CB RICHARD ELLIS

MarketView

Kyiv Offices

H1 2010

Quick Stats

	Change from H2 '09	Change from H1 '09
New Supply	↓	↓
Rent	→	↓
Vacancy	↓	↑

Hot Topics

- Financial services industry almost stopped shedding payrolls in H1 2010, with only about 800 jobs axed in five months to the end of May; meanwhile business confidence continued to strengthen for three consecutive quarters
- The majority of occupiers have by now processed the effects of the economic crisis on their operations, but demand for space remains heavily weighted in favor of upgrades rather than expansions
- Around 27,000 sq m of competitive space reached the market in first six months of the year, the lowest supply figure over such period in more than three years
- Rents remained stable, while vacancy declined by almost 4 pp on the back of still ongoing relocations from shadow premises to competitive space

CBRE
CB RICHARD ELLIS

FUNDAMENTALS

Given that Kyiv economic trends almost always tended to outshine national averages it is reasonable to infer that its gross regional product (GRP) expanded at a healthy rate in H1 2010 after contracting by an estimated 13.5% in 2009 against 15.1% plunge for the nation as a whole. With unemployment at 7.2%, labor market is also in a much better shape than that of the country in general, where the figure is some 2pp higher. Even as **office-using employment** is still deteriorating in annual terms, the present decline is mostly attributable to the adjustments in calculation methodology, announced by the authorities recently. Overall, the outlook on the occupier market is definitely brightening.

According to the National Bank of Ukraine, the percentage of Kyiv firms expecting better business conditions in the next 12 months has risen to 53.5% in Q2 2010 (+29.6pp y-o-y), while the share of respondents expecting worse business conditions has dropped to 11.8%, the lowest number in almost two years. Likewise more than a fifth of Kyiv firms now say they are planning to hire more personnel in the next 12 months, while only 12% said the same in late 2009. Corporate sentiment, therefore, is clearly improving, as businesses feel that the cycle is leaving the danger zone of a recession and is moving into a period of moderate growth.

Kyiv City Fact Sheet

Annual Data	2010*	Historical Averages (%)	2005-2009
Resident population (million)	2.79	Population growth	0.89
GRP (USD billion, 2008)**	18.2	Real GRP growth	5.4
Average monthly salary (USD)**	420	Average salary growth**	18.25
Unemployment***	7.2	Unemployment***	4.42
FDI stock (USD billion)	19.4	FDI stock growth	41.6

* through the end of March, unless otherwise stated
** at official exchange rate, eop
*** International Labor Organization methodology (% of workforce)
Source: Kyiv Statistics Office, State Statistics Committee

DEMAND

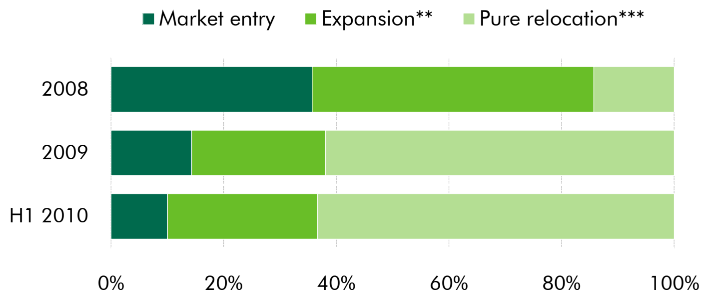
Occupier market continued to get stronger in H1 2010. **Leasing activity** is estimated to have reached ca. 49,000 sq m (+14% y-o-y) and take-up to amount to ca. 37,000 sq m (+12% y-o-y). Leasing activity grew faster than **gross absorption** on the back of still widespread subleases and renegotiations, thus the share of **effective take-up** inched downwards 2pp from a year ago to ca. 75%. Overall, while growing in annual terms in H1 2010, take-up fell 22% from six months earlier due to seasonal factors. However, we believe these figures could be somewhat understated at this point in time. Once the full data on transactions is revealed in early August, we expect to see better quarterly growth patterns of both take-up and leasing activity.

Demand remains active again but is still primarily fuelled by tenants looking to upgrade rather than to expand. Relocations from low-quality (and, therefore, unaccounted) premises is still ongoing, but could be exhausted before the year end, as they have been already taking place for more than 18 months on a massive and yet to a large degree unseen scale. Moving offices within competitive space has been especially noticeable in prime segment, where premises – particularly of large area – are already in short supply. While the number of expansion-induced transactions was negligible compared with pre-crisis years, their share has slightly increased (by almost 3pp from 2009 results) to ca. 27% of the total in six months to the end of June.

