RESEARCH REPORT
Kyiv Office Market

CBRE | Ukraine
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H1 2015

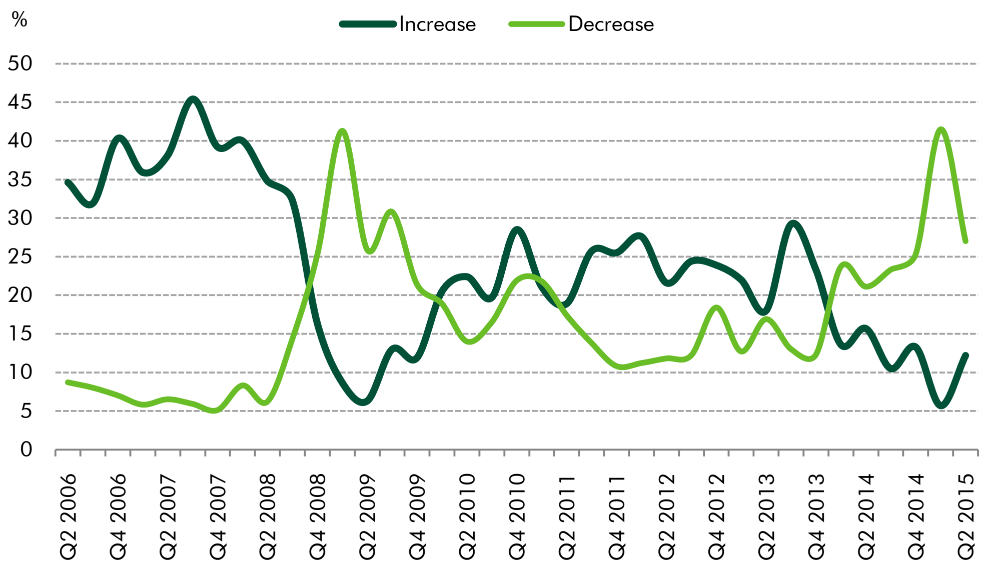
HOT TOPICS

- Sluggish occupier demand supported by relocations and renegotiations
- Constantly rising new supply: development completions amounted to c.a. 57,000 sq m as of the end of H1 2015, matching the indicator for the same period last year
- Voids keep trending upwards due to new deliveries, accompanied by stagnant demand: average market vacancy reached 32.9% (+1.9 pp from Q4 2014)
- Weakening rents on the back of another spike of currency depreciation: benchmark prime rent declined by 8% on average from $25 to $23 per sq m/month (triple net)

FUNDAMENTALS

The Ukrainian economy continued to display the negative trend over the course of H1 2015. While real GDP fell by 17.2% y-o-y in Q1 2015, further decline of the indicator slowed down to 14.7% y-o-y in Q2 2015. According to the forecasts by leading international and government organizations[1], the economy is expected to shrink by 8% – 10% by the end of 2015. The overall negative dynamics are caused by deep decline of major sectors: index of key industries decelerated by 19.0% y-o-y during January – July 2015, with construction (-26.7% y-o-y) and retail (-23.6% y-o-y) posting the sharpest drops. On the other hand, the annual real GDP growth is projected to gain momentum reaching 0.5% – 3% in 2016. Risks to the recovery are still considerable due to high exposure to the troubled Eastern conflict zone.

KYIV CORPORATE HIRING EXPECTATIONS OVER THE NEXT 12 MONTHS



Source: National Bank of Ukraine

Weak economic background is the foremost factor shaping the trajectory of the business activity. During H1 2015 key business players were predominantly concerned with rigorous cost-management thereby downsizing their staff requirements. According to the latest survey of the National Bank of Ukraine, the share of companies planning staff reductions in the next twelve months in Kyiv increased from 25.3% to 27.0%, while the percentage of firms willing to expand their employment declined from 13.3% to 12.2% over H1 2015.

[1] - IMF, EBRD, World Bank, Ministry of Economic Development and Trade, NBU

DEMAND

Depressed economic fundamentals continued to hamper office market performance in H1 2015. Uncertainty over the future negatively affected corporate decision-making, with few lease transactions materializing year-to-date. At the same time, the demand for office space did not deteriorate and stayed almost flat during H1 2015 compared to the same period last year. Estimated take-up volume stood at the level seen in H1 2014 reaching approximately 30,000 sq m. On the back of week business activity, occupier demand was still primarily driven by cost reductions and relocations with virtual absence of expansion-based requirements. Among rare expansion decisions, Nova Poshta, logistics delivery operator, extended its space by 1,500 sq m in Europa business centre.

