RESEARCH REPORT
Kyiv Office

CBRE | Ukraine

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2014

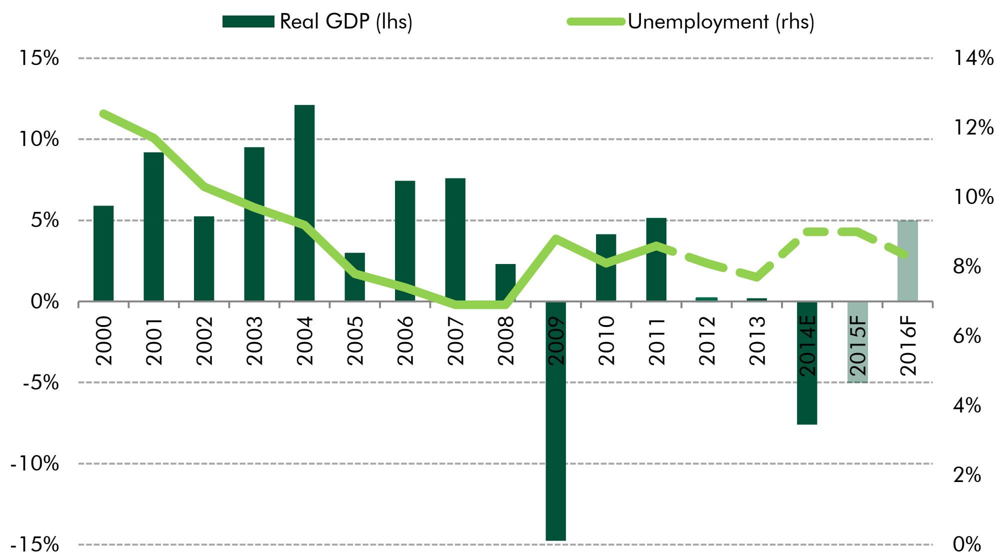
HOT TOPICS

- Weak demand: take-up fell almost twice compared to 2013
- Reduction in development activity: speculative market saw a twofold decrease year-on-year in new supply - around 56,700 sq m of office premises
- Record high vacancy rate: average vacancy reached approximately 30% (+2.5 pp from Q4 2013) on the back of new supply and weak net absorption
- Drop in rental rates: indicative prime rent declined to $25 per sq m/month (triple net) from $33 per sq m/month at the end of 2013 as the result of a sharp devaluation of the national currency

FUNDAMENTALS

Office market remained constrained in 2014 for obvious reasons of a military conflict in the East of the country and the resulting decline in economic indicators and business climate as such. The ongoing conflict added to the political instability that started in November 2013 put the first signs of Ukrainian economy improvement on hold. According to the State Statistics Committee, reduction in the real GDP[1] was only gaining momentum over first nine months of the year: the indicator fell from -1.2% in Q1 to -5.3% in Q3. Initial projections indicated that the annual real GDP is expected to drop by 7%-9%[2] y-o-y. As of January 2015, the real GDP is forecast to decline by 2%-5% in 2015, with the beginning economic recovery expected in 2016. With regards to the unemployment rate - one of the major external factors affecting the office segment - the percentage of people actively looking for a job according to the methods of the International Labor Organization (ILO) was estimated at ca. 9% in 2014 compared to 7.7% in 2013. Forecast for 2015 stands at 9% as well.

REAL GDP GROWTH AND UNEMPLOYMENT IN UKRAINE



lhs – left hand scale
rhs – right hand scale
E – estimation
F – forecast
Source: State Statistics Committee
Forecast - Oxford Economics

Another study displaying companies' hiring expectations shows that the percentage of companies interested in expanding their staff has been declining since Q3 2013, reflecting decreased business confidence. In Q1 2014 the share of companies planning staff reductions exceeded the percentage of those interested in expanding their staff – 23.7% and 13.6%, respectively. Moreover, by the end of 2014, this trend has strengthened and the gap between the indicators has grown from 10 pp to 12 pp - 25.3% and 13.3%, respectively.

