RESEARCH

Q3 2015

OFFICE MARKET REPORT

Moscow

HIGHLIGHTS

The volume of Class A and B office space delivered in Q1–Q3 2015 declined by 55% year-on-year.

The volume of vacant space of quality offices already delivered in Moscow is circa 3 mln sq m.

The rents in dollar currency were down by 14% in Class A offices and by 7% in the offices of Class B category since the beginning of 2015. The rents denominated in Russian rubles dropped by 10% in Class A offices and by 11% in the offices of the Class B category.

OFFICE MARKET REPORT MOSCOW

Konstantin Losiukov
Director, Office Department
Knight Frank

"Today we can talk about achieving some balance in the office market: commercial terms are most probably approaching the minimum possible value, while tenants and buyers are taking the opportunity of the current market situation. Despite the volume decline of the facilities already commissioned or planned for commissioning, the current status of the market is still characterized as a "tenant's market" when office space is available virtually in any business district of Moscow and the landlords offer the most attractive rental rates.

The end of the year is expected to be active in the completion of transactions, however, it is early to talk about the market recovery: the following year isn't pledged to be less difficult than 2015 and the return to pre-crisis market levels may take more than three years".

Key indicators. Dynamics*

		Class A	Class B
Total stock, thousand sq m		15,227	
including, thousand sq m		3,712	11,515
Delivered in Q1–Q3 2015, thousand sq m		464	
including, thousand sq m		296	168
Vacancy rate, %		25.5 (-4.1 p. p.)*	17.2 (-0.1 p. p.)*
Average weighed asking rental rate**	$/sq m/year	506 (-14.2%)*	294 (-6.7%)*
	rub./sq m/year	26,670 (-11.5%)*	15,452 (-10.3%)*
Rental rates range**	$/sq m/year rub./sq m/year	350–1,200 14,000–45,000	250–650 8,000–35,000
Average OPEX rate	rub./sq m/year	4,000–7,500	2,500–4,500

* Compared to Q4 2014
** Excluding operational expenses utility bills and VAT (18%)

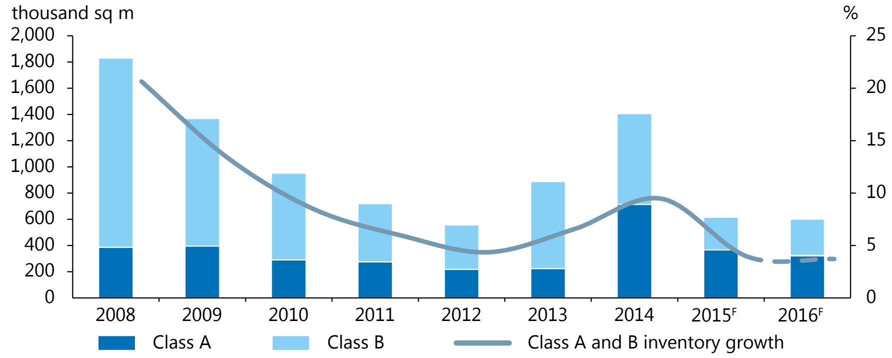
Source: Knight Frank Research, 2015

Supply

The supply volume of delivered quality office space in Moscow amounted to 15.2 million sq m as for the end of Q3 2015 with 24% accounted for Class A office space.

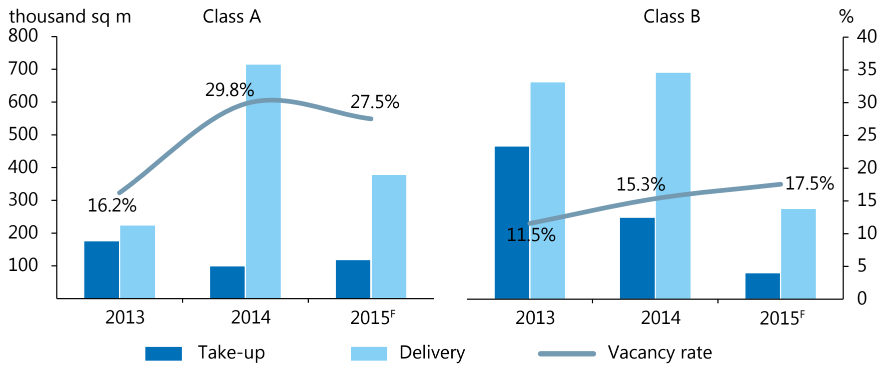
The decline in demand and limited opportunities to attract available financing led to a marked reduction in development activity: only several projects were announced throughout the year and the estimated delivery dates of facilities already under construction were postponed in most cases. The delivery volume of office space totaled 464 thousand sq m for

New delivery volume dynamics for Class A and B offices



Source: Knight Frank Research, 2015

Dynamics of delivery, take-up and vacancy rates of Class A and B offices



Source: Knight Frank Research, 2015

9 months of 2015, which is 55% less than the same period last year.

