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MarketView

Kyiv Offices

H2 2009

Quick Stats

	Change from H1 '09	Change from H2 '08
New Supply	↑	↓
Rent	↓	↓
Vacancy	↑	↑

Hot Topics

- Financial services industry continued to lose jobs in H2, shedding some 20,000 payrolls since the crisis began, but business confidence turned positive towards the end of the year for the first time in twelve months.
- The majority of occupiers have by now processed the effects of the economic crisis on their operations, but demand for space remains heavily weighted in favor of upgrades rather than expansions.
- Total competitive stock barely exceeded 1 million sq m on the back of 90,000 sq m of total annual development completions. Previous milestone of 500,000 sq m was reached in 2006.
- Rents and vacancy have both stabilized in Q4, but whereas vacancy could rise further over 2010 on account of new deliveries and sluggish demand, rents will most probably stay unchanged, subject to a stable exchange rate.

FUNDAMENTALS

Kyiv is a major hub of financial and business services industry in Ukraine. Prior to crisis, around 28% of the country's total financial services output and 44% of business services output was generated in Kyiv. Furthermore, Kyiv's share of national financial services employment was reaching 21% in mid 2008. Such a highly concentrated business activity and a large services (office-intensive) sector created excellent preconditions for office real estate development, but they also lead to market overheating which resulted in a deep slump when the things turned ugly at the end of 2008.

Kyiv economic trends always tended to outshine national averages. During the crisis, too, the local economy performed better than that of the country as a whole, but the decline has been profound nonetheless. Gross regional product contracted by 15.3% y-o-y over H1 2009 (against the national average of 16.2%) but is estimated to have picked up in the last two quarters. Less positive has been the performance of the labor market, where core office employment (COE) continued to fall m-o-m in November, and although payroll growth did improve in y-o-y terms, it was solely due to low-base effects.

It should be noted, however, that for the first time in four quarters general business confidence has turned positive across virtually all geographies and particularly in Kyiv. According to the National Bank of Ukraine (NBU), the percentage of firms[1] expecting better business conditions in the next 12 months has almost doubled to 29% in Q4 from 15% in Q1, while the percentage of those expecting worse business conditions has decreased from 34% to only 14% over the same period.

Kyiv City Fact Sheet

Annual Data	2009*	Historical Averages (%)	2004-2008
Resident population (million)	2.7	Population growth	0.96
GRP (USD billion, 2008)**	18.2	Real GRP growth	11.2
Average monthly salary (USD)**	390	Average salary growth**	24.23
Unemployment (ILO methodology)	6.2	Unemployment	3.76
FDI inflows (USD billion)	1.2	FDI stock growth	45.2

* through September, unless otherwise stated
** at official exchange rate, eop
Source: Kyiv Statistics Office, State Statistics Committee

[1]Registered in Kyiv

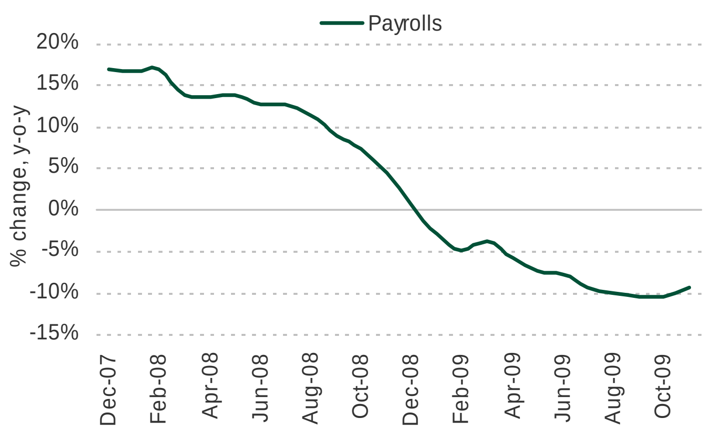
DEMAND

After stagnating in every quarter since September 2008, occupier market finally showed first signs of stabilization in H2 2009. Leasing activity over the last six months of the year reached ca. 53,000 sq m – a substantial 47% improvement from previous two quarters – yet effective take-up was some 21% below (42,000 sq m) as renewals, re-gear and subleases became widespread. Overall, while annual take-up was some 50% down in y-o-y terms, it did post a minor 7% q-o-q rise in three months to the end of December.