By far and large, letting activity was fuelled by the fact that rents declined remarkably, prompting either relocation or most commonly regearing. Among the few relocations that took place, the largest deals were in the 1,500 – 3,000 sq m range. For instance, Noosphere, IT&High tech company, leased approximately 3,100 sq m in Baroque Business Centre within Prime submarket.

Noteworthy, for those tenants that were searching for better terms or/and quality, leasing space in the newly-delivered office schemes with high vacancy and broad menu of incentives appeared like typically attractive options. However, in an effort to protect occupancy and income streams, landlords granted significant rent reductions to existing tenants who were intending to move. For that very reason quite a few planned relocations were canceled as a result of inability of relocation-based scenario to compete financially with the *stay* option.

SUPPLY

Although the corporate sentiment remained subdued, seven new office schemes were delivered onto the market over the course of the first six months of 2015. New supply of competitive office space amounted to c.a. 57,000 sq m year-to-date. Total competitive stock thus increased slightly to c.a. 1.63 mln sq m as of the end of June 2015. New office buildings were predominantly small and medium scale B class properties. Geographically, half of that volume was located within CBD in Olimpiyskyi and Podil submarkets. At this point, constantly growing supply of office space translated almost entirely into rising vacancy, thereby pushing competition even further up among new and existing business centers.

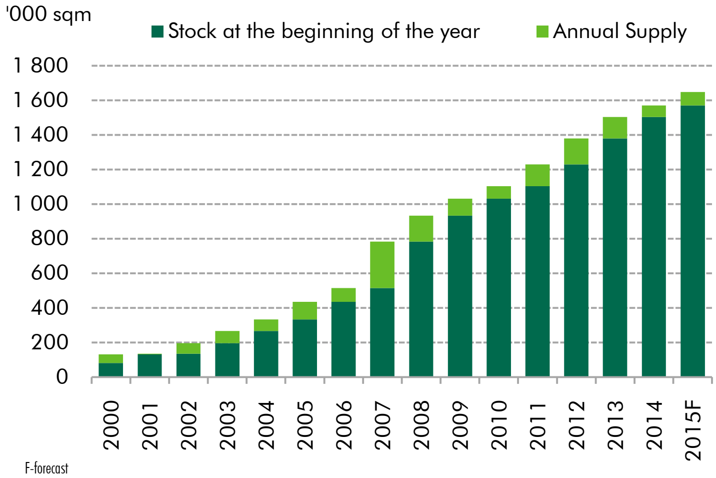
KEY OFFICE LEASE TRANSACTIONS IN H1 2015

OCCUPIER	INDUSTRY	PROPERTY	SUBMARKET	sq m
Noosphere	IT and High Tech	Baroque	Prime	3,100
Nova Poshta	Transport and Logistics	Europa	NC-SW	1,520
Kuehne + Nagel	Transport and Logistics	Office Building	NC-NW	1,000
Bieirsdorf	Healthcare and Pharmaceuticals	SP Hall	North	750
Lohika	IT and High Tech	Carnegie Center	Pechersk	700

Note: submarkets are defined according to the new central business district (CBD) delineation introduced by CBRE in September 2011Prime, 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

