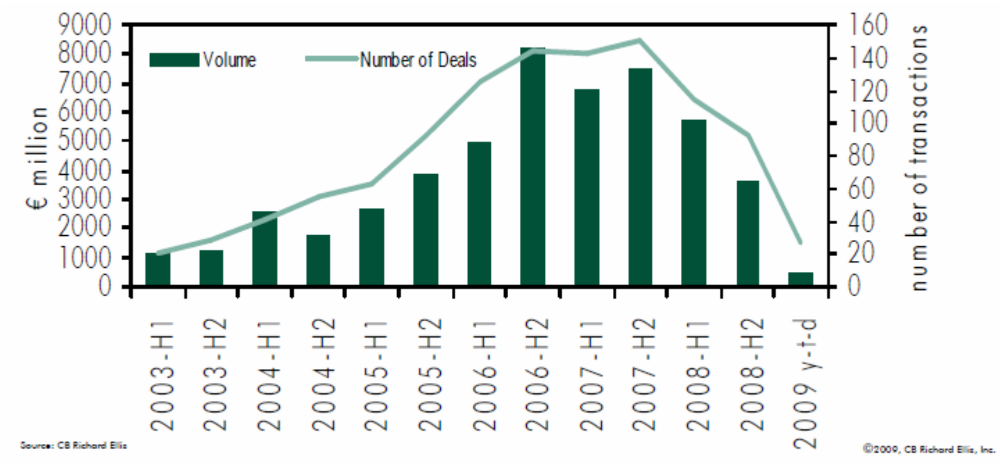
In terms of city development in the hotel sub-sector, business standard hotel accommodation tends to precede affordable and mid-market accommodation. At the affordable accommodation level, branded chains expanded regionally in Central-eastern Europe and the Baltic States over the period, but expansion was limited to individual projects elsewhere in the region, and there remains a tangible supply-gap in this sub-market. Infrastructural improvements along with expanding economic horizons will support the two- and three star development programmes in the coming period. These developments will replace Soviet-era hotels that cater to this group at present.

Hotels have suffered from the significant reduction in overnight stays, caused mostly by a sharp decline in business arrivals, since mid-2008. The resultant decline in revenue makes distressed sales highly probable in the short- and medium-term.

Investment

Since 2001, Central and Eastern Europe moved from an almost standing start towards claiming some nine percent of the pan-European investment activity.[13]

Property Investment Volume and Transaction Count, Central and Eastern Europe



Source: CBRE.

To enter a market, interested investors require legislative predictability in asset acquisition and a minimum stock of investment grade properties. These conditions were first met in Central-eastern Europe and the Baltic States. In 2001, a small number of office developments were traded in Warsaw; in 2002, the first Polish regional retail assets were traded; in 2005, strong investor demand greatly increased market activity. In Poland alone, EUR 3 billion was invested in 2005, rising to EUR 4.7 billion in 2006[14]. The investments were predominantly in investment grade assets that could boast prime location, design and the occupancy of high profile clients. Real estate investment funds were prevalent, with pension and mutual funds playing only a limited role later in the period.

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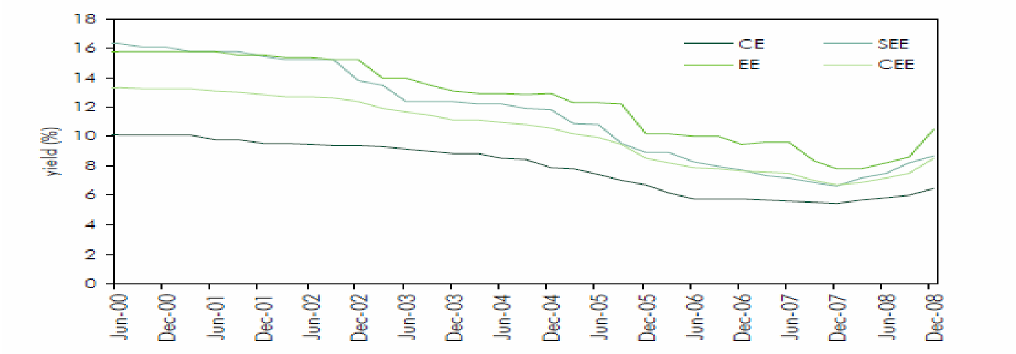
[13] CBRE data.