Demand is getting more active again but remains primarily fuelled by tenants looking to upgrade rather than to expand. After pausing, waiting and, in many cases, cutting back on space in H1 2009, occupiers started to take advantage of significantly lower rents to improve their office conditions in H2 2009. Perhaps surprisingly, but relocation into new buildings was quite widespread, despite higher costs associated with leasing shell&core. However, as competition for tenants increased and the stock of vacant fitted-out space has grown, landlords of the newly-delivered office schemes have seen their negotiation positions weaken substantially. They were therefore prepared to expand incentive packages, particularly for large tenants. At the same time occupiers looking for large volumes of prime space in CBD are facing a less care-free leasing process. The choice of space here is more restricted than overall market trends would indicate, for which reason such landlords are generally less accommodating. Still, we believe the window of opportunity to renegotiate favorable terms and lease more, better space for less money will remain open for the whole of 2010 and, possibly, beyond. This is due to the imminent delivery of large class A office schemes, where very few pre-leases have been signed so far.

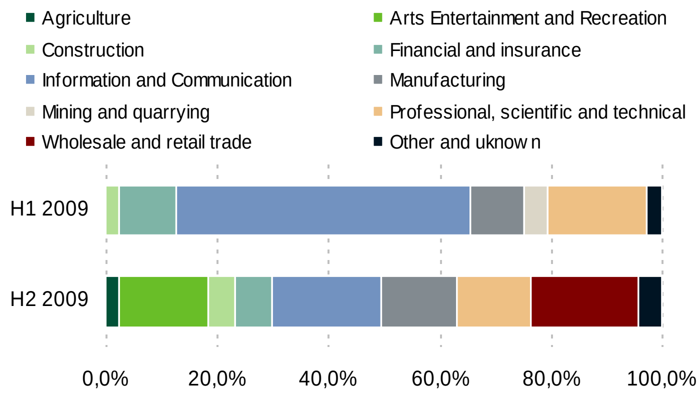
In terms of sector activity, information and communication technology firms were the most buoyant, accounting for ca. 34% of total annual take-up. Professional sector came second with some 15% share, while tenants in financial and insurance business took only 8% of the transacted space, a 70% fall from the previous year. Financial services industry was hit the hardest by the crisis and it is here that the most dramatic adjustments and cost-cutting exercises were implemented.

Core Office Employment* (% change, y-o-y)



* full time equivalent (FTE)
Source: Kyiv Statistics Office

Take-up by Business Sector (% share)



Source: CB Richard Ellis

Despite the recent improvements in business sentiment, unemployment, as a lagging indicator, will most likely continue to rise, at least for another quarter. The demand for office space therefore will remain suppressed until at least H2 2010. Moreover, many tenants in occupied buildings do not use their current space at full capacity, preferring to keep it as “reserve stock” rather than sublease it in the open market. Thus, when business conditions eventually improve and firms start hiring again, the net effect on the occupier demand will not be felt immediately.

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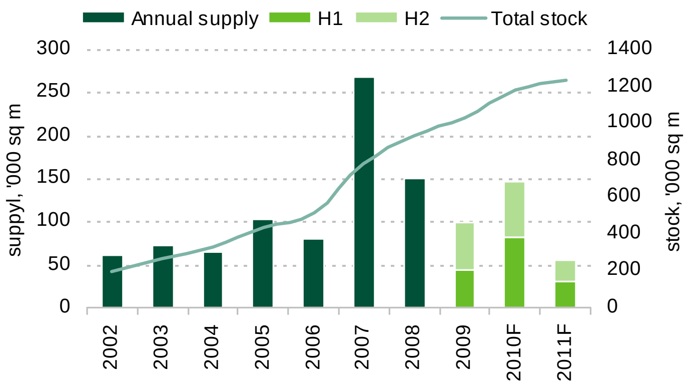
Kyiv Annual Development Completions



Source: CB Richard Ellis
F – CB Richard Ellis forecast

Major office schemes in 2009

Name	Sub-market	Developer	GLA, sq m*	Delivery
Protasov Business Park	c-CBD	DMV Group	21,000	Q1-Q3
Irva II	NC-WB	Mega Development	11,000	Q1
Flora Park	NC-WB	Flora Park CJSC	10,000	Q2
Livoberezhnyi	NC-EB	SNS	6,000	Q2
FiM Center II	NC-EB	FIM Group	7,000	Q3
Forum Kinetic Center	NC-WB	Forum Management Group	9,000	Q3
Vector	c-CBD	Alyans Center LLC	10,000	Q3
Horizon Office Park II – NT**	c-CBD	ISA Prime Development	16,000	Q3

* rounded figures
** Northern tower
Source: CB Richard Ellis

Major office schemes in 2010

Name	Sub-market	Developer	GLA, sq m*	Delivery
Dnipro Plaza	c-CBD	*private*	6,000	Q1
Eleven	NC-WB	Centerivest	8,000	Q2
Horizon Office Park II – ST**	c-CBD	ISA Prime Development	14,000	Q2
Esplanada/ Continental	CBD	Mandarin Plaza CSJV	51,000	Q2/Q3
Premium Center Business City	NC-WB	Premium Center	34,000	Q3
Pankivskyi	CBD	Green House LLC	10,000	Q3
Rialto	NC-WB	Istil	13,000	Q4

