CB RICHARD ELLIS

# MarketView

# Kyiv Offices

Full Year 2010

## Quick Stats

| | Change from 2009 | 2008 |
|---|---|---|
| New Supply | ↓ | ↓ |
| Rent | → | ↓ |
| Vacancy | ↓ | ↑ |

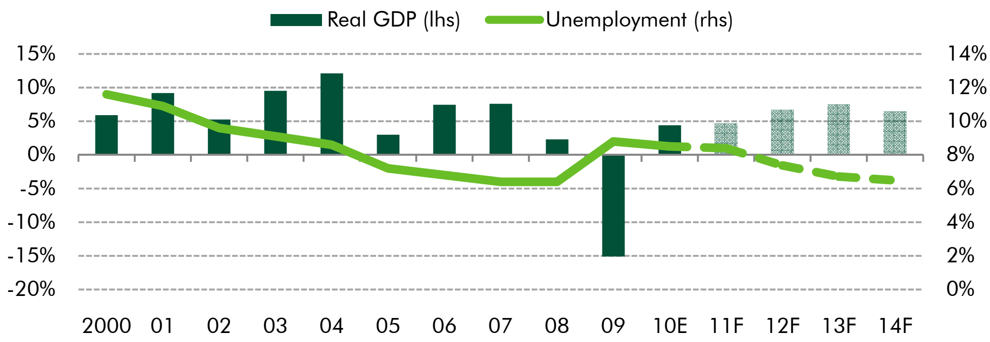
## Hot Topics

- Demand recovery: net absorption in 2010 exceeded development completions
- New supply squeeze: annual development completions dropped to the record low of 72,000 sq m
- Vacancy decline: market average vacancy fell to 17% (-8 pp y-o-y) thanks to a large number of relocations from unaccounted and low-quality premises
- Prime rents growth (+14% y-o-y)

## FUNDAMENTALS

Ukraine's real GDP recorded a 4.2% increase in 2010 following a dramatic drop of 15.1% in 2009. According to the forecast by Oxford Economics, GDP growth is set to accelerate over 2012-2013 after moderately positive dynamics in 2010-2011. An improving economy will boost business expansion, which should consequently spur demand for office space.

### Real GDP Growth and Unemployment in Ukraine



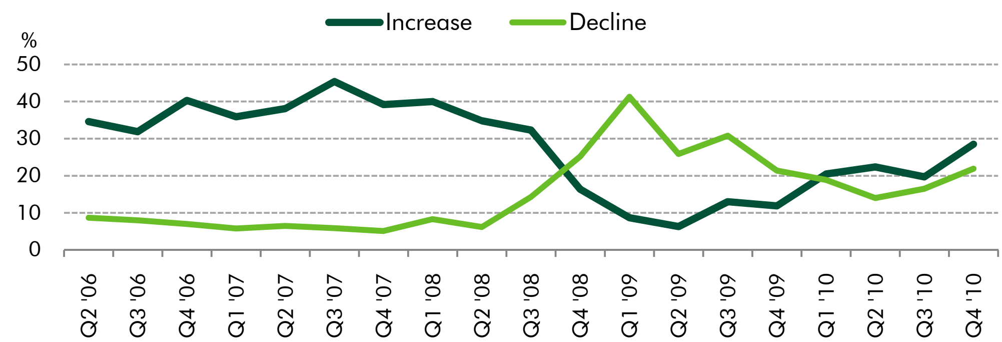

lhs – left hand scale
rhs – right hand scale
E – estimate
F – forecast

Source: National Statistics Committee of Ukraine, Ministry of Economic Development and Trade of Ukraine, Oxford Economics

Gradual recovery of economy in 2010 improved business sentiment across the country. Particularly, in Q4 2010 almost 30% of Kyiv companies were planning to hire new personnel compared to just 12% at the end of 2009. Meanwhile, the share of companies with no hiring intentions was declining over the first half of the year but then it returned to 2009 levels, reaching 22% in the final quarter of 2010.