The current dynamics in office-using employment indicate that expansionary strategies are not yet taking hold, at least among core users – such as financial and business services firms. However, labor market picture may be somewhat misguided because today's continued decline in employment is mostly due to technical reasons – particularly, changes in calculation methodologies – while the data on sector activity clearly underscores that core users are reactivating.

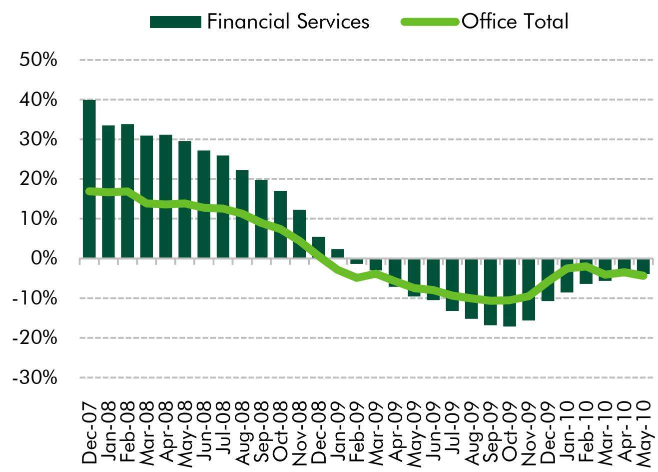
It is not surprising that the number of jobs in most office-intensive sectors of the economy has been falling through the whole of 2009. The recent crisis has taken a heavy toll on financial, professional and business services such as legal and accounting activities, as well consultancy and advisory. The demand for business-to-business products, which helped inflate the immediate demand for office space prior to crisis, almost disappeared in 2009 and played a key role in weakening occupier activity. The combined share of financial and business services firms in total office take-up fell from 47% in 2008 to only 11% in 2009. However, lack of expansionary demand from core users was compensated by strong performance of information and communication as well as hi-tech related industries. Together these industries accounted for more than a third of transactions in 2009.

Take-up by motivation* (% share)



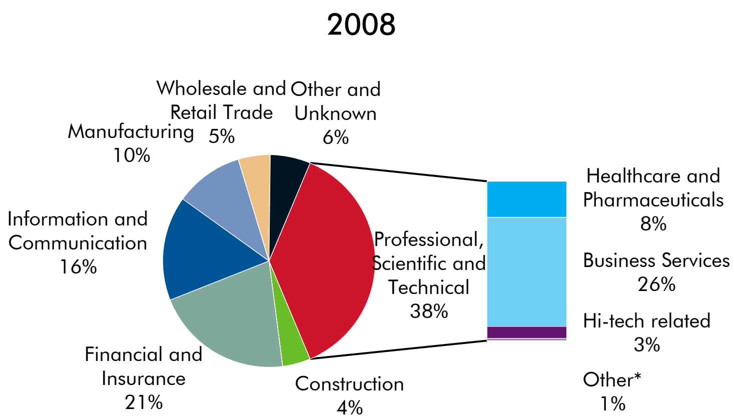
Source: CB Richard Ellis
* - share of transactions, not volume; including sub-leases
** - with or without relocation
*** - net of expansion (with or without contraction and/or consolidation)

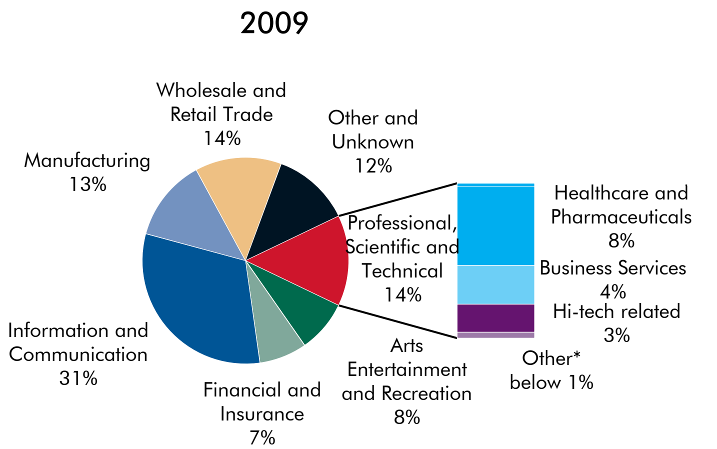
Structural Change in Office-Using Employment (% change, y-o-y)