[1] - real GDP, excluding the temporarily occupied territory of the Autonomous Republic of Crimea and Sevastopol

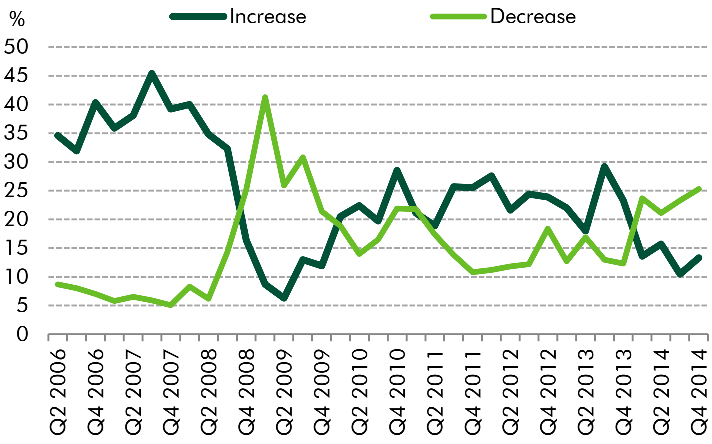
[2] - according to the latest forecasts of IMF, EBRD, World Bank, Ministry of Economic Development and Trade, NBU

DEMAND

During 2014 leasing activity has been mostly driven by relocation, consolidation and renegotiation deals. Against the background of unfavorable macroeconomic factors, demand for office premises decreased almost twice in 2014. According to preliminary estimates, take-up did not exceed 50,000 sq m by year end results. Alongside transaction volume, deal size decreased as well. Whereas in 2013 three largest transactions ranged from 5,400 sq m to 7,000 sq m took place, in 2014 the largest ones were slightly above 2,000 sq m. Among the most notable transactions are KPMG relocation to the newly built Senator Business Center and Boeing entering the market locating in Artem Business Center.

Take-up distribution by the industry indicates that IT sector, which was gaining momentum over the past three years, in 2014 noticeably slowed downed the demand for office space. Such phenomenon can be explained by the assumption that the bulk of the IT companies have satisfied their needs for office space by the end of 2013 and did not experience substantial growth at this stage. There are noticeably fewer companies in this sector that are still looking for suitable premises. As for the leaders of 2014, such industries as Manufacturing, Industrial & Energy, Wholesale & Retail trade, and Business Services increased their share in the total take-up structure to 23.3% (+12.1 pp y-o-y), 22.3% (+19.6 pp y-o-y), and 16.9% (+5.3 pp y-o-y), respectively. However, it should be noted that in view of a noticeably decreased take-up volume during 2014, only several relatively large transactions helped these sectors to achieve a notable increase in their share of total demand.

