Kyiv Office Market, H1 2017

Contraction of vacancy driven by the combination of sluggish supply and growing demand

Take-up	Forecast Completions	Average Vacancy	Prime Effective Rent
60,000 sq m (+71.4 % y-o-y)	67,000 sq m (+34.0% y-o-y)	21% (-6.5 pp YTD)	$23 per sq m/month (0% YTD)

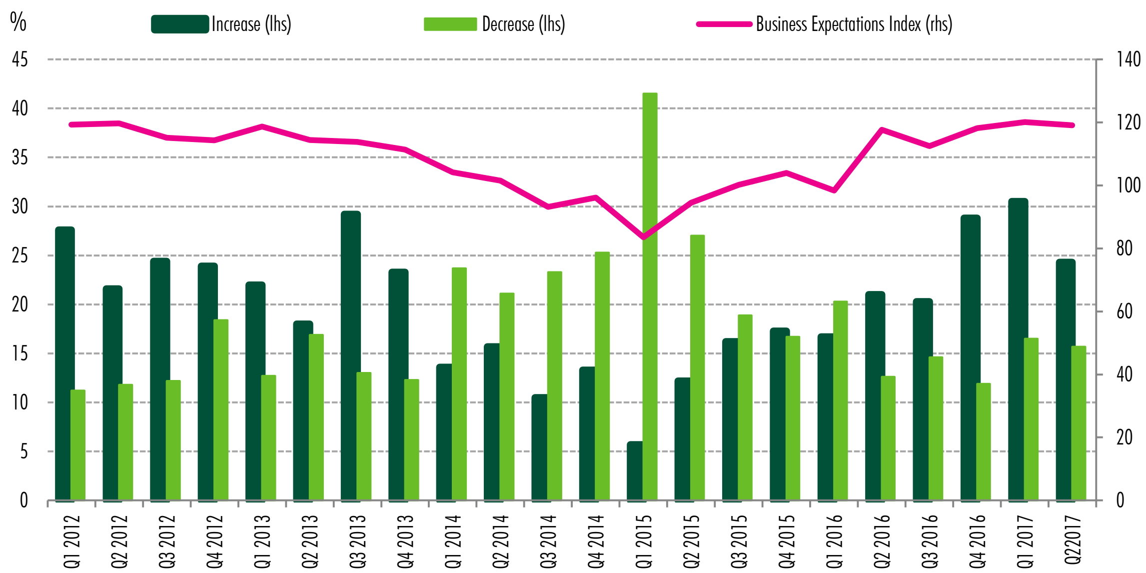
Hot Topics

- Solid take-up upturn, reaching ca. 60,000 sq m YTD (+71.4% y-o-y)
- Limited new supply in H1, with annual completions forecast to amount to ca. 67,000 sq m (+34% y-o-y)
- Contraction of vacancy: combination of sluggish supply and growing demand pushed average vacancy rate down to 21% (-6.5 pp YTD)
- Generally stable rents, with mild growth prospects on the horizon

DEMAND

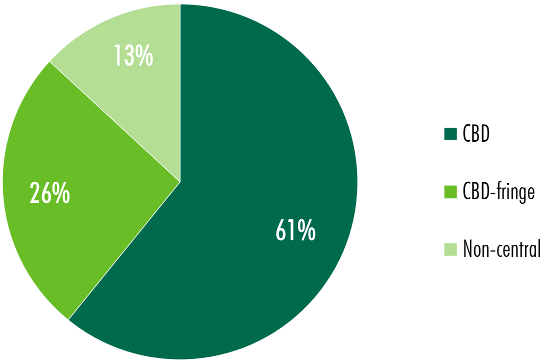
In H1 2017 business activity continued to improve, fueled by a better economic outlook. Index of Business Expectations in Kyiv posted an upward movement reaching 119.1, which is 0.9 point higher as compared to the end of 2016. Employment requirements were growing since 2016, with Unemployed-to-Job-Openings Ratio declining from 4.3 ppl per vacant position to 2.1 during the year. In H12017 the demand for employees continued to expand with only 0.7 of the unemployed per vacant position, indicating a rapidly growing employment, which is a macroeconomic 'bellweather' for the office market. Hence, due to finally visible employment gains, occupier demand for office space in Kyiv gradually rebounded.

