RESEARCH REPORT

Kyiv Retail Market

CBRE | Ukraine

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2014

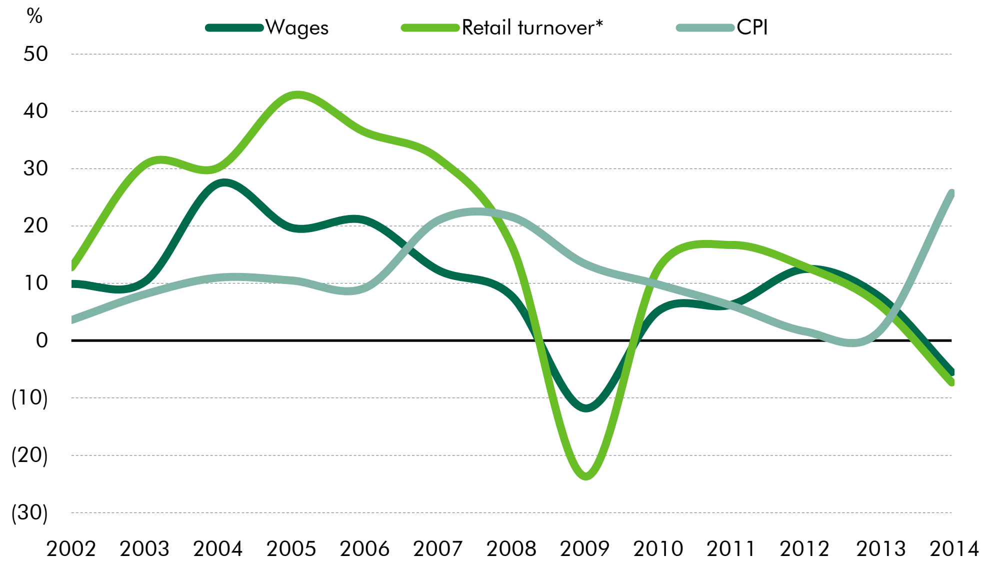
HOT TOPICS

- Fragile occupier demand with expansion plans mostly halted
- Increasing retail stock: 71,000 sq m of new supply entered the market in 2014
- Rising vacancy due to curtailed occupier demand followed by further increase in supply: prime vacancy reached 6%-8%, with secondary vacancy growing to 10%-12%
- Average 30% decline in USD-based rental rates

DEMAND

In 2014 the Ukrainian economy suffered from an economic shock caused mainly by conflict in the East and broader economic tensions with Russia. Accelerated inflation and decline in real disposable income aggravated by rising energy tariffs and increasing fiscal burden inevitably put a severe pressure on consumers' budgets. According to GfK Ukraine, Consumer Confidence Index declined by 27.7 pp during the year. Weak consumer spending translated into a sizeable decline of organized retail turnover in Kyiv during 2014 (-7.3% y-o-y).

KYIV WAGES, RETAIL TURNOVER AND CONSUMER PRICE INDEX (% CHANGE, Y-O-Y)



* - includes organized retail sales only
Source: Kyiv Statistics Office

In the same vein, retailers' demand confirmed a similar trend recorded in the prior months: retailers continued to focus on the existing stores, with expansion plans mostly halted. Majority of chain retailers closed unprofitable shops or re-evaluated their space requirements. With household budgets substantially trimmed, twelve brands left the market during the year. Ukrainian retailer Maratex, owned by Polish Empik Media & Fashion Group, closed its fashion retail chains *Esprit*, *River Island* and *OVS*. Likewise, other market exits include UK fashion brands *New Look* and *Lee Cooper Jeans*, French footwear chain *Minelli*, German brand *S.Oliver* and others.

For some players an online retail store became the preferred second option after a prime physical location, instead of a secondary located unit or a unit in a less dominant shopping centre. For example, Ukrainian luxury retailer Helen Marlen Group has launched its on-line platform by simultaneously optimizing their physical store chain. Another noteworthy online store opening of UK based retailer *Next* took place in 2014 after retailer had closed the physical retail chain in the country in the previous year. Indeed, developing online presence may be beneficial in terms of cost-cutting, as retail market is increasingly being seen as too volatile in the current macroeconomic climate. The trend, however, appears to be still in its infancy, as its impact on shopping center performance remains broadly negligible.