* rounded figures
** Southern tower
Source: CB Richard Ellis

SUPPLY

Around 47,000 sq m of speculative space was added to the competitive stock in H2, bringing the total annual development completions to ca. 90,000 sq m. Although in line with historical average, the new supply was still some 40% down on the year before and almost 70% down vs. 2007 results. This sharp drop in development activity is partly attributable to high-comparison base of the last two years but is also a direct result of tighter credit and economic downturn. In fact, CBRE estimates that as much as 170,000 sq m of office space did not reach the market in 2009 because of the crisis-related events. In many ways, however, the supply side of the market will not see the true implications of the crisis until 2011. In that year (and beyond) development completions are forecast to slow down considerably even though the economy will be well out of recession by that time. The reason lies in the lengthy investment cycle of development business in general and the amount of red tape surrounding it in Kyiv city in particular.

As never before, the construction industry is plagued by prohibitively expensive (or absent) credit resources, while low rents and high availability of space (although not in prime segment) further discourages office development in general. The supply in 2010 will be relatively high only due to one-off delivery of several large buildings (such as *Esplanada/Continental* and *Premium Business City*) and because the construction of 80% of space was commenced in 2007 or before. However, the current outlook for delivery of new office space beyond 2010 is far below the levels seen in the last five years. Indeed, with almost no new development starts recorded in 2009 and very few likely to be recorded in 2010, office stock in the next 2-3 years will grow only if halted, cash-strapped properties are re-launched.

Distressed pipeline in offices is estimated to have reached nearly 400,000 sq m since Q3 2008. So far investors have shown little interest in such schemes even in prime locations. The fire sale of Mirax Plaza, an ambitious 300,000 sq m mixed-use, to a Russian developer in Q4 is the only notable example of distressed assets recovery. It should be noted, however, that the purchaser hinted at an intention to review the previous concept and reduce the amount of residential as well as commercial space in the project, which is not unreasonable, given the current market environment. It is highly likely that the same fate awaits other zombie buildings/projects if and when somebody buys them. All in all, office pipeline will remain diminished for the next two-three years and average vacancy rate therefore could start moving to a more sustainable level as early as Q4 2010.

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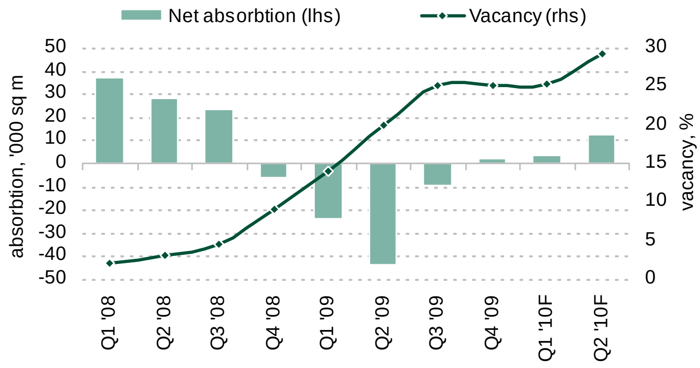
RENTS AND VACANCY

The combination of healthier demand and a very limited new supply seen in the last three months of the year, helped stabilize vacancy rate in Q4. The pace of contraction of the occupied stock slowed down substantially, as only 8,000 sq m were added to vacancy in H2, compared with ca. 68,000 sq m in H1 2009. In fact, trivial yet positive net absorption was recorded in Q4 – the first time in a year – indicating that occupiers have mostly stopped cutting on existing space. However, the fact that vacancy remained unchanged at 24.5% from Q3 also indicates that supply is still growing faster than demand – a trend, which is expected to continue for at least another two or three quarters.

Net absorption is very hard to forecast because of many variables involved; however, our view is that it is unlikely to post negative growth in the coming quarters. With hardly any companies planning expansion in the nearest future, most have at least stopped contracting, which reduces the imminent likelihood of negative absorption. Furthermore, relocation trend – i.e., companies leaving non-competitive space in favor of professional premises – will provide an additional boost to absorption. Indeed, vacancy rate is already below market average in some newly delivered office schemes. This is primarily explained by high quality of these new deliveries, which under present market conditions of sharply reduced rents, draw occupiers from old and inferior premises.