Overall, macroeconomic indicators and business confidence are apparently improving albeit slowly so far.

### Corporate Hiring Expectations Over the next 12 Months




Source: National Bank of Ukraine

[1] - Oxford Economics (Great Britain) - a leading economic forecasting consultancy

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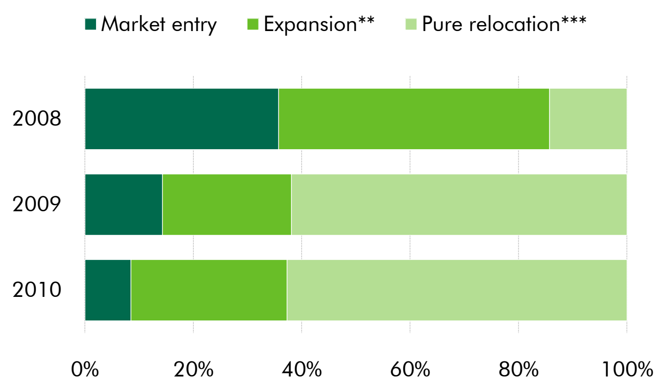
## DEMAND

The **leasing activity** on the market started to pick up considerably after reaching the bottom of the cycle in Q3 2009.

As in 2009 leasing activity is still heavily dependent on tenants looking to improve current rental conditions and/or upgrade occupied space (over 60% of all transactions) rather than to expand. However, some potential upgrades to better offices have been stalled due to high cost of relocation, especially with regards to fit out expenses. At the same time, although the number of expansion-induced transactions is still lagging behind pre-crisis levels, their share has inched upward (by 5 pp y-o-y) and reached 29%. New market entries accounted for just 8% of leases (-6 pp y-o-y).

The year 2010 has witnessed a shift in the sources of **take-up**. Financial and business services sector companies are regaining the position of leading office space occupiers. By the end of 2010 their share has risen to 25% (+11 pp y-o-y) of total transactions. Approximately one third of such companies expanded occupied space. Demand from IT and Hi-tech related companies remained consistently high, accounting for over 30% of all transactions.