While generally retailers have been postponing expansion plans, Kyiv has had a number of new entries during the past year. Among most notable new entries are Spanish brand *Pedro del Hierro*, Polish brand *Sinsay*, Italian brands *Twin-Set*, *Pinko*, *Alberta Ferretti* and *Vittorio Spernanzoni*, as well as *Calzedonia* and *Intimissimi* represented by the Italian Calzedonia Group. Furthermore, Calzedonia Group revealed its plans to open the first store of mid-range fashion brand *Falconeri* and another hosiery brand *Tezenis* in the foreseeable future. In the coffee&restaurants segment the prominent events were the opening of the first German restaurant *Vapiano* and the first French bakery *Paul*. Noteworthy is also that *Peackoks* decided to make a comeback after roughly a year of absence.

SUPPLY

Notwithstanding the unfavorable economic environment, retail market witnessed the completion of two professional shopping centers in 2014. With the delivery of Atmosphera SEC (30,000 sq m GLA) and Prospekt SEC (41,000 sq m GLA), new supply of quality retail space amounted to 71,000 sq m as of the end of the year, which is the lowest indicator for the last three years. Hence, the total modern retail stock reached 880,000 sq m, while the provision rate of retail space in Kyiv increased from 287 sq m to 311 sq m per 1,000 people.

The development activity subsided considerably during the year. At the same time, the pipeline volume remained roughly flat. The delivery dates of several large shopping malls, including Respublika (135,000 sq m), Lavina Mall (115,500 sq m) and Blockbuster Mall (120,000 sq m) were [officially] postponed until 2015. The commissioning delays mirrored negative consumer sentiment and growing uncertainty among occupiers which, in turn, hamper the pace of leasing campaigns. However, some developers were not [yet] willing to lower their rent expectations in line with market trends.

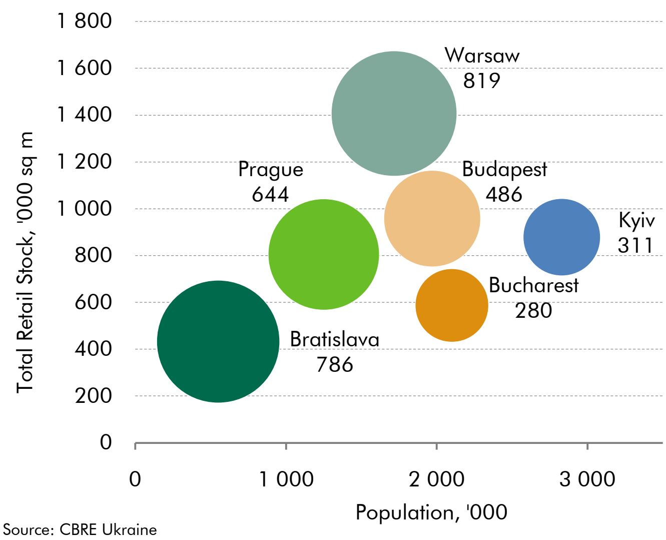
Heading into 2015, 360,000 sq of quality retail space under construction is scheduled for delivery within three superregional shopping centers. Among development starts, the construction was commenced in Lukyanivka SEC (47,000 sq m GLA) by Arricano Real Estate with completion planned for 2016. As a result, 150,000 sq m of new retail space is expected to add to the quality shopping center stock in 2016. Although a timely delivery of the whole announced volume of new retail space is doubtful, such a large volume of new additions in the nearest future is expected to increase competition in the retail sector by forcing developers to upgrade quality of their schemes in order to attract consumers and retailers.