[14] Ernst & Young 2008.

With the stock of investment grade assets limited in Central-eastern Europe and the Baltic States capital cities, increased competition amongst investors caused yields to drop to approximately 6% in 2007, from over 10% in 2001.

Investors countered the gradual decrease in available yields with smaller deals, regional opportunities and expansion into new sub-sectors such as logistics. South-eastern Europe, Ukraine and Russia, whose capital cities (plus St. Petersburg) combine strong economic fundamentals with considerable city space restrictions, displayed similar trends.

Weighted Average Prime Office Yields in Central and Eastern Europe



Source: CBRE.

At the height of the market, Central-eastern European, Baltic and Russian investments supported sub-portfolio transactions. The largest was a EUR 900 million office and retail transaction that occurred between two German real estate funds. This example also illustrates the origin of investment funds active in the region: development from 2000 to 2008 was led by western, and in the majority Western European, sources. Domestic sources of institutional money, including pension funds, are notably underdeveloped.

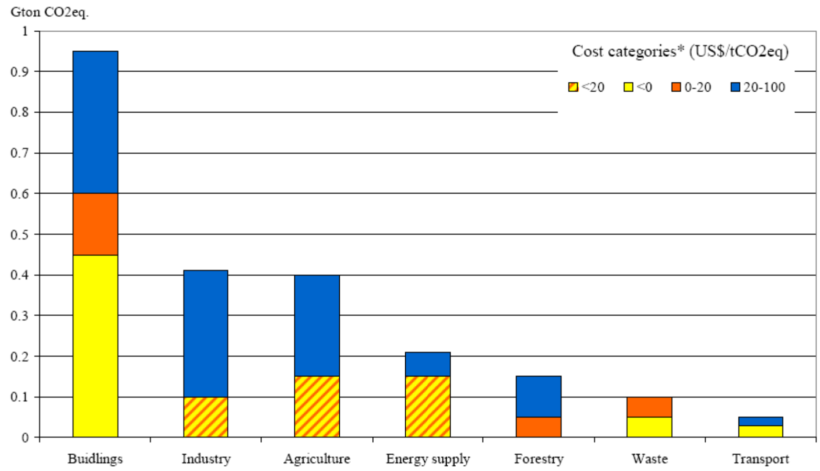
Outside a select number of the region's capital cities, real estate markets lack the depth and/or institutional arrangements to attract sector-specific funds of any origin. For the same reason, they are not attractive to pension funds or REITs, which tend to invest more conservatively still.

The outlook for the investment market depends, as described above, on the credit environment that prevails in the wake of the liquidity crisis. A permanent reduction in loan-to-value ratios, along with a rise in loan margins, appears certain from the current perspective.

Annex 2: The Built Environment under the Sustainable Energy Initiative Phase II

The built environment is estimated to account for around 39% of Final Energy Consumption (FEC), mostly as heat, in the region. For some ETC countries in the region (Armenia, Georgia, Kyrgyzstan, Tajikistan) the share is even higher and exceeds 50%. The majority of the building stock in the region was constructed between 1960 and 1990 with little or no regard to efficient energy performance. Many residential buildings consist of prefabricated multi-storey panel buildings with low grade thermal protection. Existing public and commercial service buildings are deteriorating with obsolete building service equipment and lack of proper operation and maintenance routines. The stock of public and commercial buildings in the region is still not able to meet the needs of the service sector - in spite of considerable construction growth during recent years. As a result of these deficiencies the annual energy consumption of the average building in the region is about 2.5 to 3 times higher than the average energy performance in EU countries under similar climatic conditions.

Sector CO_2 mitigation potential in economies in transition (2020)



* For the buildings, forestry, waste and transport sectors, the potential is split into three cost categories: at net negative costs, at 0-20 US$/tCO2, and 20-100 US$/tCO2. For the industrial, forestry, and energy suppy sectors, the potential is split into two categories: at costs below 20 US$/tCO2 and at 20-100 US$/tCO2.