### Annual Take-up by Motivation* (% share)



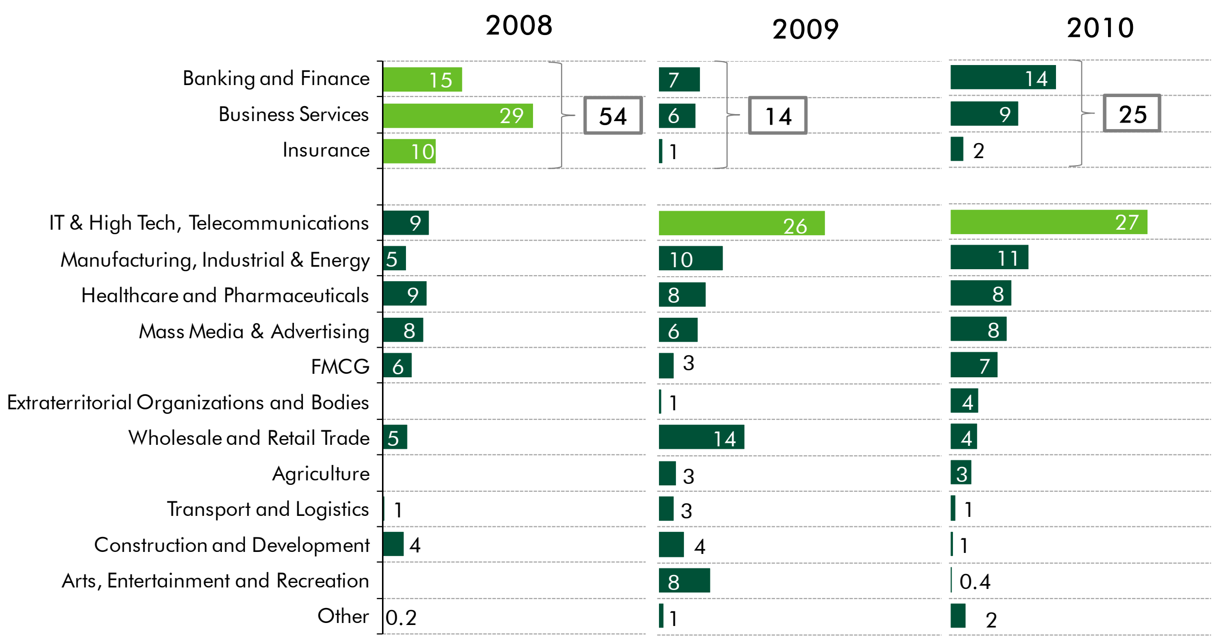

* - number of transactions, including sub-lease
** - with or without relocation
*** - net of expansion

Source: CB Richard Ellis

Relocations from low-quality (and, therefore, unaccounted) premises has been the main trend on the market for the past two years. Judging by transaction activity, the majority of large tenants have already benefited from post-crisis market conditions and improved their rental terms.

Besides, occupiers started showing interest in acquiring office mansions and/or purchasing office premises within office buildings. Growing number of inquiries from end-users translated into several transactions by the end of the year – first acquisition deals recorded since the end of recession.

### Annual Take-up by Industry (% share)




Source: CB Richard Ellis





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### Major Office Transactions in 2010

| TENANT | INDUSTRY | SCHEME | GLA*, sq m | SUBMARKET |
|---|---|---|---|---|
| EPAM Systems | IT & Hi-tech, Telecomunications | Vremena Goda | 7,057 | NC - WB |
| Atlantic Group | Mass Media & Advertising | Capital Hall | 3,584 | CBD |
| KRAFT FOODS | FMCG | BC at 23 Yaroslaviv Val St. | 3,500 | CBD |
| EBRD | Extraterritorial Organizations and Bodies | BC at 16 Nemyrovycha-Danchenka St. | 2,600 | c-CBD |
| Merck Sharp & Dohme | Healthcare and Pharmaceuticals | Horizon Business Park II | 2,540 | c-CBD |
| LG Electronics | Manufacturing, Industrial & Energy | Mandarin Plaza | 2,470 | CBD |
| SYNGENTA | Agriculture | BC at 120 Kozatska St. | 2,000 | NC - WB |

*- gross leasable area

Source: CB Richard Ellis

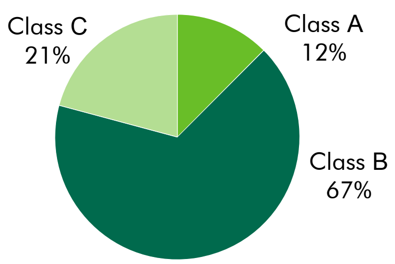
### Major office schemes in 2010*

| NAME | CLASS | SUBMARKET | DEVELOPER | GLA, sq m |
|---|---|---|---|---|
| Dnipro Plaza | B | c-CBD | Private person | 6,100 |
| Horizon Office Park II – ST | B | c-CBD | ISA Prime Development | 14,000 |
| Office building at 13a Moskovskiy ave | B | NC - WB | Petrovka LLC | 6,000 |
| Eleven | B | NC - WB | Centerinvest | 8,000 |
| Premium Center Business City | B | NC - WB | Premium Center | 34,000 |
| Volodymyrskyi | A | c-CBD | Steltex Investments | 2,900 |
| Office building at 23 Bagovutivska St. | B | NC - WB | Ukrop LLC | 3,600 |

*- including completed, but yet to be commissioned schemes offered for rent

Source: CB Richard Ellis

### Supply Structure by Class




Source: CB Richard Ellis

Overall, improving business performance of office-intensive companies along with strengthening corporate sentiment and declining landlords' expectations were the main drivers of demand for office space in 2010.

