RESEARCH REPORT
Kyiv Office

CBRE | Ukraine

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H1 2014

HOT TOPICS

- Decreasing demand: take-up continued to decrease gradually over H1 2014 compared to the healthy start in 2013
- Slowdown of development activity: around 56,700 sq m of new premises (-36% y-o-y) delivered to the speculative market
- High vacancy rate: average vacancy reached approximately 29% (+1.5 pp from Q4 2013) as a result of new supply and weak net absorption
- Decline in rental rates: indicative prime rent stabilized at $30 per sq m/month (triple net), after declining by around 10% in Q1 2014

DEMAND

Slight signs of demand recovery recorded in 2013 have been cancelled out over the first part of 2014. Deterioration of the macroeconomic situation, increased tensions in the Eastern part of Ukraine in Q1, combined with seasonal factor in Q2, have led to the fact that the majority of tenants have halted their development plans and took a wait-and-see approach. As a result, estimated take-up did not exceed 30,000 sq m, which is more than a twofold decrease compared to the same period last year. For the last several months transactional activity has been mostly driven by relocation and optimization, as well as renegotiation deals. On a positive note, there is an opportunity for occupiers to secure favorable lease terms over the period of market slowdown, as incentives grew as well.

KEY OFFICE LEASE TRANSACTIONS IN H1 2014

OCCUPIER	INDUSTRY	PROPERTY	SUBMARKET	sq m
KPMG	Business Services	Senator	Pechersk	4,500
OSCE	Public Sector	Business Center	Shevchenkivskyi	1,510
OSCE	Public Sector	Merx 2	South	930
Metinvest	Manufacturing, Industrial and Energy	Eurasia	Olimpijskyi	930
CRH	Manufacturing, Industrial and Energy	Sofia	Prime	700

Note: submarkets defined according to the new central business district (CBD) delineation introduced by CBRE in September 2011
Prime, Pechersk, Podil, Olimpijskyi, Shevchenkivskyi – CBD; South, South West, West, North – CBD fringe; NC-SW – non-central location, south west (right bank), NC-NW – non-central location, north west (right bank), NC-NE – non-central location, north east (left bank), NC-SE – non-central location, south east (left bank)

Source: CBRE Ukraine

SUPPLY

Over the first six months of 2014 the market has witnessed the total volume of new office premises announced for the whole of the year. Three modern business centers were delivered in Q1 in IQ Business Center (30,000 sq m GLA), Sigma (17,900 sq m GLA), and Domino (8,800 sq GLA). As a result, new supply in H1 2014 reached 56,700 sq m, having decreased by 36% y-o-y, with the total competitive stock thus reaching 1.56 mln sq m.

NEW SUPPLY IN 2014-2016 (MAJOR SCHEMES)*

NAME	CLASS	SUBMARKET	DEVELOPER	Office GLA, sq m	DELIVERY
Domino	BA	Podil	Local	8,800	H1 2014
Sigma	BC	NC-NW	Midland Development	17,900	H1 2014
IQ Business Center	AB	South	K.A.N. Development	30,000	H1 2014
Office building	BA	Olimpijskyi	Local	7,500	2015
Astra Residence I	AA	Podil	Kanyon	15,000	2015-2016
Business Center	AA	Podil	Local	10,000	2015-2016
Sky Towers	AB	West	Cimbrorum Holdings LLC	95,000	2015-2016