Figure 1: Kyiv Business Expectations and Corporate Hiring Expectations Over the Next 12 Months



lhs – left hand side; rhs – right hand side
Source: National Bank of Ukraine

Figure 2: Take-up by submarkets in H1 2017

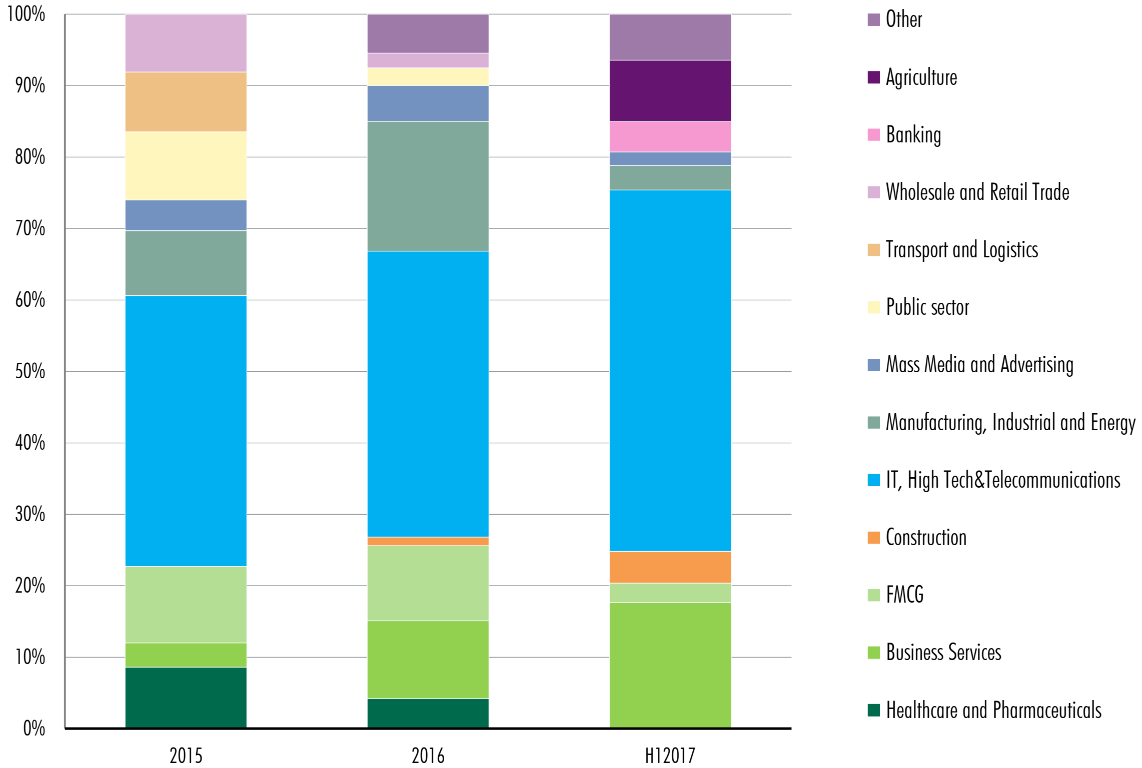


Source: CBRE Ukraine

Although the take-up was still driven by relocations accounting for more than 70% of take-up in H1 2017, the trend of an increasing number of expansion requirements along with certain cases of pre-leases became evident during H1 2017. Tenants moved to the most active city locations, as the share of CBD transactions amounted to ca. 60% of take-up.

IT, High Tech, and Telecom occupiers formed more than 50% of take-up during H12017. The trend of growing space requirements from Business Services (particularly, serviced offices and co-working operators) continued in H1 2017, with the share of leased space reaching ca. 18% (+7 pp YTD) in the total take-up. Unlike the previous year, larger leasing transactions became more frequent during the first six months of 2017. Netcracker, an IT company, leased 4,500 sq m in newly-build Astarta BC. After opening the first location in Gulliver BC in the beginning of the year, Creative Quarter, a co-working operator, leased 2,000 sq m with potential expansion to 4,000 sq m for its second location in Astarta BC. Room 8 Studio rented 4,500 sq m in Kosmopolit BC also expanding its previous space requirements. Furthermore, Grammarly, an IT company, relocated to BC Gulliver with planned expansion to 3,200 sq m. As a result, take-up volume totaled to ca. 60,000 sq m (+71.4% y-o-y) over the course of H1 2017.

