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MarketView

Kyiv Offices

H1 2011

Quick Stats

	Change from H2 '10	Change from H1 '10
New Supply	↓	↑
Rent	↑	↑
Vacancy	↓	↓

Hot Topics

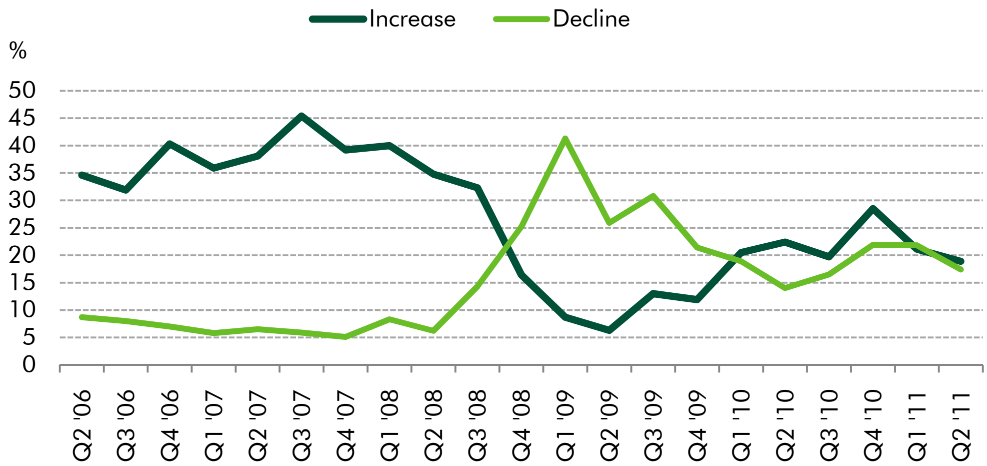
- Demand up: take-up grew 24% y-o-y on the back of several large transactions and elevated leasing activity
- New supply decrease: just under 26,000 sq m of new space (all Class B premises) entered the market
- Vacancy decline: the combination of sluggish supply and growing demand pushed the market average vacancy rate to 13.0% (-4.2pp from Q4 2010)
- Prime rents growth: virtual absence of new class A premises drove prime rents up by 9% over H1 2011

FUNDAMENTALS

In Q1 2011, Ukrainian GDP rose by an estimated 5.3% y-o-y after 3.3% increase in the previous quarter. This acceleration was driven primarily by a 12.7% jump in household consumption. The latest official statistics on GDP for Q2 2011 has not been published yet, but the data on basic sector performance is encouraging. After slowing to 6.7% y-o-y in April from 8.5% y-o-y in March, output revived in May, growing by 9.1% y-o-y. The current GDP forecast for the whole of 2011 varies between 4.0% and 5.5%[1].

Given that economic recovery has not been firmly established yet, businesses remain cautious in their employment plans. In July, the percentage of Kyiv companies planning to hire new personnel was only 18.9% compared to almost 30% at the end of 2010. At the same time, the share of companies with no hiring intentions increased to 63.6% in Q2 2011 (+14.1pp, from Q4 2010). In line with these trends, the level of unemployment throughout the year is estimated to stay within the range of 7.7% and 8.0%, almost unchanged from the end of 2010, when it was 8.1%.

Kyiv Corporate Hiring Expectations Over the Next 12 Months



Source: National Bank of Ukraine

DEMAND

Reported **take-up** totaled more than 80,000 sq m in H1 2011, a 24% improvement from H1 2010 results. This relatively high transaction volume was due to several large deals - in excess of 2,000 sq m each - accounting for around 57% of total take-up (7 deals in Q1 and 3 deals in Q2). In contrast, the share of large transactions over the same period last year was only 22% (5 deals).

Significant input was made by two notable owner acquisitions and large leasing transactions in the recently delivered *Eleven* and HTBC ST (Phase II) office schemes – 44% of total take-up. Eleven can also boast the largest 6,000 sq m deal with TNK-BP, an oil company. The second largest lease transaction recorded in H1 2011 was for 4,400 sq m of space in a newly-built *Rialto* building, which went to Swedbank.

[1] - Latest forecasts provided by the following organizations: EBRD, Oxford Economics, Cabinet of Ministries of Ukraine, Ministry of Economic Development and Trade of Ukraine, Troika Dialog, Goldman Sachs, National Bank of Ukraine

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The majority of this year transactions were completed within Class B office buildings in non-CBD locations on the West (Right) bank. East (Left) bank saw only two deals: 1,200 leased by Utair and around 3,000 sq m let by Aerosvit, both local airline companies.