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



F-forecast
Source: CBRE Ukraine

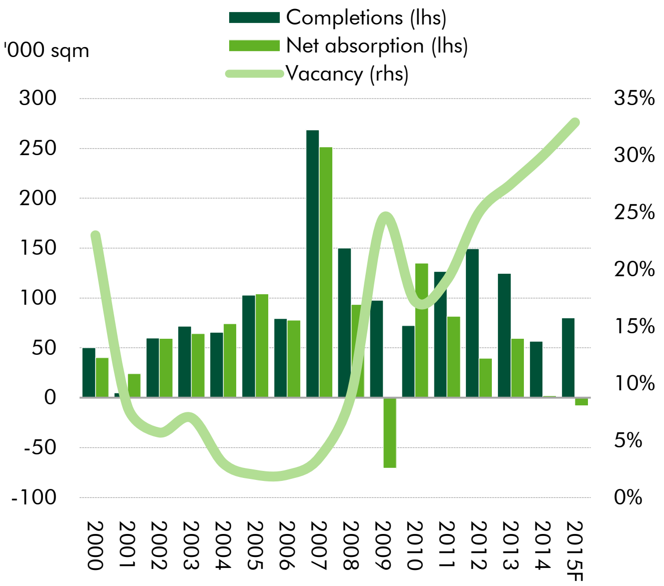
Looking at the pipelined projects, approximately 23,000 sq m of new supply is expected to enter the market in the second half of the year, thus bringing the total figure of new supply to 78,800 sq m (+20.7% y-o-y). Notwithstanding the fact that the construction pace decelerated significantly, ca. 160,000 sq m of new office space is announced for completion in 2016-2017, 53,000 sq m of which is likely to be translated into actual completions in 2016. The construction works on the large scale mixed use development Sky Tower (95,000 sq m GLA) and business center (10,800 sq m) within shopping and office center Retroville were mostly halted, with delivery expected not earlier than 2017. Notably, some developers of operating business centers (Irva Business Centre, Protasov Business Park in particular) are planning building extensions in the near future.

NEW SUPPLY IN 2015 (MAJOR SCHEMES)*

NAME	CLASS	ADDRESS	SUBMARKET	SUBMARKET	DEVELOPER	Office GLA, sq m	DELIVERY
Office building	BA	Zhylyanska St., 32/36	CBD	Olimpiiskyi	Enerhobudlizynh	3,100	H1 2015
Office building	BA	Verhniy Val St., 6-10	CBD	Podil	Local	10,000	H1 2015
LB Bussines Center	BA	Laboratornyi Lane, 12	CBD	Olimpiiskyi	Local	9,900	H1 2015
Forum West Side (Phase I)	BB	Oleny Telihy St., 6	CBD-fringe	West	Forum Management Group	5,000	H1 2015
Bussines Center	BA	Horkoho St., 46-46A	CBD	Olimpiiskyi	Local	7,500	H1 2015
Office building	BC	Holosiivskyi Ave.	Non-central location	NC-SW	Local	15,000	H1 2015
Office building	BB	Novovokzalna St., 3	CBD-fringe	South-West	Local	6,800	H1 2015
Lahoda (Phase III)	BB	Polyova St., 21	CBD-fringe	South-West	Kaskad Impex	9,000	H2 2015
Red Star	BC	Chervonozoryanyi Ave., 56	Non-central location	NC-SW	Local	12,500	H2 2015

* according to developers' announcements
Source: CBRE Ukraine

NEW SUPPLY, NET ABSORPTION AND VACANCY RATE



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

Although the corporate sentiment remained subdued, seven new office schemes were delivered onto the market over the course of the first six months of 2015. New supply of competitive office space amounted to c.a. 57,000 sq m year-to-date. Total competitive stock thus increased slightly to c.a. 1.63 mln sq m as of the end of June 2015. New office buildings were predominantly small and medium scale B class properties. Geographically, half of that volume was located within CBD in Olimpiyskyi and Podil submarkets. At this point, constantly growing supply of office space translated almost entirely into rising vacancy, thereby pushing competition even further up among new and existing business centers.

VACANCY AND RENTS

Due to persistent uncertainty surrounding business activity even in the short-term, corporate occupiers were extremely cautious with respect to real estate decisions. There were three basic strategic options available to tenants with cost-cutting aims in mind: relocation, renegotiation of existing terms typically combined with space contraction. Therefore, low levels of take-up in recent months had a negligible impact on the vacancy rate. While deep economic downturn continued to stifle demand for office premises, gradually rising supply did not help decrease vacancy, which grew to 32.9% (+1.9 pp) across the market as of the end of Q2 2015.

However, the average market vacancy rate hides significant variations at the submarket level. Core central locations including Prime and Podil tend to have lower vacancy rates - 21.4 % and (19.2 %) respectively – than the city on average. These two submarkets displayed completely opposite dynamics. Prime submarket experienced declining vacancy (-1.9 pp) supported by the absence of new supply and tenants' desire to upgrade quality and location under the conditions of bargain deals in recent six months. At the same time the sharpest percentage increase in vacancy was recorded in the Podil submarket (+9.7 pp) during H1 2015, due to new space deliveries coupled with generally lower volume of supply in the submarket. Shevchenkivskyi and Pechersk submarkets – -0.5 pp and -2.6 pp – also posted declining vacancy over the course of H1 2015, but alas Pechersk was still maintaining the highest vacancy rate of 42.9% across the market. Availability in the CBD fringe (class B location) also decreased slightly (-2.2 pp) from Q4 2014, notwithstanding several new deliveries in the submarket. Generally, market showed tentative preconditions for deceleration in vacancy growth in the CBD and close to the CBD area. Quite the contrary, availability in non-central submarket rose consistently during the last six consecutive quarters reaching 39.6% as of the end of Q2 2015. This is partly due to new deliveries; however, the biggest impact was due to in-city migration to better location and quality on reduced rental levels.