Another positive market trend in 2010 was the revival of interest from occupiers in pre-leasing office space under construction with expected market delivery in 2011.

## SUPPLY, NET ABSORPTION AND VACANCY

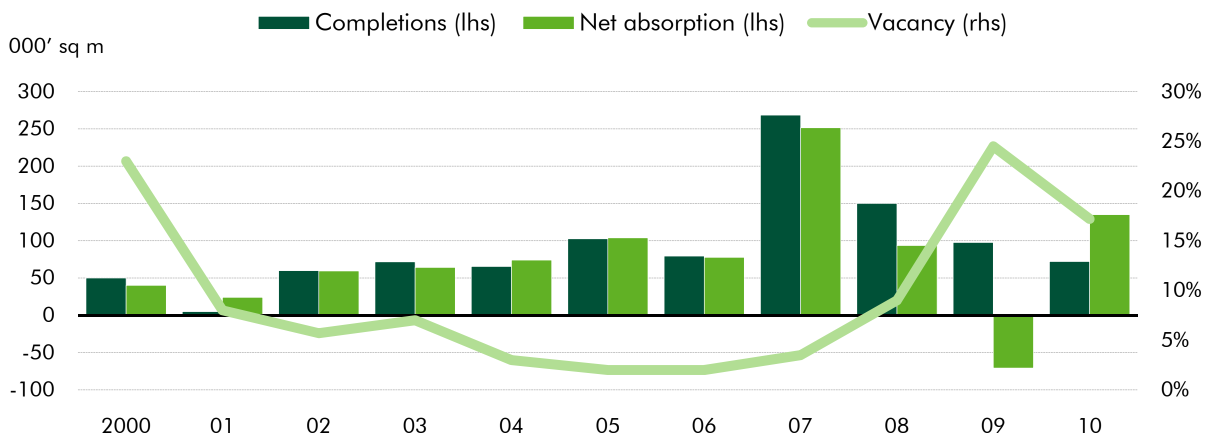
**Total competitive stock** has seen the addition of just 72,000 sq m of office space (-26% y-o-y) in 2010 and totaled ca. 1,100,000 sq m by the year-end. Annual development completions were the lowest in five years. Virtually all newly delivered schemes are class B premises meaning that Kyiv market remains structurally undersupplied in terms of grade A space, which currently accounts for only 12% of the total stock.

The year 2010 was marked by a number of relocations from unaccounted office stock into modern premises. As a result, **net absorption** exceeded the volume of annual development completions, reflecting an overall improvement on the market.

Sweeping relocations from unaccounted low-quality premises brought about a decline in **market average vacancy**, which dropped to 17% (-8 pp y-o-y) by the end of the year.

On the back of strengthened demand for top quality space and lack of modern office premises in core commercial districts, prime vacancy shrank further reaching 5.7% in Q4 2010 (-9.3 pp y-o-y).

### New Supply, Net Absorption, Vacancy Rate

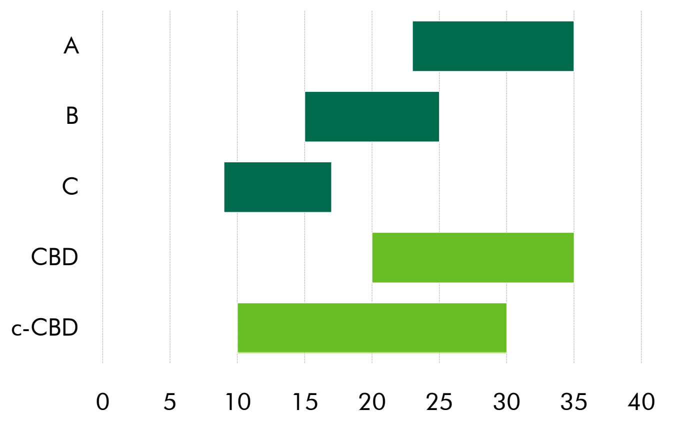



Source: CB Richard Ellis

## RENTS

Having stabilized at the end of 2009 prime base rents remained mostly stable at the level of $28/sq m/month (net of VAT) in H1 of 2010. However, on the back of recovering demand and increasing focus on prime premises, the deficit of class A offices put an upward pressure on prime rents driving them up to $32/sq m/month (+14% y-o-y) by the year-end. Needless to say that affordability of grade A office space in comparison to pre-crisis levels was among major incentives to relocate. With vacancy level in secondary office buildings well into double-digits, average rents there remained mostly flat throughout the year.