The rationale behind most relocations was either consolidation with upgrade or expansion. Market entry as a motivation for letting an office space remains a rare occasion.

In H1 2011, the market saw two acquisitions for owner-occupation, accounting for 24% of total take-up (or 19,600 sq m). In general, the number of companies contemplating an option to buy office premises is growing. The majority of companies are looking for a space of ca. 2,000 sq m within a detached and reconstructed office mansion or newly-built office building offered for sale.

In terms of industry sector breakdown, mass media & advertising companies came first with a 19% share of the total take-up thanks to one-off acquisition of newly delivered office building in Podol district of Kyiv. The demand from finance services companies has been getting stronger as well and now accounts for 17% of total transactions in H1 2011. Also of note was higher activity on the part of IT & hi-tech/telecommunications, agricultural and manufacturing companies whose share in total take-up comprised around one third of all transactions.

SUPPLY

Four Class B office schemes with a total GLA of around 36,000 sq m were delivered to the market in H1 2011. Effectively, however, since one of the buildings was sold to the final occupier at delivery, speculative stock grew by only 25,700 sq m. As a result, Kyiv total competitive stock by the end of H1 2011 reached ca. 1,125,000 sq m. The largest development completion was Rialto building (15,200 sq m).

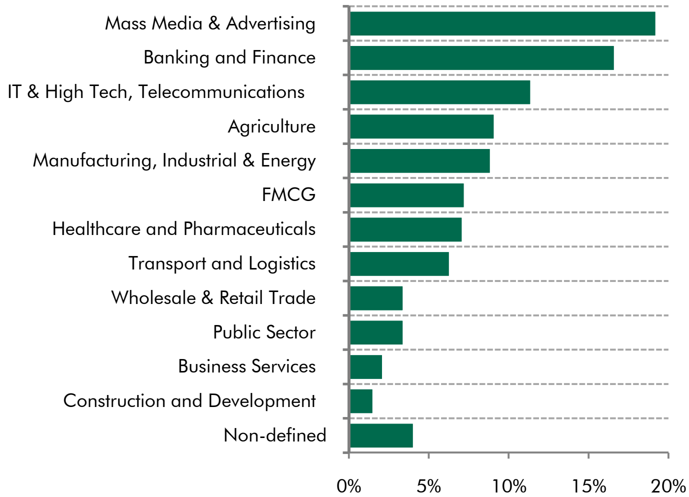
Three schemes announced for the delivery in H2 2011 should add another 23,800 sq m of office premises to the market. In aggregate, therefore, annual new supply in 2011 is expected to hit an eight-year low, amounting to just under 60,000 sq m (-17% y-o-y). Furthermore, new deliveries this year are exclusively restricted to Class B premises, therefore in the long-run Kyiv market will remain structurally undersupplied in terms of prime, grade A space.

Key Office Lease Transactions in H1 2010

OCCUPIER	INDUSTRY	PROPERTY	SUBMARKET	GLA*, sq m
TNK-BP	Manufacturing, Industrial & Energy	Eleven	NC-WB	5,923
Swedbank	Banking and Finance	Rialto	NC-WB	4,400
Kernel-Trade	Agriculture	BC at 92-94 Dmytrivska St.	c-CBD	3,500
Aerosvit	Transport and Logistics	201-203 Kharkivske highway	NC-EB	3,000
Pfizer	Healthcare and Pharmaceuticals	HTBC ST (Phase II)	c-CBD	2,540
Unilever	FMCG	Mikom Palace	NC-WB	2,130
Nycomed	Healthcare and Pharmaceuticals	Eleven	NC-WB	1,300
Pernod Ricard	FMCG	Eleven	NC-WB	1,300
UTair-Ukraine	Transport and Logistics	Praga	NC-EB	1,200
Coca-Cola	FMCG	BC at 17G Skovorody St.	CBD	1,170
Alacor	Construction and Development	Eurasia	CBD	1,000

*- gross leasable area
CBD – central business district, c-CBD – close to CBD, NC-EB – non-central location on the east bank, NC-WB – non-central location on the west bank
Source: CB Richard Ellis

Take-up by Industry in H1 2011



Source: CB Richard Ellis

Key Office Schemes in 2011

NAME	CLASS	SUBMARKET	DEVELOPER	GLA, sq m	COMPLETION
Rialto	B	NC-WB	ISTIL	15,200	H1 2011
Shekavitskyi	B	NC-WB	Stolytsya Investment	10,300	H1 2011
Office building at 120/4 Kazachya St.	B	NC-WB	local	7,000	H1 2011
Office building at 2a Novovokzalna St.	B	c-CBD	DMI Group	3,500	H1 2011
Pankivskyi	B	CBD	Green House LLC	9,600	H2 2011
Forum Victoria Park (Phase I)	B	NC-WB	Forum Management Group	7,200	H2 2011
Office building at 19 Druzhby Narodiv boul.	B	c-CBD	local	7,000	H2 2011