Due to the February spike in devaluation of national currency, albeit substantially reversed in the March, rental rates were subject to further downward pressure. The indicative prime rent declined by 8% on average from $25 to $23 per sq m/month (triple net) during the first quarter, maintaining stability through the end of Q2 2015. Nevertheless, the upper limit of the asking rental range for A class office space went down on average 15-20% from $32-$36 at the end of 2014 to $28-$30. Secondary buildings and locations have seen 20%-40% rental declines over the first six months of 2015. The combination of gradually rising vacancy and falling rents provided grounds for beneficial relocation decisions, in particular, for those occupiers who managed to secure long term lease contracts.

KYIV OFFICE ASKING BASE RENTAL RANGE, BY LOCATION AS OF Q2 2015 (USD/SQ M/MONTH)

Class A location	Quality A	Quality B	Vacancy Q4 2014	Vacancy Q2 2015
Prime	$23-28	$16-22	23.3%	21.4%
Pechersk	$20-30	$15-20	45.5%	42.9%
Podil	$18-25	$15-20	9.5%	19.2%
Shevchenkivskyi	-	$7-20	27.7%	27.2%
Olimpijskyi	$16-30	$10-20	22.9%	27.2%
Class B location	Quality A	Quality B	Vacancy	Vacancy
CBD fringe	$18-26	$7-20	25.8%	23.6%
Class C location	Quality A	Quality B	Vacancy	Vacancy
Non-central area	$16-18	$7-12	35.0%	39.6%

Source: CBRE Ukraine

KYIV OFFICE SUBMARKETS AND NEW SUPPLY DISTRIBUTION

Source: CBRE Ukraine

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YIELDS

The office market has not witnessed any notable transactions during H1 2015 as economic and geopolitical challenges rattled investors' confidence. Estimated prime yield stood flat at 13.5% in the office segment during the first six months of 2015. As economic fundamentals are projected to remain weak until the end of the year, we expect prime yields to remain unchanged. Business confidence recovery is a necessary prerequisite for a pick-up in investment activity, which cannot be realistically expected until the second half of 2016, when the economy is expected to start displaying signs of stabilization and, perhaps, gradual recovery.

OUTLOOK

While economic activity was stagnant over the few recent months, signs of gradual recovery are expected towards the end of the year. Corporate occupiers, however, will remain cautious until there is more predictability with the macroeconomic environment. Leasing activity will be driven for the most part by relocations and renegotiations, with no expansions decisions expansion trend expected until the end of the year. Tangible positive changes in business activity and demand for office premises can be expected in the latter part of 2016. Although market fundamentals remain weak to support additions of new space, another c.a. 23,000 sq m within two new office buildings are expected to enter the market in H2 2015.

As a result, new supply of office space will reach 78,800 sq m by the year end. Minor increase in average market vacancy will follow in case currently announced completions do take place this year. Generally, office rents for quality space are likely to remain relatively unchanged over the course of the next 6 months. We expect to see more frequent cases of extended rent-free periods or greater fit-out concessions. Particularly broad menu of incentives is attainable in the new and mostly empty office buildings.

Looking ahead, further increase in supply is expected in 2016-2017, with some 160,000 sq m of office space planned for completion. This constant increase in supply implies rising competition in the sector, pushing back recovery of rental rate and contraction of vacancy. Secondary outdated buildings will face the major impact of rising competition, while prime business centers with the best location are likely to experience declining vacancy as soon as occupiers' demand recovers. Along with the traditional leasing of office space, small and medium businesses started to see more benefits in co-working space and hot-desking. In light of the prevailing economic uncertainty, the major factor facilitating the adoption of this format is quick adaptation to tenants' employment and space requirements. However, the availability of quality co-working centers is limited, with only a handful of properties providing full set of services.

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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**