KYIV CORPORATE HIRING EXPECTATIONS OVER THE NEXT 12 MONTHS



F-forecast
Source: CBRE Ukraine

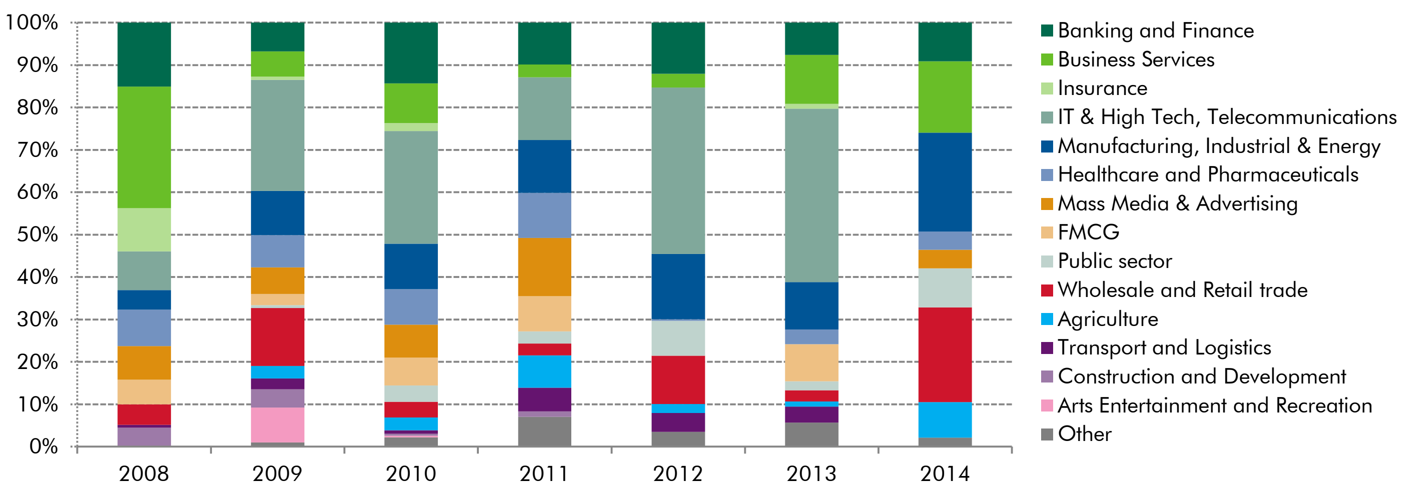
KEY OFFICE LEASE TRANSACTIONS IN 2014

OCCUPIER	INDUSTRY	PROPERTY	SUBMARKET	sq m
KPMG	Business Services	Senator	Pechersk	2,146
Boeing	Manufacturing, Industrial and Energy	Artem	Shevchevkivskyi	2,100
Glencore Ukraine/ Serna	Agriculture	Toronto	Olimpijskyi	1,950
n/a	n/a	DeVision	Podil	1,800
OSCE	Public Sector	Business Center	Shevchenkivskyi	1,510
SDL Tridion Development Lab	Business Services	SP Hall	North	1,146
Media Invest Group	Mass Media and Advertising	Eurasia	Olimpijskyi	1,016
OSCE	Public Sector	Merx 2	South	930

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

ANNUAL TAKE-UP BY INDUSTRY (% SHARE)



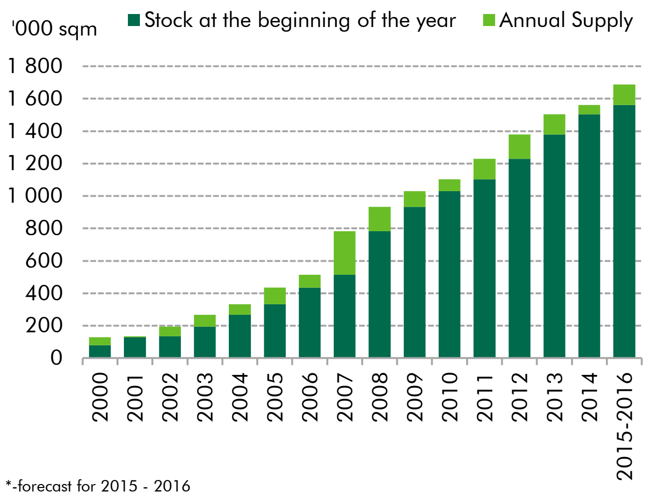
Source: CBRE Ukraine

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 Tower	AB	West	Cimbrorum Holdings LLC	95,000	2015-2016

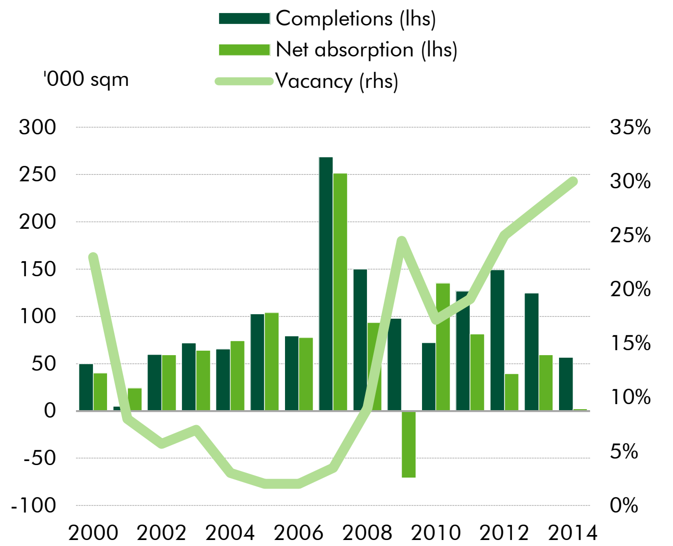
* according to developers' announcements
Source: CBRE Ukraine

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



*-forecast for 2015 - 2016
Source: CBRE Ukraine

NEW SUPPLY, NET ABSORPTION AND VACANCY RATE



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

SUPPLY

In terms of supply the office market has not witnessed significant changes during the last six months of 2014, as all announced for the whole of the year new properties entered the market in the first half of the year. Three modern business centers were delivered in Q1 are IQ Business Center (30,000 sq m GLA), Sigma (17,900 sq m GLA), and Domino (8,800 sq m GLA). As a result, new supply in 2014 reached 56,700 sq m, having decreased more than twice y-o-y, with the total competitive stock reaching 1.56 mln sq m. Around 130,000 sq m of the projects currently under construction and planned for delivery in 2015-2016 still constitute 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 increase further, especially as new properties approach commissioning.

VACANCY AND RENTS

The total vacancy rate remained high by the end of 2014, having increased by 2.5 pp over the year and reached approximately 30%. This is the record level in the history of Kyiv market. Continuing the trend evident throughout 2013, the bulk of vacant premises concentrated in newly built properties, which are fully or almost fully vacant, as well as in poor quality buildings typically located outside CBD. According to Q4 results two submarkets in CBD most in demand were Olimpijskyi and Podil. Olimpijskyi submarket demonstrated moderate decline in vacancy for the third year in a row.