Figure 3: Take-up by Industry (% share)



Source: CBRE Ukraine

Table 1: Key Office Lease Transactions in H1 2017

OCCUPIER	INDUSTRY	PROPERTY	ADDRESS	TRANSACTION TYPE	SQ M
Coworking Platforma	Business Services	Leonardo	19-21 Bohdana Khmelnytskoho St.	Expansion	2,000
Creative Quarter	Business Services	Gulliver	1A Sportyvna Sq.	Market Entry	1,200
MEGOGO	IT, High Tech & Telecommunications	Rialto	18 Novokonstantynivska	Relocation	2,000
Ring LLC	IT, High Tech & Telecommunications	Toronto Kyiv	100 Velyka Vasylkivska St.	Relocation&Expansion	1,000
Grammarly	IT, High Tech & Telecommunications	Gulliver	1A Sportyvna Sq.	Relocation&Expansion	3,200
Bosch	Manufacturing, Industrial and Energy	Silver Breeze	1A Tychyny St.	Relocation	2,000
Regus	Business Services	West Side	6 Telihy St.	Expansion	1,300
hexa	IT, High Tech & Telecommunications	Vinzavod	68 A Konstiantynivska St.	Relocation	1,000
Intellias	IT, High Tech & Telecommunications	Office building	Frunze St.	Relocation	1,000
PROMO	IT, High Tech & Telecommunications	Lagoda	21 Poliova St.	Relocation	1,000
PUMB	Banking	Spaska 5	5 Spaska St.	Relocation	2,500
Intergalbud	Construction	Office building	Nemyrovycha-Danchenko St.	Relocation	2,600
Netcracker	IT, High Tech & Telecommunications	Astarta	58 Yaroslavska St.	Relocation	4,500
Astarta	Agriculture	Astarta	58 Yaroslavska St.	Relocation&Expansion	5,000
Room 8 Studio	IT, High Tech & Telecommunications	Kosmopolit	6 Vadyma Hetmana St.	Relocation&Expansion	4,500
Creative Quarter	Business Services	Astarta	58 Yaroslavska St.	Expansion	4,000
PDF filler	IT, High Tech & Telecommunications	Parus	2 Mechnikova St.	Relocation	3,000
Sigma Software	IT, High Tech & Telecommunications	Astarta	58 Yaroslavska St.	Relocation	2,000
GIZ	Other	Panorama	20 Velyka Zhytomyrska St.	Expansion	1,300
Tonis	Media	Parus	2 Mechnikova St.	Relocation	1,100
Innovecs	IT, High Tech & Telecommunications	Premium	6 Vatslava Havela Blvd.	Expansion	2,000

Source: CBRE Ukraine

SUPPLY

In H1 2017 new supply of office space amounted to ca. 18,900 sq m in Phase I of Astarta BC (16,100 sq m GLA) and the extension of Forum Westside BC (2,800 sq m GLA). As a result, total competitive stock reached ca.1.7 mln sq m growing by 1% during January - June 2017. While in the beginning of the year the volume of new space planned for delivery was limited to just 30,000 sq m, development activity started to gain traction during first half of the year. Next phase of Astarta BC previously planned for delivery in 2018 was rescheduled to be opened in H22017, in view of strong occupier interest for the project, with ca. 60% of premises preleased in Phase I and Phase II.

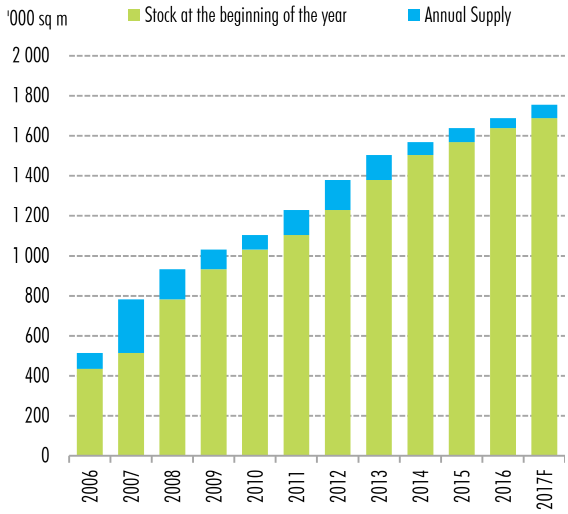
In addition, K-FUND commenced new redevelopment project UNIT City in anticipation of rising occupier demand from tech companies and start-ups. Hence, additional 20,000 sq m in Phase I of UNIT City are announced for delivery this year. Other future schemes expected to enter the market in 2017 are an office building at 1B Sahaidachnoho St. (10,000 sq m GLA) and the reconstruction of an office building at 36 Volodymyrska St. (5,200 sq m GLA). Therefore, we updated our annual forecast completions to ca. 67,000 sq m (+34% y-o-y) for 2017. In 2018 the volume of new completions is expected to amount to ca. 42,000 sq m displaying approximately 37% y-o-y decline in new deliveries.