Source: CB Richard Ellis

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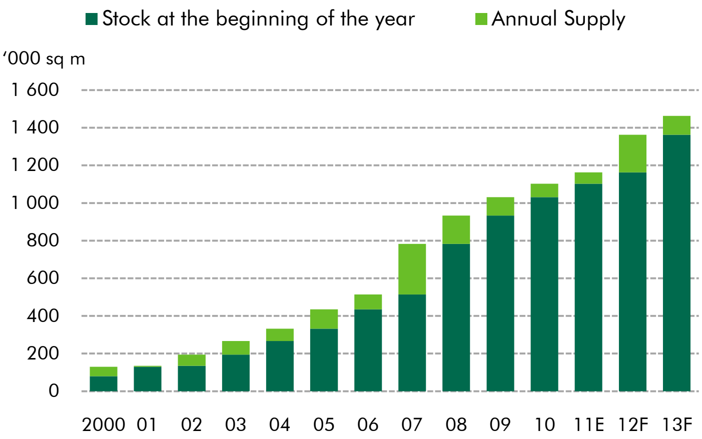
Key Office Schemes Expected in 2012-2013

NAME	CLASS	SUBMARKET	DEVELOPER	GLA, sq m	COMPLETION
Esplanada/ Continental	A	CBD	Mandarin Plaza CSJV	51,000	H1 2012
Domosfera	B*	NC-WB	DeVision	24,600	H1 2012
Toronto-Kyiv	A	c-CBD	Toronto-Kyiv LLC	32,500	H2 2012
101 Tower	A	c-CBD	K.A.N. Development	46,000	H2 2012
Merx (Phase II)	B	c-CBD	Merx Group	21,800	H2 2012
Horizon Podol (Phase II)	A	c-CBD	ISA Prime Development	15,400	H2 2012
Mariya	A	CBD	K.A.N. Development	40,000	H1 2013
Silver Breeze	B	NC-EB	Svitland Ukraine	27,200	H2 2013
Sigma	B	NC-WB	Midland Development	17,900	H2 2013

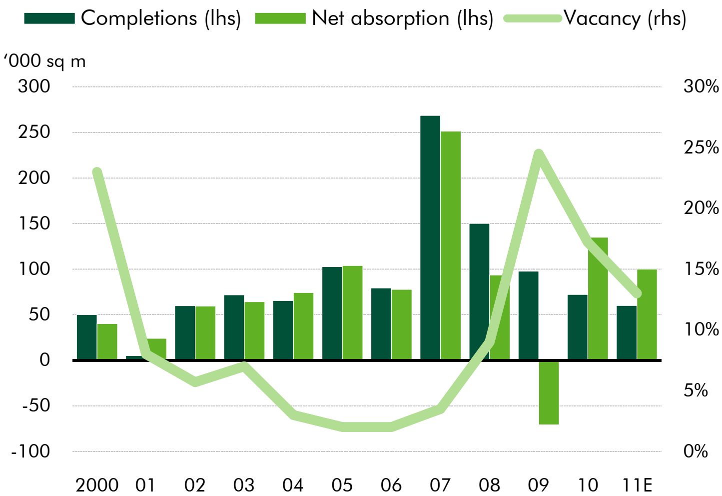
* - quality of a building – Class B, Location – Class C
Source: CB Richard Ellis

Kyiv Annual Development Completions and Total Competitive Stock



E – estimate
F – forecast
Source: CB Richard Ellis

New Supply, Net Absorption and Vacancy Rate



lhs - left hand scale
rhs- right hand scale
E – estimate
Source: CB Richard Ellis

In terms of geographical spread, the disparity between West (Right) and East (Left) bank remains wide and, if anything, is likely only to grow further, given that East Bank may not see any new additions to the stock in 2011. The majority of new schemes are located in the non-central locations on the West bank. CBD area will most probably see only one development completion in H2 2011 (9,600 sq m of office premises in *Pankivskyi*).

In the first six months of 2011 developers have significantly stepped up their operations, prompting an upward revision to our previous forecast for future supply. We now expect 20% more space to be delivered in 2012 (Scenario 2) - i.e., 200,000 sq m, including only key office schemes currently under construction. Another 100,000 sq m of space is expected to hit the market in 2013. It is noteworthy that new supply in 2012 is likely to be the most high-quality in history since around 73% of deliveries scheduled for that year are Class A premises. 2013, in contrast, will see mostly Class B premises, which are expected to have 60% share of new additions.