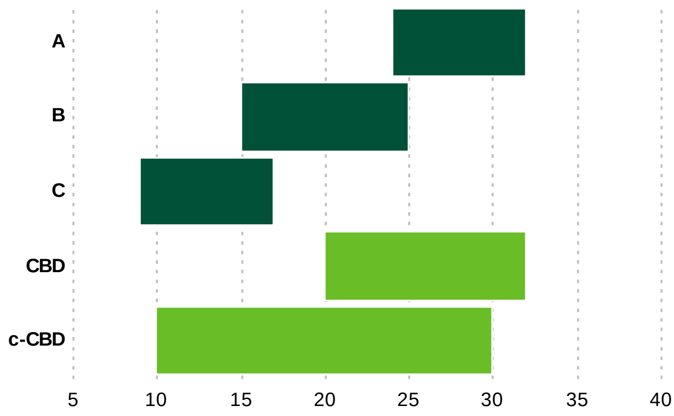
It is important to note, however, that office development completions in 2010 are forecast to total in excess of 140,000 sq m – the third highest annual supply on record. Some schemes may not eventually reach the market, but overall deliveries are nonetheless likely to be significant. Therefore, even in case net demand gathers pace towards the second half of the year (as we forecast), it will be insufficient (at least initially) to match the increase in stock and vacancy therefore is more likely to rise further than to decline.

Net Absorption and Vacancy



Source: CB Richard Ellis
F – CB Richard Ellis forecast

Kyiv Office Rental Range as of Q4 2009 (USD/sq m/month)



Source: CB Richard Ellis

Prime rents remained flat at $28/sq m/month in Q4, having declined by only 7% in H2. Overall, by the end of 2009 prime USD rents were down 67% from their peak in Q3 2008 and 53% down in y-o-y terms. The fall in UAH equivalent has been less dramatic – 47% from the peak in Q2 2008 and 39% y-o-y.[2] Clearly, the bottom has been reached and the fundamentals as well as details of recent deals are pointing that further declines (in at least UAH terms) are unlikely. Imminent rental growth, however, should not be expected either, as additional deliveries in the mid of 2010 will spur vacancy, keeping rentals in check.

[2]At quarterly average official exchange rate

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OUTLOOK

2010 will be the year when businesses finally switch from tactics to strategy, but that is the end of good news. Despite the fact that survival decisions may be leaving most boardrooms, bullish sentiment in property terms is not expected to return as yet. The private sector, especially those occupiers who suffered most from the downturn such as financial and business services, will wait for better signs of recovery than just a few quarterly rises in GDP before starting to hire again. A bounce-back in demand for space should not therefore be expected, but a period of reactivated tenant requirements for offices is definitely anticipated given that long-term thinking is generally back again. Provided a relatively mild post-election period, some businesses may actually embark on moderate expansion as early as Q2 2010, but that trend will likely be limited to a handful of specific sectors and firms. A broader across-the-board recovery should not be expected until domestic demand gathers pace as expected sometime in H2 2010. Nevertheless, given how fundamentally undersupplied in quality Kyiv office market was before the crisis, relocations will remain popular. This trend can potentially contribute to making the market more professional as some vacant class C and/or class B- properties get excluded from competitive stock.

Development activity will not be gone altogether, but it will need to drop further before rising again. The significantly reduced pipeline and the fact that almost no development projects were initiated in 2009 or will be initiated in 2010 mean that the delivery of new office space in 2011 and 2012 will slow considerably – just about when the economy should be moving closer to its pre-crisis level. Absorption therefore may start pushing vacancy to the level that would justify rental growth in the early 2012. A gradual increase in rents towards the end of 2011 is also possible, especially in prime buildings, where vacancy is far below the market average. Class A is therefore likely to spearhead rent rise and much before the rest of the market picks up the trend.

DEFINITIONS

(in alphabetical order)

CBD – central business district

c-CBD – "*close to CBD*"; a notional submarket created to identify properties within 2km distance off CBD

Core Office Employment (COE) – all people employed in the following two broad industry categories: *financial intermediation* and *real estate, renting* & *business activities*, as per United Nations economic activity classification (Revision number 3.1)

NC-EB– "*non-central location on the east bank*"; a notional submarket created to identify properties outside of **CBD** and **c-CBD** areas on the east (left) bank of the Dnipro river

NC-WB – "*non-central location on the west bank*"; a notional submarket created to identify properties outside of **CBD** and **c-CBD** areas on the west (right) bank of the Dnipro river

Leasing Activity – see the definition for **take-up** (below)

Net Absorption – 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 deal flow is very limited or made up of unusual one-off deals. 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.

Take-up – represents the total floorspace 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 deals (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). **Leasing activity** will also exclude space that is under offer, but it will include all the other deals such as sales and leasebacks, renewals, regears, as well as subleases, which are excluded from **take-up**.

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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