**Kyiv Office Rent Range as of Q4 2010**




Source: CB Richard Ellis

## OUTLOOK

In H2 2010 as a result of economic recovery and stronger demand, few developers managed to resume construction works on some previously halted projects, most of which are large class A buildings with GLA of over 40,000 sq m. Thus, the completions outlook for 2012 and beyond improved in comparison with our forecasts made at the beginning of 2010.

Taking into account the revival of construction activity in the segment we single out two possible scenarios for the next two years:

1. The first scenario envisages delivery of all major office schemes to the market according to the announced timeline.
2. The second scenario assumes delays in delivery of pipelined schemes.

Our main assumption for both scenarios is the level of net absorption which serves as an indicator of future demand.

We expect positive trends in demand dynamics to continue over 2011-2012 based on the following factors:

- Improved corporate sentiment
- Positive outlook for the economy growth
- Improved leasing activity in 2010

In 2010 the market witnessed the divergence of trends for class A and B segments. Vacancy in class A buildings dropped below 10% and pushed prime rents up, while secondary rents remained flat due to higher vacancy level in this tier of the market. Thus, it would be reasonable to consider net absorption for class A and B separately.

However, due to office classification limitations, low transparency and market immaturity, arriving at plausible forecast for average net absorption figure is quite a challenge in itself, not to mention differentiating the forecast for separate segments.

In 2011 we expect net absorption to decline due to fewer relocation-driven leases (majority of tenants seeking relocation have already upgraded occupied premises during 2009-2010), while expansion and market entries are not expected to reach pre-crisis level. Net absorption in 2011, therefore, might reach the average figure for 2002-2008. According to our estimates, faster economic growth in 2012 should increase demand by ca. 20% and possibly even higher.





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### Scenario 1 – All major office schemes are delivered to the market according to announced timeline

| | 2011 | 2012 |
|---|---|---|
| **Main assumptions** | | |
| Class A, thnd sq m | 51 | 142 |
| Class B, thnd sq m | 70 | 22 |
| Net absorption, thnd sq m | 100 | 120 |
| **Calculated parameter** | | |
| Vacancy, % | 17.0 | 18.1 |

Summary: Delivery of all pipelined premises will keep vacancy rate at a two-digit level. Therefore, rental growth will be restrained by vacant space in the newly completed offices. With new grade A completions set to run at low levels in 2011 (one project expected to be delivered close to the year-end) we expect further prime rents growth of ca. 15% y-o-y. Ambitious additions to class A stock announced for delivery in 2012 would slow down rental growth or might even bring it to a temporary halt. We expect 2012 to witness significant tightening of vacancy in class B offices, as recovering demand would eat into available stock on the back of contracted completions in class B segment of the market. At the same time, aggregate market vacancy will remain high, keeping rents in check at least until H2 2013.

### Scenario 2 – Pipelined schemes enter the market with delays

| | 2011 | 2012 |
|---|---|---|
| **Main assumptions** | | |
| Class A, thnd sq m | - | 153 |
| Class B, thnd sq m | 46 | - |
| Net absorption, thnd sq m | 100 | 120 |
| **Calculated parameter** | | |
| Vacancy, % | 11.5 | 12.7 |

Summary: Commissioning delays of both class A and class B offices will support gradual absorption of available stock, bringing vacancy below 13%. With the virtual absence of new supply of class A premises in 2011 prime rents are expected to increase in core areas by impressive 20-25%. However, 2012 could bring completely different picture as market average vacancy will be rising fed by excess space in the newly delivered class A properties. Significant new additions to prime stock in 2012 will put downward pressure on rents. At the same time, since certain part of the announced grade A pipeline is available for sale it will have a lesser affect on the letting market, keeping rents from falling. Meanwhile, constrained development completions over 2009-2012 in class B segment will drive vacancy rate down and put upward pressure on rents in 2012.