70% of that volume is concentrated in small office buildings with ca. 2,000 – 5,000 sq m of GLA. The only larger office building planned for 2018 is a business center (11,100 sq m GLA) within the Retroville retail project developed by Stolitsa Group in a remote residential part of the city. Overall, new office supply in the course of 2017 and 2018 is going to be scant at most, which will inevitably lead to a significant reduction in vacancy and should bring about growth of rental rates.

Looking into the distribution of new office space by the quality of premises, we recorded a consistent decline in the delivery of Grade A premises during the past three years. The trend is indicative of an emerging deficit of high-quality space during 2017-2018. Only two Grade A business centers including Astarta BC and K-Most are currently in pipeline with delivery in 2017 and 2018 respectively. Furthermore, both schemes are announced to be green certified: Astarta BC will be the first green business center in Kyiv certified according to BREEAM standards, while K-Most is announced to be certified in accordance with LEED standards.

Even though the sustainability remains in its early stages of adoption among office market players, green certification is expected to become more widespread in new developments, providing such properties with longer-term competitive advantages.

Figure 4: Kyiv Annual Development Completions and Total Competitive Stock ('000 sq m)



Source: CBRE Ukraine

Table 2: New Supply in 2017-2018*

NAME	CLASS	ADDRESS	SUBMARKET I	SUBMARKET II	GLA, SQ M	DELIVERY	STATUS
Astarta (Phase I)	AA	58 Yaroslavska St.	CBD	Podil	16,100	H12017	Stock
Forum Westside (Phase IV)	BB	6 Oleny Telihy St.	CBD-fringe	West	2,800	H12017	Stock
Astarta(Phase II)	AA	58 Yaroslavska St.	CBD	Podil	12,600	H22017	U/C
Office building	BA	1B P. Sahaidachnoho St.	CBD	Podil	10,000	H22017	U/C
UNIT CITY	BB	1 Dorohozhytska St.	CBD-fringe	West	20,000	H22017	U/C
Office building	BA	36 Volodymyrska St.	CBD	Prime	5,200	H22017	Reconstruction
Astarta (Phase III)	AA	58 Yaroslavska St.	CBD	Podil	9,000	2018	U/C
Office building	BA	10 Mykhailivska St.	CBD	Prime	5,000	2018	U/C
Office building	BB	39 Spaska St.	CBD	Podil	1,800	2018	Reconstruction
Office building	BA	3 Tsytadelna St.	CBD	Pechersk	4,000	2018	Reconstruction
Office building	BB	14A Lypkivskoho St.	CBD-fringe	South-West	2,200	2018	U/C
Office building	BC	10-14 Dniprovska Naberezhna	Non-central location	NC-SE	3,500	2018	U/C
K\MOST	BB	5A Zoolohichna St.	CBD-fringe	West	5,500	2018	U/C
Office building	BC	47 Pravdy Ave.	Non-central location	NC-NW	11,100	2018	U/C

* according to developers' announcements
Source: CBRE Ukraine

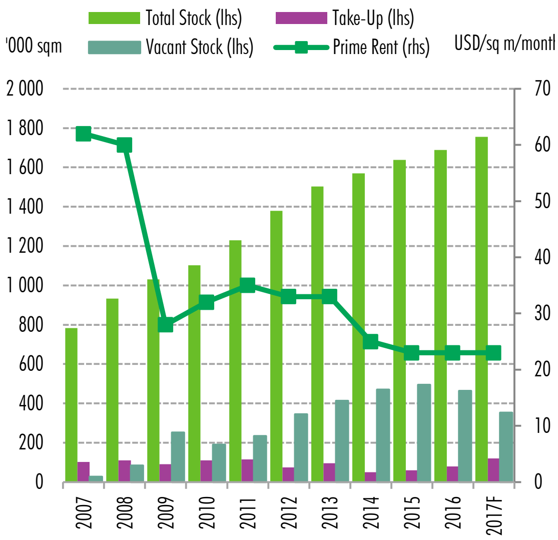
VACANCY & RENTS

While the volume of new deliveries declined consistently and considerably over the last five years, occupier demand was gaining momentum during H1 2017. Despite mild growth in the new supply with the delivery of Phase I of Astarta, a healthier take-up with several cases of expansion accelerated the absorption rate of office premises. Hence, the average vacancy significantly declined by 6.5 pp from 27.5% to 21.0% over the course of the first six months of 2017. In terms of geographical distribution, vacancy continued its downward trend across all submarkets, which implies that general business expansion started to drive the demand for office space rather than demand shifts from submarket to submarket.