The imbalance of supply and demand is illustrative of the current state of the office market: the vacancy rate of Class A offices is 25.5%, while in Class B – 17%. Class A office market experienced a decrease in the vacancy rate within 9 months of 2015: optimization of office space was performed by tenants together with withdrawal from the market of the large office units or whole buildings, which is due to a number of already closed transactions or with the large ones that are currently under negotiation, resulting from asking commercial terms level decline.

If we compare the current market situation with the crisis period of 2008–2009, when the vacancy rate was at record maximum at the end of 2009, it is worth noting that today the volume of vacant space is more than 1.5 times higher in the absolute values than the last crisis level. The total stock of available office space in delivered Class A and B buildings is 3 million sq m available today for tenants and end-user buyers.

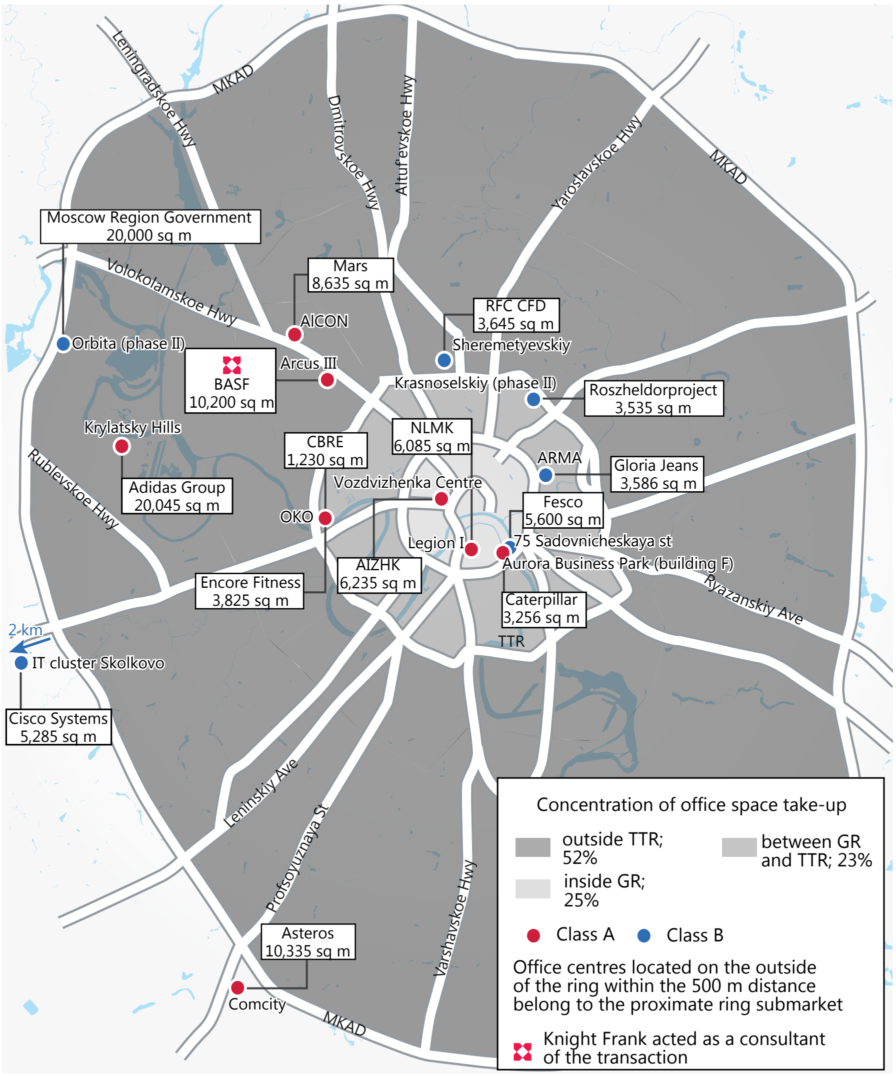
Kuntsevo Plaza, 19 Yartsevskaya st

Demand

The net take-up of quality office space fell by almost 60% year-on-year for the period from January to September and amounted to 166 thousand sq m. The activity in the office real estate market over the first 9 months of 2015 was largely due to the high volatility of the Russian national currency. So, in 2015 the first quarter faced the minimum value of the volume of lease and purchase transactions of high-quality office space amid an extremely high degree of uncertainty in the economy. But by the end of the quarter after the stabilization of the ruble the companies returned to negotiation process, resulting in an increase in the volume of transactions in Q2 2015. In turn, Q3 2015 was the most active: the intentions for relocation were announced and lease and purchase transactions of office space were completed, these transactions were the largest ones from the beginning of the year. It should be emphasized that tenants were actively involved in negotiations on the revision of the lease terms: the share of such transactions increased, reaching a total of 63% of all transactions for the first 9 months of 2015 amid falling rates and weakening ruble from Q4 2014.