Around a third of the business-as-usual emissions projected for 2020 in the region of operations could be saved through building sector mitigation measures. This is the highest potential contribution across end-use sectors. A conservative assessment of investment requirements to realise this potential is EUR 570 billion – over half of which could be realised through investments with little or even negative net costs. These measures include thermal insulation, refurbishment of HVAC systems, installation of control systems, use of renewable energy, heat recovery, including residential build-in systems etc. Technologies and measures are known with very little technical risk.

Notwithstanding this considerable potential there are several difficult hurdles to capturing these savings. In the **public sector** funds are limited, while commercial models to enable private partnerships are not well developed.

In the **residential sector** the institutional framework to support municipal initiative to improve building standards is rarely in place. Housing associations are not well established in the region and the legal framework required to enable investment in capital improvements is generally inadequate. Affordability remains a major constraint. Lack of individual metering of energy consumption, perverse billing procedures, non cost-reflective tariffs and widespread cross subsidies from commercial or industrial energy users to residential consumers remove incentives for investment by residents and energy service providers and lead to problems with collection rates which have knock-on effects on utility investment.

In **industrial buildings** energy performance is rarely looked at as companies focus on investments to drive expansion or process modernisation. Market penetration of modern technologies is still low. Lack of skilled designers, facility managers as well as lack of market environment for energy services makes implementation of energy efficiency costly and in general more expensive than in developed countries.

Countries beyond the EU lack the **regulatory framework** on energy efficiency, energy performance standards of buildings, mechanisms for energy performance assessments, the necessary tools for public sector investment within budget regulations as well as being subjected to bureaucratic public procurement rules. There is limited application of energy performance standards and weak enforcement. Other regulatory tools, such as demand side management by energy utilities, have not been developed beyond the new EU member states.

In the **public sector** the Bank has launched a programme to develop the contractual framework to allow public sector entities to engage private firms to invest in energy efficiency improvements and be repaid from future realised energy savings. This is a key challenge to address as local authorities do not have the resources or expertise to develop a form of energy performance contract that takes account of the complex budget and procurement rules applicable in the public sector and at the same time is attractive to local companies expected to implement energy saving projects and secure financing. This programme is initially being supported by grants from the Global Environment Facility to fund project development and implementation in Russia and by the Czech trust fund to support project development in Ukraine and will provide a basis for further roll-out in other EBRD countries of operations.

In the **commercial and industrial sectors** the Bank will expand its project screening process to identify projects in its pipeline where energy savings may be realised in clients' buildings. Particular focus will be in the property and tourism sector. This will include the following services:

- energy efficiency screening of all built environment projects;
- energy performance assessment of projects with significant sustainable energy project; and
- technical assistance in terms of energy audits, energy performance certificates, advice and consultation on sustainable building design, technical specification of recommended measures.

In order to strengthen building energy efficiency the following activities would be considered under Phase 2:

- policy dialogue in selected countries on improving the building sector regulatory framework;
- corporate policy support for sponsors with a pipeline of sound built environment projects;
- capacity building activities aiming at promotion and dissemination of information on improving energy efficiency in buildings; and
- pilot built environment projects with high replication potential in ETCs are planned to be supported by grants on EMS (energy management systems).

As these programmes develop, the Bank will review its range of instruments to ensure appropriate facilities are available to meet the financing needs of projects to improve building energy efficiency and promote the use of energy from renewable sources. This may include allocation of funds under credit lines, financing of dedicated entities supporting Energy Service Companies (ESCO) activities, financing of budgetary enterprises responsible for buildings maintenance and allocation of funds for energy efficiency in corporate loans.

Annex 3: Environmental and Social Aspects of the Sector Strategy

Overview

A range of potential environmental and social issues and impacts may arise on property and tourism related projects both during the construction and implementation phases. These include, inter alia, impacts on habitats and biodiversity, issues of waste water treatment and solid waste management, resettlement and economic displacement, land use planning and approval process and associated public information disclosure and consultation practices, cultural heritage and sustainable tourism. The PR are structured to adequately cover the above key environmental and social issues of projects as well as lay out the way the client develops and implements environmental and social management systems.