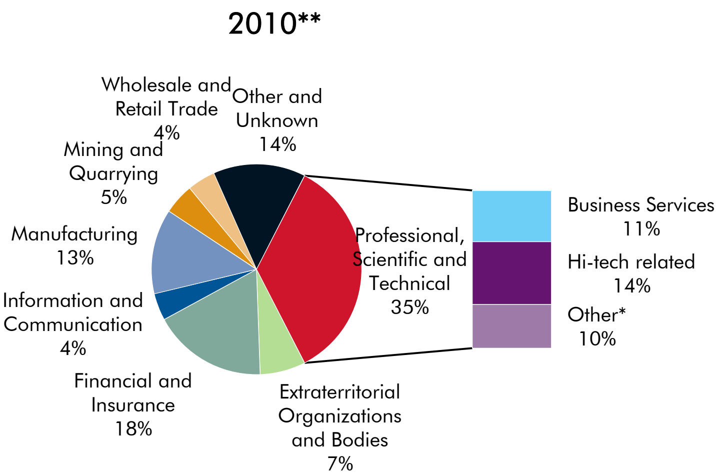


Source: Kyiv Statistics Office, CB Richard Ellis calculations

Take-up by Industry – a historical view







Source: CB Richard Ellis
* - mostly mass-media and advertising firms
** - preliminary data through the end of July

Major office schemes in 2010

Name	Submarket	Developer	GLA, sq m*	Delivery
Dnipro Plaza	c-CBD	Private Person	6,000	Q1
Horizon Office Park II – ST	c-CBD	ISA Prime Development	14,000	Q2
Lucky.Net Telecom office	NC-WB	Petrovka LLC	3,000	Q2
Bagoutovskaya office scheme	NC-WB	Ukrop LLC	7,000	Q3
Eleven	NC-WB	Centerinvest	8,000	Q3
Premium Center Business City	NC-WB	Premium Center	34,000	Q3

Source: CB Richard Ellis

Major Office Schemes in 2011

Name	Submarket	Developer	GLA, sq m*	Delivery
Esplanada/ Continental	CBD	Mandarin Plaza CSJV	51,000	Q1
Shekavitskyi	NC-WB	Stolitsa Investment and Construction Company LLC	8,000	Q2
Pankivskyi	CBD	Green House LLC	10,000	Q2
Topaz	NC-WB	Artem Holding Company	7,000	Q3
Rialto	NC-WB	Istil Group	13,000	Q4

Source: CB Richard Ellis

The latest preliminary results for take-up suggest that both financial and business services firms are once again playing an active role on the occupier market. Their combined share of deals has risen to 29% for seven months to the end of July. The share of professional, scientific and technical firms has jumped 21pp from previous year thanks to one-off completion of several large deals involving companies that specialize in mass-media and advertising as well as in hi-tech related activities. It should be said, however, that only a handful (ca. 10%) of core tenants who leased new space did so for expansion purposes. Although most drastic cutbacks are definitely in the past, we believe that the demand for office space on part of most occupiers will continue to be limited to relocation requirements for cost saving and quality improvement purposes at least until the end of 2010.

SUPPLY, NET ABSORPTION AND VACANCY

Total competitive stock improved by only 27,000 sq m of space over H1 2010, a rather sluggish pace even by unimpressive historical standards. Supply was down 39% on a year earlier, when economic crisis was at its peak. This sharp drop in development activity is primarily attributable to tighter credit and economic downturn, but is also a result of continuing commissioning delays on the part of landlords.

Vacancy rate went down on the back of few development completions and continued strong relocation drift in the occupier market. By the end of Q2 2010 market average rate dropped to 18.5% (-6pp from Q4 2009 and -1.5pp y-o-y), whereas the same rate in prime buildings was just above 8.5% (-6.1pp from Q4 2009 and -5.1pp y-o-y). This declining trend, however, is unlikely to be sustained in the mid-term, because ready-to-be-commissioned office schemes remain largely tenantless. Indeed, out of 135,000 sq m of competitive space that is forecast to enter the market in the next 18 months, only 22,000 (16%) has been pre-leased or pre-sold so far. Demand is healthy, but not expansionary, and relocation trend has its limits, so vacancy is likely to decline at a much slower pace in H2 2010 and could actually temporarily stabilize at two-digit level in mid-2011.

