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COVID-19 Impact on Construction Business in Ukraine

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Introduction

Current world economic crisis has started as a result of quarantine lockdown restrictions imposed due to the COVID-19 pandemic, which has rapidly spread to the rest of Europe. These restrictions meant that the construction and real estate sectors had to react fast.

In this document, we examine the state of the Ukrainian construction market after the restrictions were put in place and look into the future of the Real Estate industry post quarantine.

Construction by nature is quite a reactive sector: when an economic crisis is over and growth resumes, first positive news usually come from consumer durables and apparel. During the initial growth period companies usually utilise existing facilities such as production bases, office premises, unoccupied rooms in hotels rather than investing in new properties.

Looking at previous financial crises in Ukraine, we can see a pattern, which is common for developing countries: fast devaluation of the local currency during the acute phase of the crisis, which results in a spike in sales of consumer electronics, household appliances, real estate and other investment purchases. This is how people try to protect their savings in local currencies, which can vanish in inflation.

Prices of Material and Current Rates

Due to the depreciation of the national currency in the first quarter of 2020, a 5% price growth was seen for imported finishing materials, electrical equipment and plumbing. Main building materials in the residential sector are domestic materials, therefore not affected by the currency exchange rate. Furthermore, shipping costs are becoming lower due to the drop in oil prices. Imported materials and equipment for internal fit-out make up to 50% of the total volume and their cost generally grows proportionally to the devaluation of the national currency.

Supply Availability and Importance of specifications

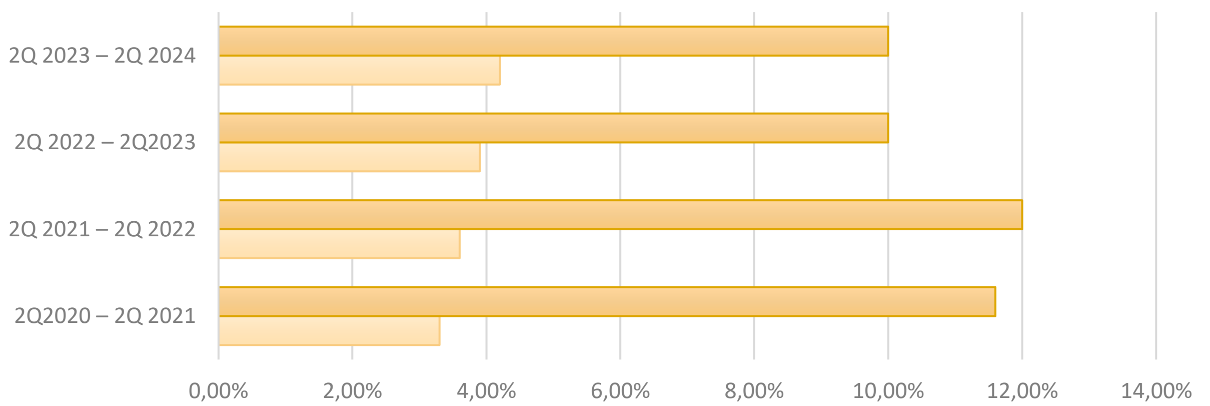
On March 17th 2020 the Ukrainian government implemented quarantine restrictions in response to the COVID-19 pandemic. Current projects face delays in sourcing supplies and equipment from Italy, UK and China. Local manufacturers, however, have no restrictions during the quarantine period. Despite this, it's difficult to find a local supplier to supply the required materials.

Availability of imported materials will depend on the specific quarantine restrictions in a particular country. Due to the number of border crossing points being reduced from 219 to 49, there were delays in the import of materials.

Inflation Forecasts

The inflation rate in construction during January - February 2020 was +3.3%[1]

General Inflation forecast updated by the Government on 29th of March 2020 is presented below:



	2Q2020 – 2Q 2021	2Q 2021 – 2Q 2022	2Q 2022 – 2Q2023	2Q 2023 – 2Q 2024
Ukraine Average	11,60%	12%	10%	10%
UK Average	3,30%	3,60%	3,90%	4,20%

A new forecast from the government shows a possible fall in GDP in 2020 by 4.2%[3]. The International Monetary Fund forecasts a 7.7% fall of Ukrainian GDP in 2020[4] We believe we face a similar scenario to 2015 when due to Russian military intervention in Ukraine, GDP fell by 10%.