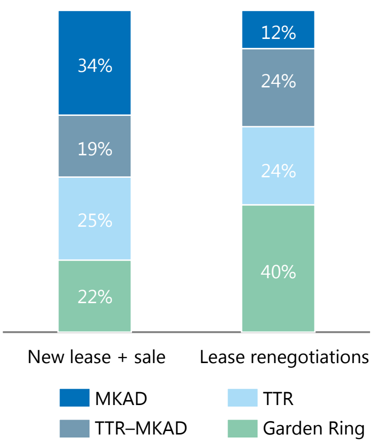
The transaction structure in terms of its sector distribution of the companies was influenced by several large transactions of the first three quarters. Adidas Group leased circa 20 thousand sq m of office space in Krylatsky Hills business park, thus the share of companies of the retail sector increased to 12%, but in the same period of 2014 it was insignificant. The increased

Key lease and purchase transactions closed in Q1–Q3 2015



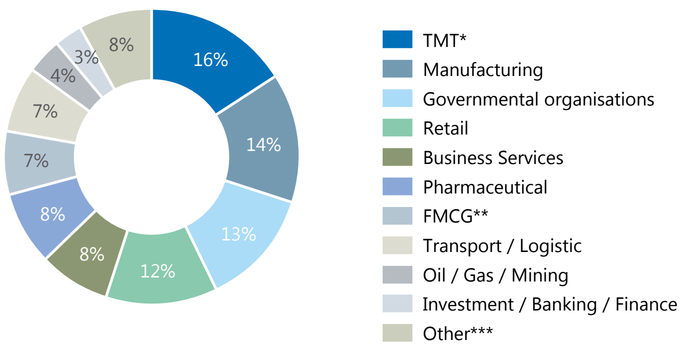
Source: Knight Frank Research, 2015

Distribution of deals by location



Source: Knight Frank Research, 2015

Tenant mix



* IT, media and telecommunications
** Fast moving consumer goods and services
*** Consumer services; Architecture and construction

Source: Knight Frank Research, 2015

share of state authorities in the structure of demand for quality office space is due to the lease of about 20 thousand sq m of office space by the Government of the Moscow region in Orbita business center (phase II).

The share of companies of the financial and banking sectors continue to decline, which was largely influenced by the imposure of sectoral sanctions from 2014 and the credit and financial constraints: the index reached its minimum value of historical significance for the first three quarters – 3% of total transactions.

The largest volume of lease and purchase office transactions in the first three quarters of 2015 were located in the facilities located near the Moscow Ring Road (34%) due to three major transactions with the total volume of more than 50 thousand sq m in the office centers of this area. However, companies still have the opportunity to lease an office in more developed areas closer to the center of Moscow on rental rates comparable to the rates in the outer areas.

The companies that leased offices within the Garden Ring were the most active in the renegotiation of commercial terms: its share increased from 30% to 40% for the first 9 months of 2015 compared with the same period of 2014. The companies that had dollar lease agreements paid 30–40% more than the current rental rates, today they are forced to revise the terms of the lease.

Commercial terms

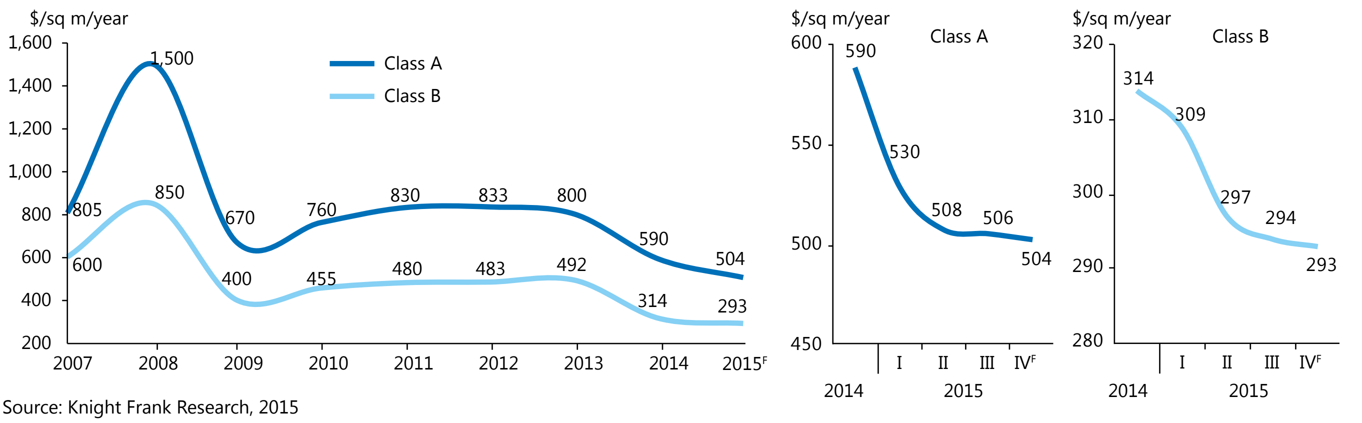
The average asking rental rates for quality office space in Moscow were going down over the three quarters of this year. The average rental rates in Class A offices denominated in US dollars dropped below historical lows and reached 506 $/sq m/year and at the offices of the Class B – 294 $/sq m/year, falling by 14% and 7%, respectively, for the first 9 months of 2015.