KYIV RETAIL MARKET NEW ENTRY/EXIT

MARKET NEW ENTRY	
Pedro del Hierro	Calzedonia
Sinsay	Intimissimi
Twin-Set	Prenatal Milano
Pinko	Beyond
Alberta Ferretti	Paul
Vittorio Spernanzoni	Vapiano
Keddo	Coffee Shop Company
Sal Y Limon	Egersund Seafood
MARKET EXIT	
Minelli	Perekrestok (X5 Retail Group)
Esprit	OBI
Lee Cooper	I am
River Island	Bosco Sport*
OVS	Roberto Cavalli
New Look	S.Oliver

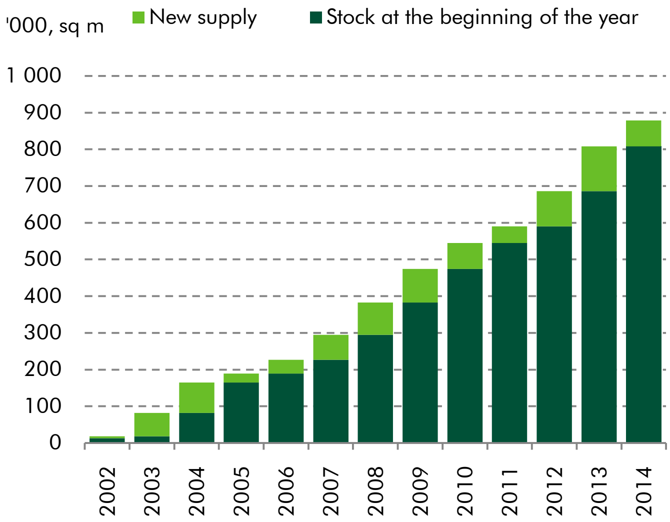
* - one brand store is present is Autonomous Republic of Crimea, temporarily occupied territory;
Source: CBRE Ukraine

RETAIL PREMISES PER 1,000 INHABITANTS IN SELECTED CEE CAPITALS IN 2014



Source: CBRE Ukraine

KYIV SHOPPING CENTER STOCK



Source: CBRE Ukraine

At the same time, given low penetration of international retailers, new shopping centers might provide grounds for cross-border market entries to operators requiring entry volume.

VACANCY AND RENTS

Due to a moderate increase in supply, accompanied by weak retailers' demand, average market vacancy grew by approximately 4pp during 2014. Although retailers were still focused on the most prosperous shopping centers with highest footfall and strong anchors, sharp decrease in sales caused mainly and compounded by rapid currency devaluation made some occupiers unable to pay rents. As retailers started optimizing their budgets, prime vacancy increased to 6%-8% by year end after three years of stability. Nonetheless, landlords who were flexible to renegotiate lease terms were able to maintain almost full occupancy and were the best performers on the market. However, the situation is more critical in secondary shopping centers with weak fundamentals. These properties witnessed stronger impact of contraction in retailer demand, as tenants were inclined to close less successful or sub-performing units in secondary schemes, sometimes reallocating to better-performing projects. As of the end of 2014 secondary vacancy stood at the range of 10%-12%, a good portion of which came from the new supply that remained partially unabsorbed.

Sharp currency devaluation and drop in sales weighed heavily on retailers' budgets, prompting occupiers to renegotiate rents. In order to keep occupancy at reasonable levels, the majority of shopping centers owners granted rent discounts or fixed the UAH/USD exchange rate at an agreed level for short periods of time. Frequent reviews, usually between 3 to 6 monthly, typically followed. Such rate 'freezes' resulted in a ca. 30% decline in USD-based rental rates. As a result, prime rents declined to the $66-$112/sq m/month range for typical mall units of 100-200 sq m. Secondary base rents varied in the $33-$56/sq m/month range for the typical gallery units.

YIELDS

No investment transactions were recorded in the retail sector over 2014, as investors' interest naturally retreated from the market in the wake of economic recession exacerbated by high country risks. Therefore, estimated prime notional yields increased by 1pp during the year to 13.5%.

Investors' activity will remain subdued as long as the tensions in the East persist and economic environment remain unfavorable. However, in view of high consumer potential coupled with low market saturation by quality shopping centers compared to other CEE markets, less risk-averse players might consider investment into retail properties in the prime end of the market by taking advantage of opportunity to earn higher risk premium once the investment climate improves. Stabilization of the situation in the East of the country is therefore fundamental to making Ukraine an attractive destination for investment, following the many positive policy changes of 2014.