In H12017 indicative prime effective rent remained stable at $23/per sq m per month, while asking rates for prime space varied from $15 to $30 per sq m/month. Asking rates for Grade B premises were in the $10 - $22 per sq m/month range, with effective rent standing between $8 to $20 per sq m/month. Looking into future dynamics, we expect the gap between asking and effective rates to continue narrowing.

As part of the trend, tenants with stronger budgets are increasingly more likely to bear larger shares of fit-out costs; however, landlord fit-out contributions are still required by the predominant number of occupiers.

Figure 6: Market Fundamentals



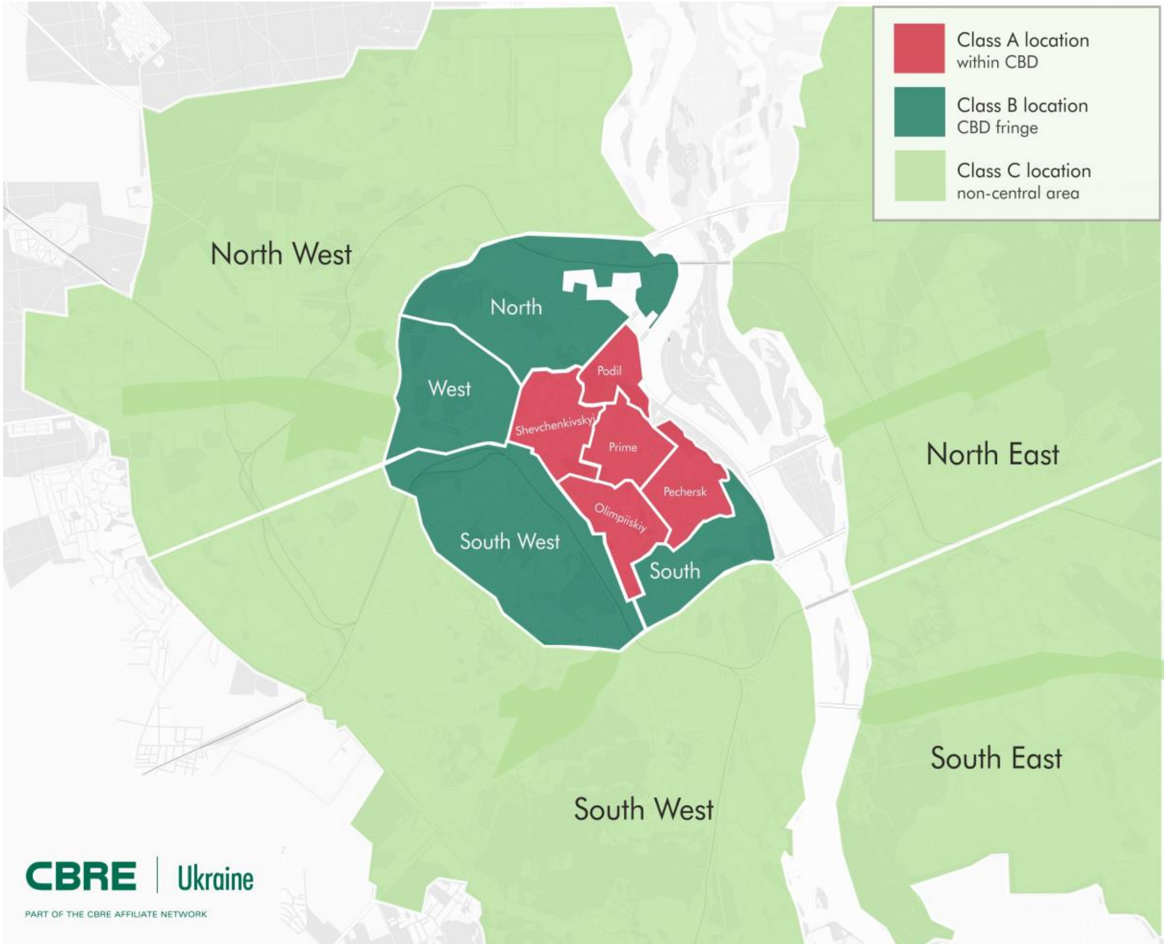
lhs – left hand side
rhs – right hand side
Source: CBRE Ukraine