Historically, commissioning delays of 2-3 years have been common, making second scenario more likely. If, contrary to our expectations, the market will follow the first scenario, the potential oversupply might hold back the market recovery for a few more years.

## DEFINITIONS

**CBD** – central business district

**c-CBD** – "*close to CBD*"; a notional submarket created to identify properties within 2 km distance off CBD

**Office-using Employment** – all people employed in the following two broad industry categories: *financial intermediation* and *real estate, renting & business activities*, as per United Nations economic activity classification (Revision number 3.1)

**NC-EB**– "*non-central location on the east bank*"; a notional submarket created to identify properties outside of CBD and c-CBD areas on the east (left) bank of the Dnipro river

**NC-WB** – "*non-central location on the west bank*"; a notional submarket created to identify properties outside of CBD and c-CBD areas on the west (right) bank of the Dnipro river

**Leasing Activity** – represents the total floorspace known to have been let or pre-let, sold or pre-sold to tenants or owner-occupiers during the survey period. Unlike **take-up** (see definition below) it includes sales and leasebacks, renewals, regears, as well as subleases.

**Net Absorption (occupancy growth)** – represents the change in occupied stock within a market during the survey period

**Prime Rent** – represents the top open-market tier of rent that could be expected for a unit of standard size commensurate with demand, of highest quality and specification and in the best location in a market at the survey date. **Prime Rent** reflects the level at which relevant transactions are being completed in the market at the time but need not be exactly identical to any of them, particularly if deal flow is very limited or made up of unusual one-off deals. If there are no relevant transactions during the survey period, the quoted figure is more hypothetical, based on expert opinion of market conditions, but the same criteria on building size and specification will still apply. For offices, the **prime rent** should represent the typical "achievable" open market headline rent which a blue chip occupier would be expected to pay for:

- an office unit of standard size commensurate with demand in each location, typically 500 sq m
- an office unit of highest quality and specification within the local market
- an office unit within the prime location (CBD, for example) of a market

**Take-up (gross absorption)** – represents the total floorspace known to have been let or pre-let, sold or pre-sold to tenants or owner-occupiers during the survey period. A property is deemed to be taken-up only when contracts are signed or a binding agreement exists. Pre-let refers to **take-up** that was signed either in the planning or construction stage. All deals (including pre-lets and pre-sales) are recorded in the period that they were signed. Exclusions include space that is under offer, sales and leasebacks (as there has been no change in occupation), contract renewals (unless the occupier took additional space, when only the additional space is included).

**Total Competitive Stock** – represents the total completed space (occupied and vacant) in the private sector at the survey date, recorded as gross leasable area. Includes purpose-built, space converted from other uses and independent space forming part of a mixed-use development. Total Competitive Stock excludes any buildings that are not considered to be 'competitive' or active in the marketplace. Exclusions include; government and public buildings, where the public sector space is purpose built and owner occupied and the public sector does not engage in the open market; singly occupied properties, occupied by a tenant as the owner or on a long-term lease agreement; properties that are not considered to be actively competitive due to a size threshold, age, use or class.

**Vacant Space** – represents the total gross lettable (or rentable) floor space in existing properties, which is physically vacant and being actively marketed at the survey date. Space that is physically vacant, but not being marketed or is not available for occupation is excluded from **vacancy**. Space that is **under construction** is also excluded from **vacant space**.

**Vacant Space Rate** – represents the percentage ratio of total **vacant space** to **competitive stock**







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