*- according to developers' announcements
Source: CBRE Ukraine

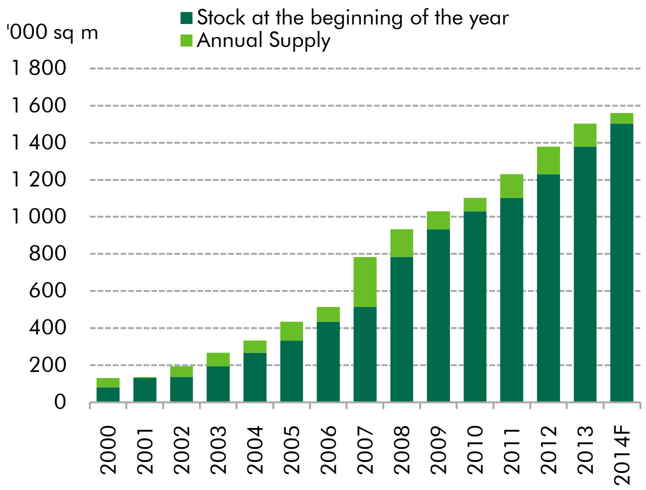
As 2014 progresses, no new office buildings are expected to be commissioned. As for projects currently under construction, around 130,000 sq m are planned for delivery in 2015-2016, which is still a considerable volume for the market in light of the existing record high two-digit vacancy level and weak demand. It is also remarkable that approximately 70% of new supply will be "concentrated" in one building – mixed use Sky Towers. Therefore, taking into account the high vacancy rate, substantial new supply and constrained take-up, the competition among business centers is likely to further increase, especially as new properties approach commissioning.

VACANCY AND RENTS

Modest demand coupled with the new supply commissioned in H1 2014 has not contributed to the absorption of office space. As a result, the average market vacancy rate increased by roughly 1.5% from Q4 2013 and reached approximately 29% as of end of June. The significant factor which constrains office space absorption is that most recent developments are delivered in shell & core condition. For shell & core fit out, the typical tenant's improvements average USD 400-500 per sq m. Before the crisis it was a common practice that tenants shouldered all fit out expenses, as the market was on the landlord's side. Currently, due to a weak demand, landlords have to offer better terms and started making concession to tenants by way of providing the so-called 'warm shell' or equivalent of up to $150-250/sq m of capital contribution. However, as real estate budgets come under greater scrutiny, the level of landlords' contribution is becoming insufficient for tenants in the current environment. The landlords at the same time are mostly cash strapped and unable to provide substantial contribution. The parties typically try to find a middle ground with long 50% rent free periods, where the other 50% is used by the tenant to finance the fit out. The result is that the period of exposition of a newly-built business center is growing.

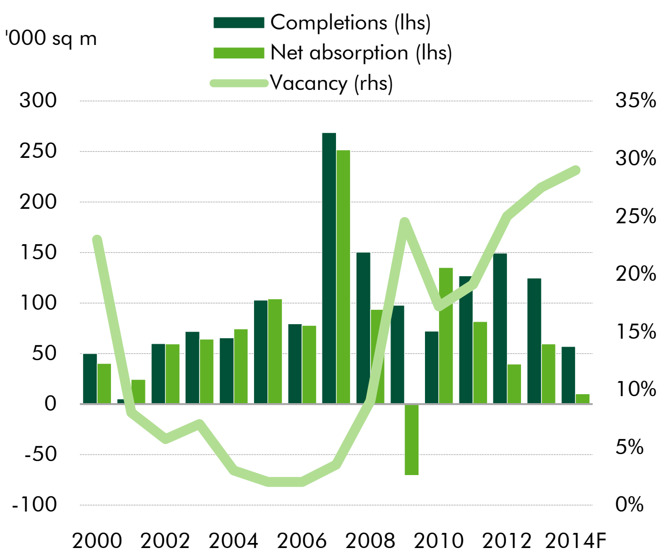
The situation is, however, not homogeneous across the board. Vacancy rates vary significantly among office properties. The most successful and professionally marketed and managed business centers with flexible rental policy and especially substantial landlord's fit out contributions are nearly fully occupied, while some predominantly new deliveries as well as older & especially poorly-located buildings can stay mostly or significantly vacant for substantial periods of time. The growing polarization of vacancy between business centers is distinct feature of the current market.