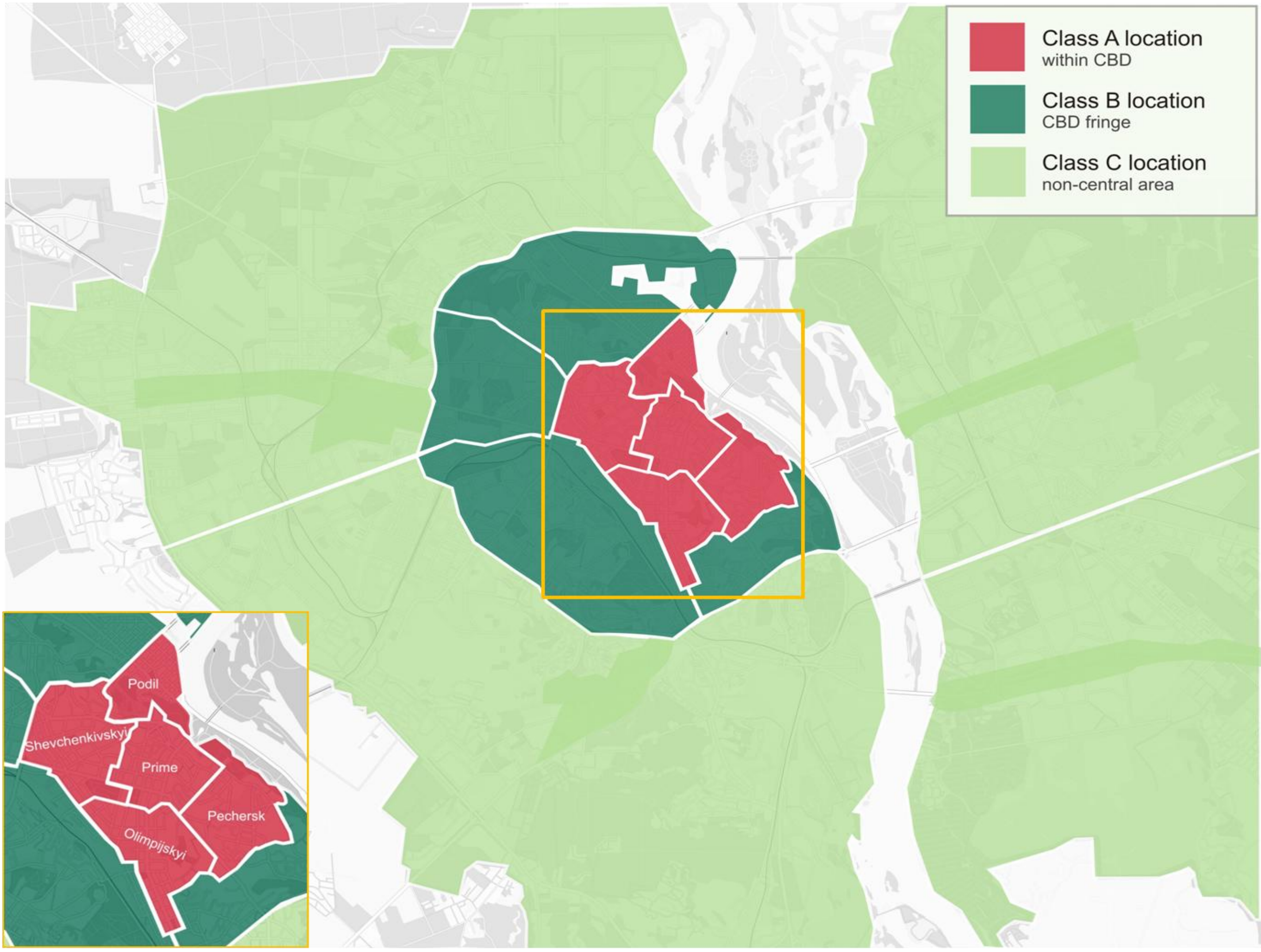
By the end of Q4, the submarket indicator reached about 23% (-3.3 pp y-o-y). The vacancy rate in Podil stabilized at around 10%, which is almost the same level as in 2013. Another notable trend is an increase in vacancy within Prime (+16.5 pp y-o-y) and CBD fringe (+11.1 pp y-o-y) areas. Against the background of absence of new supply the volume growth of available office space on the most prestigious submarket indicates tenants began to relocate from the more to the less expensive premises and/or reduce the occupied space in 2014. A sharp increase in vacant premises within CBD fringe can partly be explained by the delivery of IQ Business Center (30,000 sq m GLA). The vacancy rate in the non-central area remained consistently high at a 35% level (+1.1 pp y-o-y). On a positive note, net absorption is still albeit nominally positive, which means that the average vacancy rate in 2014 grew mostly due to new supply rather than business contraction, i.e. reduction of office premises and staff.