Exchange Rates

Currency	07th of January 2020	15th of May 2020	Maximum in 2020	Devaluation, %
UAH/USD	23.68	26.67	28.18	12.6%
EURO/USD	27.68	28.78	30.96	3.9%

Effect of Contractor and Sub-Contractor Insolvencies

Contractors in Ukraine face a cash threat due to following factors:

- Unstable exchange rate of UAH against USD and EUR. Contractors are experiencing difficulties if they must carry out their duties on projects which were signed in local Ukrainian currency with a large proportion of imported materials.
- Many private companies will face a reduction in salaries, unemployment and would rather save money than invest in property. As a response to this, the Ukrainian President promised to implement a new mortgage program with a yearly interest rate of 10% (currently the interest rate is minimum 19-20% per annum and is offered by few banks only). The Government also promised to provide more affordable loans to private companies to let them pay employee salaries.4 Construction work is not restricted during quarantine, but workers have difficulties in accessing job sites due to the ban on all public transport within the country. Construction staff must organise their own transportation if they want to continue work. Approximately 20% of construction sites were already stopped during quarantine, particularly on residential projects. Sales of apartments in Kyiv region dropped down 3-5 times[6] but developers expect the resumption of demand after removal of quarantine restrictions.

The construction sector can expect the following impacts:

- Job cuts;
- A decrease in salary for remaining staff;
- Part-time hours for those in admin function;
- Budget cuts;
- Reduction in profit and increased competition for on-going projects;
- Debt increase in respect to subcontractors;
- Reduction or complete suspension of investments into fixed assets, which will lead to the decline of sales in related industries;
- A price increase will follow in the event of devaluation of the national currency.

Possible positive outcomes:

- More competitive loan support from the government;
- New cheap mortgage programs announced by President.

Overheads, Preliminaries and Profits

Due to the restriction imposed on public transport across the country, Construction companies have two options: either reduce the number of staff on-site or organise private transport. In addition to this, there are costs associated with health and safety gear which are required to comply with the advice from the Ministry of Health and the Cabinet of Ministers.

Depending on the size of a construction project additional expenses may reach up to 8,000 USD per month[7].

There will be a decrease in profits in short and mid-term, due to the increase in competition for remaining projects and the reduction of funds available for residential projects.

How will developers recover costs from overspend on projects?

As a response to the recent local currency devaluation, developers are fixing their contract's currency rate at around 25 UAH/USD. If the exchange rate reaches 30 UAH/USD developers will recalculate their prices accordingly.[6]

Additional costs which will arise due to COVID-19 quarantine restrictions and social distancing, companies plan to cover from their profits and clients will not incur extra costs.

The consequences of the crisis and opportunities for the Construction and Real Estate industries

Ukrainian economy will face the same challenges as the rest of the world. A fall in world energy prices will lead to a fall in prices for other commodities, which are the basis of Ukrainian exports.

Together with decreasing project volumes in the private sector, we expect the growth of several infrastructure projects supported by the government. These projects aim to employ people who have lost their jobs in the private sector as well as support manufacturers during the crisis.

In response to the crisis, the Ministry of Infrastructure of Ukraine will create a permanent collegial body - the Commission, which, based on the recommendations from the European Union, will review, evaluate and recommend investment projects in the field of transport, road management and postal services.[8]

The road industry shows that the state tries to maintain investments in infrastructure development. In response to COVID-19 affecting the budget, the state promises to find opportunities for additional funding for road construction by offering credit funds under state guarantees.[9]

Agricultural projects will likely carry on as planned. These projects will benefit from tougher competition. On 28th April 2020, President Zelenskyi signed a law that opens the market of agricultural land to Ukrainian investors. Starting from the 1st of July 2021 privately owned land becomes a commodity which can be legally sold. Local agricultural businesses will become more attractive for investments.

In Real Estate huge changes are expected in commercial offices, retail and logistics projects.

Growth of online sales will be accelerating, while revenues of traditional offline shops will be challenged between the constant level of OPEX costs to run existing shops and reduced numbers of customers. We can expect increased vacancy of retail property and a freeze of both new and ongoing projects of shopping malls.

One of the key reasons why online shopping has been a success is modern logistic services, therefore, we can expect a higher level of investor’s attention to existing and new logistic projects.

Office real estate is at a crossroad with many options for further transformation:

- Some companies will leave offices and transfer all administration activities to the cloud. This will result in OPEX expenses used for maintaining the office will drop to nearly 0;
- Another option is for companies to transfer their offices into Co-working spaces, where staff don't have fixed desks. Instead, companies can combine office work and work from home depending on projects, tasks and duties. Companies like that will either resize existing offices and transform them into a new administration model or will transfer own offices into Co-working spaces.
- The final option is to stay as is but adapt to the new requirements for social distancing.

In general, it is not yet clear how existing open office planning standards can fit into our new social distance reality and thus office property will face a very uncertain and turbulent period of transformation and adaptation to new models of business activities.

In the initial period of post quarantine business life, we can expect that construction companies will suffer from the absence of work in the commercial sector. New and ongoing projects can be frozen as many customers will have to reinvent their business models to remain competitive on the market.

Each industry and company will need to keep in mind a possible second wave of COVID-19 which may occur in autumn 2020. Under such circumstances, the commercial construction market may face recession until the end of 2020, when new business and social rules will force Real Estate landlords and tenants to transform and adapt existing property.

During the next period, which will likely begin in 2021 we can expect a sharp growing demand for construction services in different economic sectors.

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