Figure 5: Kyiv Office Asking Base Rental Range, by Location as of Q2 2017 (USD/sq m/month)

Class A location	Quality A	Quality B	Vacancy Q2 2016	Vacancy Q2 2017
Prime	$23-30	$16-22	10.2%	9.9%
Pechersk	$20-27	$15-20	21.30%	23.2%
Podil	$18-22	$15-20	10.4%	5.1%
Shevchenkivskyi	-	$10-20	14.70%	11.1%
Olimpijskyi	$14-28	$13-20	26.6%	21.9%
Class B location	Quality A	Quality B	Vacancy	Vacancy
CBD fringe	$22-26	$10-20	26.9%	22.30%
Class C location	Quality A	Quality B	Vacancy	Vacancy
Non-central area	$14-16	$10-13	38.9%	34.40%

Source: CBRE Ukraine

Map of Office Submarkets in Kyiv



Source: CBRE Ukraine

INVESTMENT

In the course of 2014-2015 office market found itself under a protracted pressure of growing stock, accelerating vacancy and falling rents in the face of severe political and economic crises. Owing to macroeconomic stabilization and more predictable outlook, the negative trend took a swing back up over 2016, with much stronger recovery in business activity and demand from corporate occupiers driving the absorption up and vacancy down. This trend of improvement was particularly evident during H12017. As a result, investor appetite for prime assets and value-added opportunities began to strengthen, as capital values began to stabilize and bid-ask gap started narrowing down. In H1 2017 several small-scale transactions materialized in the office sector.

Among the development transactions, Echo Investment sold its office park project planned on 4ha land plot to a local residential developer. Details of the transaction remained confidential.

We expect the remainder of 2017 to be marked by more pronounced acquisitions of Prime (9,000 sq m GLA) and Eurasia (30,000 sq m GLA) business centers by Dragon Capital Investments Limited. A handful of banks with large [primarily foreclosed on] property portfolios, continue to actively market their assets with a number of transactions expected to close in H2 2017. While we see an improving investment activity on the horizon, investment flow will be limited primarily to smaller private equity players, as debt financing remains scant at best.

OUTLOOK

Looking into the rest of 2017, we expect the demand for office space to grow in line with the overall improvement in business activity in the country. Strengthening of leasing activity is expected to be evident during the second half of the year. We anticipate a number of transactions to be closed and announced during this period. Tenants looking to relocate are likely to absorb a fair portion of vacant space through relocations or expansions in line with macroeconomic and employment dynamics.

In parallel, development activity is forecast to remain subdued. Nearly 48,000 sq m of new office stock is scheduled to be delivered in H2, bringing the volume of annual new supply to ca. 67,000 sq m (+34% y-o-y). As no large construction is expected to be commenced during the rest of 2017, office development activity will be declining for at least another year, with only 42,000 sq m (-37% y-o-y) currently planned to be completed in 2018. Geographically, office pipeline is concentrated in the CBD accounting for 60% of space under construction. In addition to new development, we expect a rising number of small scale reconstructions in the CBD area. The recent deceleration of development pipeline and rising business activity may spell near-term deficit for the good quality office space, especially as we are looking towards 2019 and 2020. The trend of declining vacancy is expected to continue over the second half of the year fuelled by growing demand from occupiers and no large-scale development projects deliverable in the next 18-24 months.

At the same time, although the office demand improved notably, it still did not return to the sustainable level of a healthy economy. Therefore, we expect rents to stay broadly stable across the board for the rest of 2017 and possibly beyond until more pronounced absorption volumes are recorded. In general, looking beyond this year, we expect the gap between asking and effective rents to shrink moderately, as the demand for space in the best buildings will gradually exceed the available supply. Therefore, moderate growth of prime effective rent is possible during the next year in Grade A buildings and well-located Grade B properties with low vacancy. Material additions to supply from the current standpoint are possible starting from 2020-21, or ca. 2 years after development financing is expected to become available on a relatively broad basis.

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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**