KYIV OFFICE ASKING BASE RENTAL RANGE, BY LOCATION AS OF Q4 2014 (USD/SQ M/MONTH)

Class A location	Quality A	Quality B	Vacancy Q4 2013	Vacancy Q4 2014
Prime	$25-36	$15-25	6.8%	23.3%
Pechersk	$22-30	$20-23	38.9%	45.5%
Podil	$22-28	$17-25	11.4%	9.5%
Shevchenkivskyi	-	$17-25	22.3%	27.7%
Olimpijskyi	$22-32	$15-26	26.2%	22.9%
Class B location	Quality A	Quality B	Vacancy	Vacancy
CBD fringe	$15-28	$12-20	14.7%	25.8%
Class C location	Quality A	Quality B	Vacancy	Vacancy
Non-central area	$20-23	$8-15	33.9%	35.0%

Source: CBRE Ukraine

KYIV OFFICE SUBMARKETS



Source: CBRE Ukraine

Due to continuing devaluation of the Ukrainian Hryvnia the indicative prime rent in USD terms decreased further by 17% over the last six months of 2014. For the whole year the indicator weakened by around 25%. By the end of December, the indicative prime rent stabilized at $25/sq m/month (triple net). However, transactions around the prime rent benchmark are still rare. Generally, across the board, rents have suffered 20% up to 40% drop in USD equivalent, where prime properties have suffered the least, and less competitive properties have suffered more. Over 2014, the upper limits of secondary rents have decreased from about $30 to $20, in few cases even to $17 and under. As a result, office rent transactions not denominated in USD (or Euro) is starting to be practiced. More and more landlords are becoming flexible and competitive not only in terms of base rent but also other concessions, such as fit out contribution, free rent concession, more flexibility with early termination/contraction options, and the like. Still, prime properties are still reluctant to provide long-term discounts but rather endeavor to offer short-term rent concessions. The spread between open market asking terms and final deal terms keeps growing, just like the spread between the headline and effective rent.

After a long period of stability, operating expense (OPEX) levels have also experienced downward pressure during 2014, albeit suffering less than rents. In most cases OPEX'es are still non-transparent and often times overstated (and may include hidden additional rent). The average market level in USD equivalent decreased in Q4 from $6.5 to $6.0 (net of VAT). Cases of OPEX quoted in UAH are still rare.

YIELDS

No investment transactions were completed in the Kyiv market in 2014. In view of economic turmoil stirred up by tensions in the East, investment sentiment already exposed to rising uncertainty turned into decreasing willingness to commit capital to the market. Prime notional yields in the office segment inched upwards by 0.5% over Q1 2014 and remained stable at 13.5% by the end of the year. The indicator is likely to remain stable in 2015, provided economic and political situation does not deteriorate. Realistic potential transaction yield levels have, however, moved up to the cost of equity levels, as borrowing is out of the question and USD/EUR rental peg has been undermined.

OUTLOOK

Given uncertainty over duration or intensity of the conflict in the East, the market situation remains constrained with no clear long term strategy for most players. As a result, our H1 2014 demand & supply forecast remains largely unchanged. These two market components are relatively predictable in the current environment:

- Demand remains constrained in view of the macro-economic and political conditions. Therefore, occupiers may continue the upgrading 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 proper office space.

- 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 likelihood, 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 rates will help fill existing modern business centres; 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.

The situation with rental rates and rents as such is more complicated due to a dramatic decline in the Ukrainian Hryvnia value. Therefore, as of January, two possible scenarios can be predicted:

- Further escalation of the Eastern conflict may result in further rental decreases in USD terms and, as a result, UAH denomination of rental rates will expand. It is difficult to predict the level of decline in rental rates in USD terms.

- In the more sparing and preferred scenario, under which the military conflict will not grow or preferably will be contained, the rates may see further gradual reduction but should stabilize during 2015 with the prime effective USD rate somewhat upwards of $20/sq m/month.

Notwithstanding all negatives of present days, businesses in Kyiv are operating in a reasonably normal mode, with the market at large being in expectation of an end to the conflict. There is a market-wide consensus that the end of conflict will mark a rather immediate beginning of recovery. Macro assistance from the IMF and other individual country donors coupled with reforms required by these international lenders and linked to this stepped assistance are expected to produced the required volume of positive change on which solid economic base can be founded, once 'business as usual' has been restored.

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**

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