Experience

Reflecting the growing and diversified portfolio (office building, retail property, logistics & warehousing, residential, property funds and hotels), the Bank's environmental and social due diligence and monitoring work for the sector has significantly expanded. In order to go forward, it is necessary to take stock of the valuable experience accumulated during the last property and tourism strategy period: a third party environmental audit has become standard requirement for the complex and large-scale or equity investment projects; the Bank's environmental specialists have carried out environmental and social due diligence visits for many of the projects as well as monitoring visits for the medium and high-risk projects; and third party life and fire safety audits have been carried out for the hotel projects in Croatia to ensure the safety of the hotel guests, employees and buildings.

Environmental and social due diligence on urban-regeneration projects will continue to focus on, inter alia, issues such as possible soil contamination of brown-field sites; environmental infrastructure provisions such as waste water and solid waste treatment/management capacities; universal access solutions such as wheel chair access to public buildings; consideration of cultural issues; mitigation measures for resettlement and economic displacement; environmental, health, safety and labour management of general contractors and legal protection of immigrant construction workers through adequate contract documentation. Energy efficiency issues will continue to be addressed as appropriate by the Bank's energy efficiency specialists.

For the property funds and multi-property development projects, the Bank will continue to require that the client adopts and implements environmental and social due diligence and monitoring procedures agreed by the Bank. With regard to tourism, a technical cooperation supported project by the Western Balkans Assembly, has been assisting the Montenegro Government to develop sustainable tourism development.

Future Challenges

Anticipating further development of the property and tourism sector portfolio, as a consequence of the addition of a new member country, Turkey and a shift in emphasis towards the eastern and southern part of EBRD’s region of operation and regional cities, the Bank’s future environmental and social challenges may involve issues such as yet-to-be developed environmental infrastructure provisions, insufficient environmental enforcement capacities and inadequate health and safety mitigation measures at construction sites. While taking up the challenges, new property and tourism projects will be subject to the Bank's 2008 Environmental and Social Policy and incorporate, where appropriate, Environmental and Social Action Plans (ESAP) into the legal documentation in order to address issues raised during due diligence, in line with the Bank's mandate to actively support environmentally sound and sustainable development through its investment projects.

For each project, national and EU environmental standards are required to be met and where EU environmental standards do not exist, the client will be required to apply other good international practice such as the World Bank Group Environmental, Health and Safety Guidelines. Projects are also required to comply, at a minimum, with national labour, social security and occupational health and safety laws, and the principles and standards embodied in the ILO convention related to the abolition of child labour, the elimination of forced labour, the elimination of discrimination related to employment and the freedom of association and collective bargaining.

The region in which the Bank operates has diverse and rich cultural heritage. With respect to property projects where there are elements of cultural heritage to be considered, the Bank expects to work with clients to assist in the process of both preservation and in deriving benefit according to best practice set up by such institutions as the United Nations Educational, Science and Cultural Organisation (UNESCO). Worldwide there has been a growing move to ensure that tourism not only does not harm the environment but also brings sustainable benefits. To this end, the Bank shall work with clients on tourism projects to both maximise local benefits-sharing by communities and also preserve and take advantage of cultural heritage.

The Bank’s region is significantly affected by climate change, and the property sector provides important opportunities to mitigate it as seen in Annex 4. Environmental due diligence which incorporates an energy efficiency analysis for each project identifies specific energy saving/green gas reduction opportunities in the project context, and the Bank provides further technical advice to implement such opportunities where necessary and appropriate.

The Bank’s countries of operation are also endowed with rich biodiversity. The Bank recognises the need for the protection and conservation of biodiversity in the context of property and tourism projects. Through the environmental appraisal process the client will identify and characterise the potential impacts on biodiversity likely to be caused by the project. The client will also need to identify measures to avoid, minimise or mitigate potentially adverse impacts and, where appropriate and as a last resort, propose compensatory measures.

The Bank will monitor projects' environmental and social performance by reviewing the required Annual Environmental and Social Report and conducting site visits where necessary. The Bank will continue to co-operate with civil society as well as other organisations to generate synergies to enhance environmental and social sustainability for the sector.