VACANCY

In H1 2011, the market absorbed more than 68,000 sq m of space (-18pp y-o-y). The slowing down of net absorption rate indicates that previously widespread relocation trend – when occupiers moved from unclassified buildings to competitive stock – is losing steam.

Because there was not enough new supply to compensate for the increased activity of occupiers, vacancy rate fell 4.2pp from December 2010 to 13.0% by the end of June 2011 (-5.5pp y-o-y). Vacancy in prime buildings already reached a three-year low of 3.4% (-2.3pp from Q4 2010 and -5.5pp y-o-y). The lowest availability rate was recorded in the c-CBD area (around 4.8%) and the highest rate was observed in the NC-WB area (25.4%). CBD vacancy rate was 11.2%. This data clearly show that many occupiers took advantage of favorable commercial terms in today's market and opted for office buildings in the vicinity of CBD.

RENTS

The benchmark prime rent in core areas demonstrated upward movement in H1 2011, having increased from $32 to $35 sq m/month (net of VAT and OPEX) in six months to the end of June. The growth rate, however, has slowed after accelerating in H2 2010.

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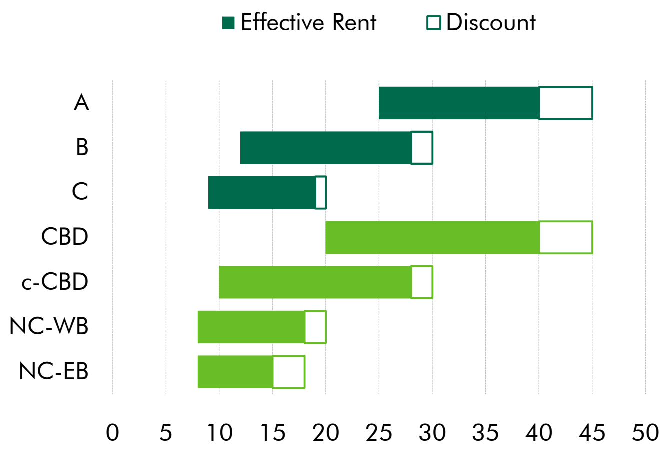
Asking rents in prime-located Class A office schemes can reach up to $45/sq m/month (net of VAT and OPEX). Effective rents, however, are 10-15% lower as discounts may still apply. Due to still high vacancy in non-prime locations, average net effective rent for secondary office premises is almost identical to that recorded six months ago - i.e., $23/sq m/month.

Rents in CBD and c-CBD locations are in sharp contrast to those in NC areas of the city as stock quality in these two submarkets differs significantly. In H1 2011, CBD rents went up in prime Class A and several most successful Class B properties. Office rents in buildings located outside of CBD are steady with small fluctuations, if any.

Kyiv Office Base Rental Range as of Q2 2011 (USD/sq m/month)



Source: CB Richard Ellis

YIELDS

There were no investment transactions registered in Kyiv over the reported period. Nevertheless, the yields compressed by 1pp driven by positive economic outlook and improved market sentiment at the beginning of the year. Prime office yields, therefore, stood at 13% in Q1 2011 and remained unchanged in Q2 2011 as there were not enough positive economic news to bring about another decline in yields.

While office sector was popular among investors before the recession, retail properties are currently attracting more attention due to more rapid recovery of the sector. Also, the lack of quality product on the market has made investors and developers alike refocus on the land sites and projects. Yet, although retail sites enjoy most attention, the most notable development transaction in H1 2011 - the acquisition of the Gorkyi Park project by the French developer SCC - includes an office component.

Until the end of the year, we do not anticipate to witness any investment transactions in the office market. Should the economy stay on the upward path and financial market continue to demonstrate stability, yields may decline further in the next two quarters.

OUTLOOK

Regrettably, economic growth and employment trends are not strong enough to provide a major boost to demand for offices premises. However, because the market is still offering favorable prices, we expect tenants to continue securing modern space in good locations. We, therefore, anticipate leasing activity to remain stable in H2 2011.

Total annual development completions in 2011 are forecast to be trivial by historical standards. The shortage of new supply coupled with higher tenant's activity will help to bring average market vacancy rate further down over the next two quarters. Provided occupiers' activity stays on the current level, vacancy rate could drop to 10% by the year end.

Absence of new class A premises in 2011 will continue to drive prime rents up for the rest of the year, while secondary rents are expected to remain flat due to the persistence of high vacancy in the segment. By the end of the year, moderate rental growth might resume in most successful secondary office buildings with good locations and minimal vacancy rate.

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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**