Development completions are forecast to slow down considerably in 2012, just as the economy returns to pre-crisis level. While pipeline may look diminished vis-à-vis historical record, it is still large enough to satisfy immediate demand.

CBRE
CB RICHARD ELLIS

The quality of future completions, however, is lagging behind international standards, ensuring that prime real estate remains in short supply.

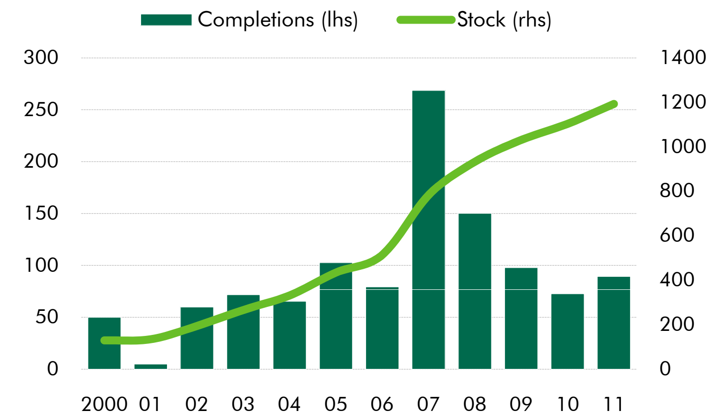
Net absorption is very hard to forecast because of many variables involved; however, our view is that it is unlikely to post negative growth in the coming years. With hardly any companies planning expansion in the nearest future, most have at least stopped contracting, which reduces the imminent likelihood of negative absorption. Furthermore, relocation trend – i.e., companies leaving non-competitive space in favor of professional premises – will continue to provide an additional boost to absorption at least this year.

Most relocations from grey (unaccounted) space will take place in 2010, so net absorption is likely to be higher than annual development completions, and vacancy is therefore expected to decline noticeably. Later in 2011, as new space enters the market, and relocation boost to absorption patters out, vacancy may stay unchanged or fall only marginally. Only 2012 can be the year when vacancy will finally be defeated, as demand gets truly expansionary against the backdrop of economic revival and supply remains subdued.

RENTS

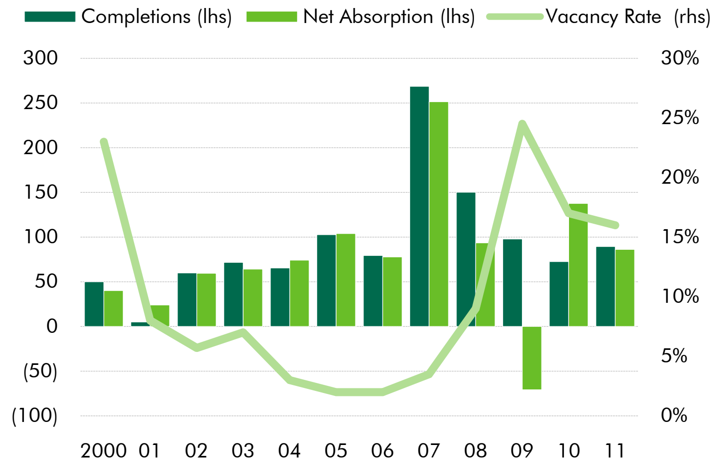
Prime rents remained flat at $28/sq m/month in H1 2010, having declined by only 7% in H2 2009. By the end of 2009 prime USD rents were down 67% from their peak in Q3 2008 and 53% down in y-o-y terms. The fall in UAH equivalent has been less dramatic – 47% from the peak in Q2 2008 and 39% y-o-y[1]. Clearly, the bottom has been reached and the fundamentals as well as details of recent deals are pointing that further declines (in at least UAH terms) are unlikely. Imminent rental growth, however, should not be expected either, as additional deliveries in the mid of 2011 will feed vacancy, keeping rentals in check. Slight increases in prime rents, however, are very real, given that vacancy here is almost two times below market average. Indeed, because only a few (if any) class A buildings will be delivered to the market over 2010-2011, we expect the gap between prime and secondary rents to widen.