REGIONS

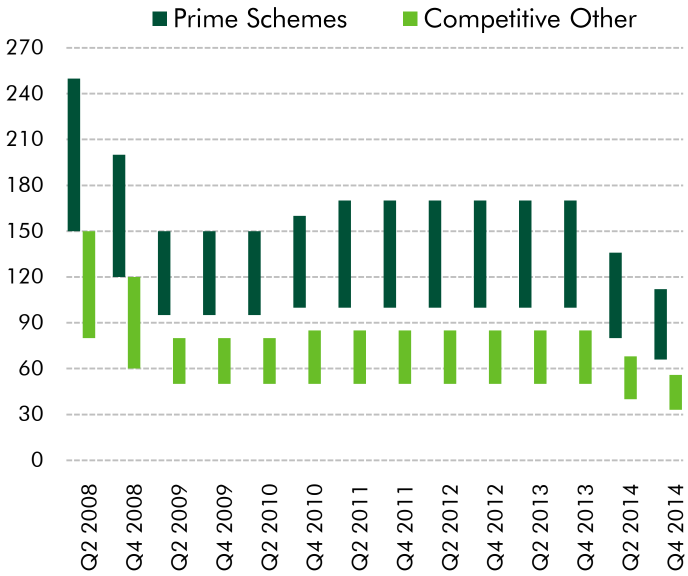
Concerns over the ongoing confrontation in the East and reduction in disposable income had a major impact on consumer willingness to spend throughout the country. The Ukrainian market experienced a 9.6 % y-o-y drop of retail turnover. Due to the protracted conflict, majority of retailers closed operations in Donetsk and Luhansk regions

KEY SHOPPING CENTERS IN PIPELINE IN 2014

NAME	LOCATION	COMPLETION/ ANNOUNCED DELIVERY
Respublika	135,000	H1 2015
Lavina	125,000	H2 2015
Blockbuster Mall	100,000	H2 2015
Retroville	80,400	H1 2016
TSUM	22,500	H2 2016
Lukyanivka	47,000	H2 2016

Source: CBRE Ukraine

BASE RENTS IN KYIV (USD/SQ M/MONTH)



Source: CBRE Ukraine

KEY RETAIL SCHEMES IN 2014-2015 IN UKRAINE

RETAIL SCHEMES DELIVERED IN 2014				
NAME	CITY	DEVELOPER	GLA, sq m	COMPLETION/ ANNOUNCED DELIVERY
Karavan (Phase III)	Dnipropetrovsk	DCH	10,200	H1 2014
Pivdenna Galereya (Phase II)	Simferopol	Arricano Real Estate	19,700	H1 2014
Port City 2	Lutsk	Investytsii i razvitie	26,000	H1 2014
Meganom (Phase II)	Simferopol	Krymska Developerska Compania	45,000	H1 2014
City Center (Phase II)	Odesa	Local developer	21,000	H1 2014
City Center Kotovskyi	Odesa	Local developer	20,100	H1 2014
Future Retail Schemes Under Construction				
Nikolskyi	Kharkiv	Bud House Group	52,000	H2 2015
Forum Lviv	Lviv	Multi Development/Bud House Group	36,000	H2 2015
Yessa (Zebra)	Odesa	Bud House Group	39,000	H2 2015
Victory Gardens (Leopolis)	Lviv	Local developer	44,500	H2 2015

Source: CBRE Ukraine

and focused on safer cities with large population and with a regional role. While conditions will remain difficult for the foreseeable future, some retailers with stronger budgets see the current downturn as an opportunity to invest for future growth. Rapidly expanding Danish homewear retailer JYSK Holding opened six new stores (750 – 1200 sq m) mostly in Western part of the country, including Lutsk, Rivne, Lviv, Khmelnytskyi, Vinnytsya, as well as Dnipropetrovsk. During the last two years the number of JYSK stores increased almost threefold since the retailer began its operation directly, without involvement of franchisee partner as it did previously. Moreover, JYSK announced its long-term plans to expand their store chain up to 150 retail units over the next 10 years. Turkish mid-range fashion retailer LC Waikiki opened its first store (1,200 sq m) out of the capital city within Riviera shopping centre in Odesa. In the coffee&restaurants segment KFC fast-food operator entered the Dnipropetrovsk market through opening the first two restaurants in SEC Most City Center and Terra SC. Ukrainian retailer MTI opened its new Lenovo store in King Cross Leopoplis center in Lviv.