KYIV ANNUAL DEVELOPMENT COMPLETIONS AND TOTAL COMPETITIVE STOCK ('000 SQ M)



F-forecast
Source: CBRE Ukraine

NEW SUPPLY, NET ABSORPTION AND VACANCY RATE



F – forecast
lhs – left hand side
rhs – right hand side
Source: CBRE Ukraine

The prime rent declined by 10% mainly due to a sharp devaluation of the Hryvnia over the first three months of 2014. As rental rates are typically quoted in USD per sq m per month (rarely in EUR), landlords mostly had to provide immediate concessions, with the resulting stabilized headline rent leveling out at ca. $30/sq m/month (triple net). Due to the undisclosed nature of the market, lease terms are always confidential, with actual or effective deal terms often going substantially below the benchmark levels. As a result, there is significant gap between asking and transaction terms.

KYIV OFFICE ASKING BASE RENTAL RANGE, BY LOCATION AS OF Q2 2014 (USD/SQ M/MONTH)

Class A location	Quality A	Quality B
Prime	$30-42	$20-26
Pechersk	$32-35	$24-28
Podil	$25-30	$19-25
Shevchenkivskyi	-	$22-30
Olimpijskyi	$25-35	$14-25
Class B location	Quality A	Quality B
CBD fringe	$15-36	$12-20
Class C location	Quality A	Quality B
Non-central area	$22-24	$8-18