Kyiv Annual Development Completions and Total Competitive Stock ('000 sq m)



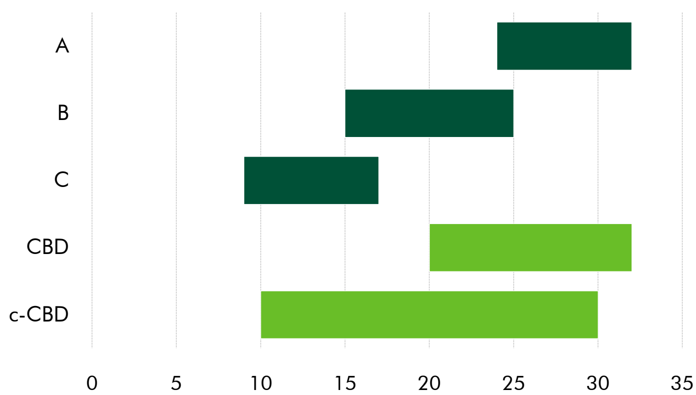
Source: CB Richard Ellis

Development Completions, Net Absorption and Vacancy Rate



Source: CB Richard Ellis

Kyiv Office Rental Range as of Q2 2010 (USD/sq m/month)



Source: CB Richard Ellis

[1] At quarterly average official exchange rate

CBRE CB RICHARD ELLIS

For More information regarding the MarketView, please contact:

CBRE Ukraine Office

4 M. Hrinchenka St.,
Kyiv 03038
t: +38-044-390-00-00

Sergiy Sergiyenko
Managing Partner
e: sergiy.sergiyenko@cbre.com

Radomyr Tsurkan
Managing Partner
e: radomyr.tsurkan@cbre.com

Volodymyr Bezruchenko
Head of Research
e: volodymyr.bezruchenko@cbre.com

CBRE
CB RICHARD ELLIS

Class A office schemes enjoy quite a narrow rental range, as they are very few in number with more or less standardized technical parameters. On the contrary, class B properties represent a rather heterogeneous group where differences between buildings' characteristics can vary to a great extent. Like its counterpart at the top end of the market, class C office schemes have a tight rental range, which is due to very similar technical parameters among buildings of this category, even though their number is significant.

OUTLOOK

The recession in the office market is history, but booming environment, akin to the go-go years of 2005-2008 will not return soon. Broad-based market recovery in terms of rental rates will be strongly conditional on the improvements in the labor market. The only good news in this regard so far is the absence of bad news. Most firms have already completed their cost-containment adjustments, yet they only began building plans for the future. Amid fears of double-dip recession and uncertainties over the sustainability of recovery, many will probably wait for another quarter or two before putting their plans into action. Even as requirements for new office space are not showing signs of abating, they are rarely dictated by the need to expand.

Until now **occupancy growth** heavily depended on relocations from untracked properties into proper competitive stock, as deferred demand for quality space resurfaced thanks to improved affordability. A multitude of tenants have emerged from the shadow of inferior premises providing extra absorption and cushioning the extreme downturn of 2009. While being highly helpful on its own, this massive migration is unsustainable. If rents are to grow, vacancy needs to fall further and in the view of some 130,000 sq m of new space almost surely coming online in the next 18 months, expansions need to become more widespread.

The presently unfavorable supply-demand disequilibrium does not spell disaster, yet it does mean that rental growth across the market is some time away. Given how fundamentally undersupplied in quality Kyiv offices were before the crisis, prime segment was always bound to be in a much better shape than the market overall. Rental growth in best properties is, therefore, real and close, provided exchange rate stays broadly unchanged. Early 2011 or even late 2010 is the time when we believe landlords of prime buildings may begin to demand higher payments. The rest of the market will need to wait longer, until at least 2012. Indeed, one of the most obvious aftermaths of the recession has been a partial decoupling of prime space from "the rest" of the market. Botched properties even in CBD will no longer be able to take a comfortable ride on the back of near zero vacancy (when it eventually comes) in their higher quality peers. If this crisis has shown anything, it is that real estate development, as a long-term business by definition, cannot be short-term in methods. Only professionally developed, well-thought and quality maintained buildings can support occupancy at an adequate level during crises and hope to be the first to recover once these difficult times are over.

DEFINITIONS

CBD – central business district

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

CB RICHARD ELLIS