While occupier demand remained curtailed, the development activity was still in motion in the regional cities. In particular, six retail schemes were commissioned in the first half of the year, including Phase II of Pivdenna Galereya SEC and Phase II of Meganom SEC in the annexed Autonomous Republic of Crimea. At the same time, no shopping centers were delivered over the last six months of the year.

As a result, annual new supply of professional retail space in the regional cities amounted to 142,000 sq m, which represents a ca. 20% decrease compared to the previous year.

However, ca. 170,000 sq m of modern retail space within four professional schemes remain under construction. Amongst the notable projects under construction are Forum Lviv (36,000 sq m GLA) and Victory Gardens (44,500 sq m GLA) in Lviv, Nikolskyi (52,000 sq m GLA) in Kharkiv and Yessa SEC (39,000 sq m GLA) in Odesa. All four schemes are planned for completion in 2015, though delays are possible.

OUTLOOK

While 2014 is in the past, many of the macroeconomic challenges and geopolitical tensions will continue to haunt the market in 2015. Thus though the year ahead is looking somewhat more predictable, the economic forecasts are little changed and still point towards a difficult year ahead.

Given the highly uneven economic growth picture in 2015, a significant recovery in consumer sentiment is still doubtful. Many consumers are dealing with declining purchasing power, which will continue to influence purchase behavior in the coming months. What this all means for property performance is that occupier demand will continue to remain sluggish as a result of predictably weak sales. National retail chains are therefore expected to maintain cautious expansion policies by expanding presence in 'sure bet' locations under 'difficult to refuse' terms.

Such attitude will largely apply to international retailers, though some are expected to put any new leases on hold, which some may be willing to take advantage of arising opportunities to occupy the best retail units for at favorable rates.

Notwithstanding the continued economic and political uncertainty, pipeline volumes are likely to remain stable albeit the construction pace will likely slow down. No new developments of shopping centers are expected to start in 2015. As a result, approximately 360,000 sq m within three retail schemes are announced for delivery by the end of 2015. However, there is high probability that delivery dates will be postponed in view of slow retailer demand. In case of timely delivery of the whole announced volume, average market vacancy will grow, particularly in secondary schemes. At the same time, rising vacancy and abundance of new supply on the market will likely force rents down, especially in lower profile shopping centers. Many landlords will have to focus their attention on encouraging existing retailers to remain in their schemes, and in many cases this will mean negotiating [ever] more flexible lease terms and covering fit-out costs for the most valued tenants.

DEFINITIONS (in alphabetical order)

Prime Rent - represents the typical "achievable" open market headline rent which an international retail chain would be expected to pay for a ground floor retail unit of up to 200 sq m commensurate with demand in each location. It is assumed that the occupier will also be agreeing to a package of incentives that is typical of the market at the time.

Prime Yield – represents the yield which an investor would receive when acquiring prime property in a prime location (CBD or major urban intersection, for example), which is fully let at current market value rents. Prime Yield should reflect 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 a hypothetical yield is quoted and is not a calculation based on particular transactions, but it is an expert opinion formed in light of market conditions, but the same criteria on building location and specifications still apply.

Shopping center - a retail property that is planned, built and managed as a single entity, comprising units and "communal" areas with a minimum gross leasable area (GLA) of 5,000 sq m and offering good quality tenant-mix, at least 50% of which should consist of chain retailers.

Under Construction - represents the total amount of gross leasable area of properties where construction has commenced on a new development or in existing properties where a major refurbishment/renovation is ongoing at the survey date. This is where site works (foundation works) have begun or the ground has been broken (excavation works). It does NOT include demolition, sites being cleared for possible development in the future, or site preparation works where no specific development plans have been approved.

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