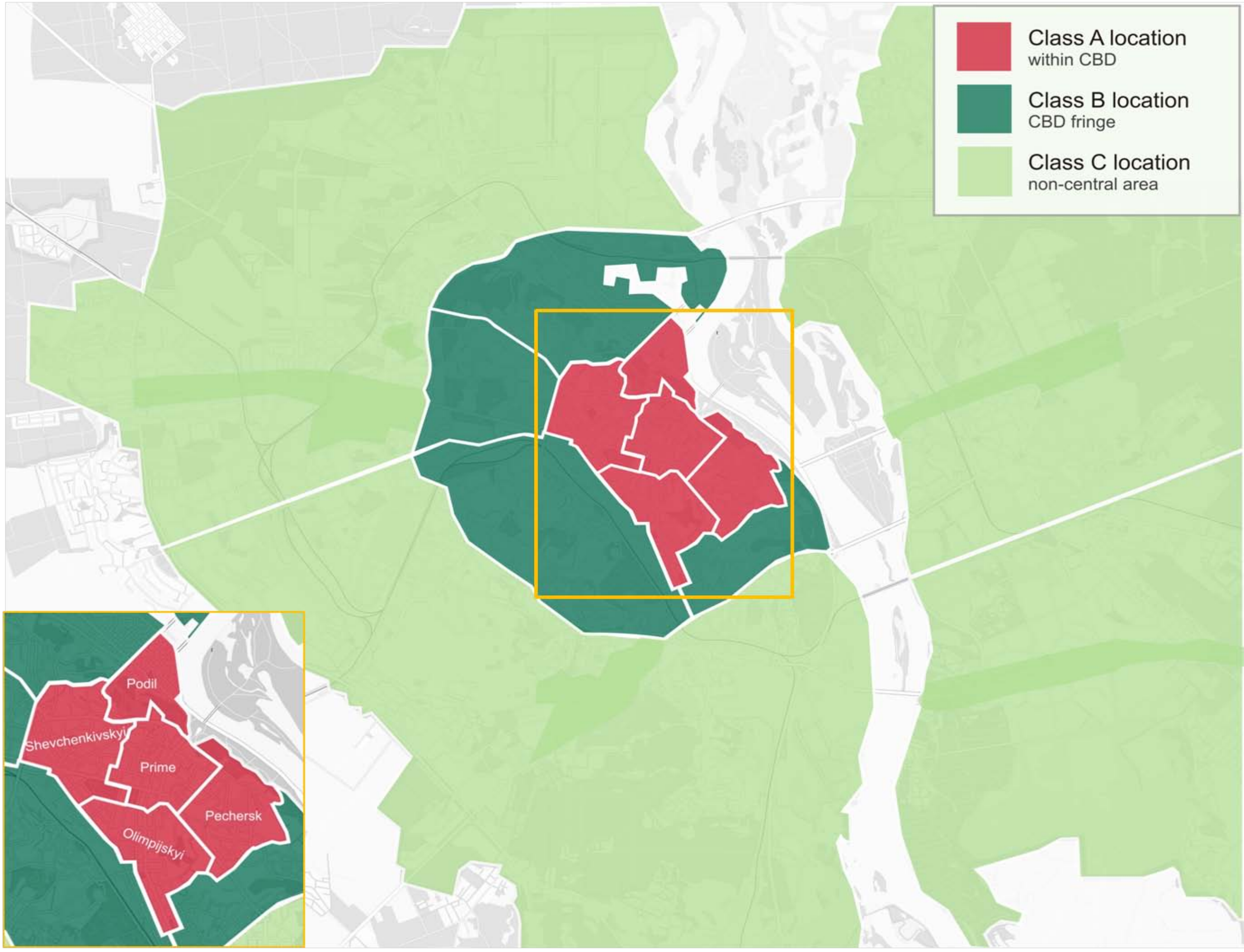
Source: CBRE Ukraine

Rent discounts in some cases in non-prime market segments reached up to 30% along with a wide range of other incentives, typically being flexible surrender of space or break options. As of the end of June, asking rents for modern class B premises fluctuated in the $8-$30/sq m/month (triple net) range. Significant variations in rental performance on the secondary market are attributed predominantly to the location factor.

YIELDS

After three years of relative stability, prime notional yield for the office segment went up by 1pp to 14% over H1 2014 in view of growing country risk of Ukraine. The indicator is likely to remain stable till the end of 2014, provided economic and political situation does not deteriorate.

KYIV OFFICE SUBMARKETS



Source: CBRE Ukraine

OUTLOOK

In the medium term perspective the situation on the office market is likely to remain complicated, as demand – in particular employment – remains constrained under uncertain macro-economic and politic conditions. Therefore, occupiers are expected to continue the upgrade trend without expanding the premises. Better location and better building for less money will remain the main relocation motivation. Existing non-professional stock (converted apartments, industrial loft open spaces without office lobby, old Soviet-era administrative buildings, etc.) will continue to be the donors of office occupiers who can now afford a proper office space.

Until the end of 2014 the upper limit of rents – i.e. prime rent - is likely to remain broadly unchanged, as demand for the best quality premises is relatively small and stable. The lower bracket will also likely be stable, as the market is witnessing unprecedented cases when rental rates for non-central class B properties reached the floor at $8/sq m/month. The most likely scenario is that fluctuations will be observed inside the existing range of rental rates with a downwards trend.

Recent data shows that new supply may hit its cyclic low in 2-3 years after the whole professional office space currently under construction (around 130,000 sq m) is delivered to the market. With high probability, new large projects will not be stared for several years due to the high vacancy rate, weak demand and virtual absence of financing. On the one hand, future shortage of new supply against the background of high vacancy rates will help to fill existing modern business centers. At the same time, the highly competitive environment will accelerate obsolescence of lower-quality properties - both in terms of location and building parameters. As a result, the market will become more mature, with the stage set for more sustainable development projects, able to withstand long-term competition and market swings.

DEFINITIONS (in alphabetical order)

CBD – central business district

Leasing Activity – represents the total floor space 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 transaction flow is very limited or made up of unusual one-off transactions. 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 floor space 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 transactions (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**

CONTACTS

For more information regarding the Market Review, please contact:

CBRE | Ukraine
Expandia LLC
4 M. Hrinchenka St.,
Kyiv 03680
t: +38-044-390-00-00
e: ukraine@cbre.ua

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

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

Maryna Gavrylenko
Head of Research
e: maryna.gavrylenko@cbre.ua