In the third quarter of the year the weighted average asking rental rates in ruble terms reached the level of 26,670 rub./sq m/year in Class A offices and 15,452 rub./sq m/year in the offices of Class B.

We are now witnessing a situation when the landlords of vacant office space are still trying to reduce the asking rental rates after an active reduction of the asking commercial terms in Q4 2014–Q1 2015, resulting in a slight correction of the indicator. Therefore, the smallest decline in the weighted average indicator in 2015 was observed in the third quarter: compared with Q2 2015 the rental rates declined by less than 1% in dollar terms in the offices of Class A and by 1.3% in Class B, the decline in ruble terms was about 2% both in the offices of Class A and Class B.

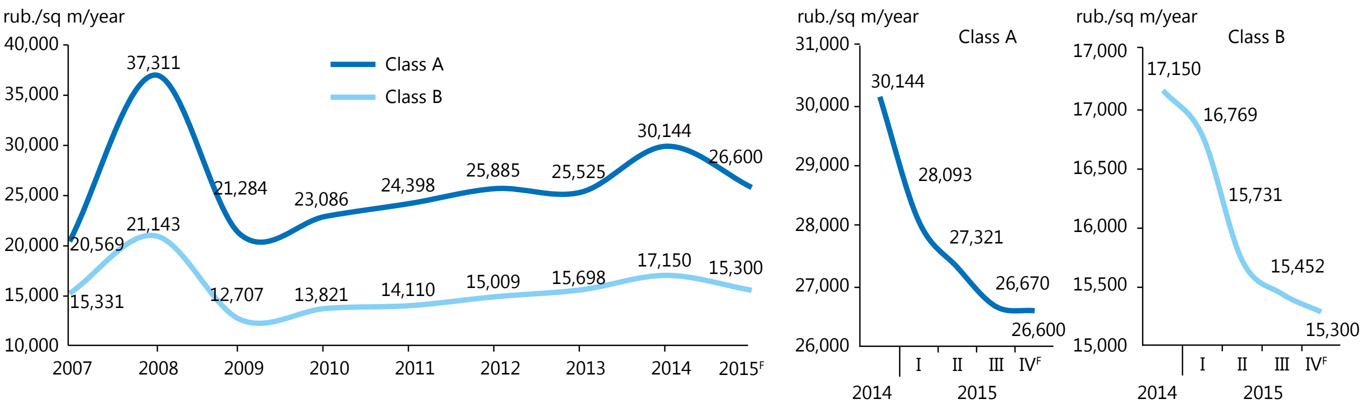
The development of ruble-denominated market which had started at the end of 2014 was continued during Q3 2015. Today a growing number of landlords are willing to sign long-term ruble agreements in contrast to H1 2015, when the terms of exchange rate fixation or exchange rate band were available only for 1–2 year of the lease term.

Average asking rental rates dynamics for Class A and B offices denominated in USD



Source: Knight Frank Research, 2015

Average asking rental rates dynamics for Class A and B offices denominated in RUB



Source: Knight Frank Research, 2015

Forecast

The current year will show a decline of the volume of office space delivered by 56% after the record high value of 2014 over the last 5 years. Last year's forecasts of the volume of office space, scheduled to be commissioned before the end of 2015 were at the level of 1 million sq m, but according to the adjusted plans of developers the volume of new space to be delivered will be 620 thousand sq m.

The implementation of facilities under design stage or at the initial construction stage was rescheduled in 2014–2015. Thus, we expect that the delivery volume of Class A and B offices in 2016 will be at the level of 2015 and will amount to 600–650 thousand sq m.

In contrast to the 2008–2009 crisis the country's economy and, consequently, the office real estate market expects a lengthy recovery period. According to the conservative forecast scenario of the Ministry of Economic Development the Russian economy will demonstrate growth not earlier than in 2017. The volatility in the oil markets and an unfavorable geopolitical background will continue to contribute to the instability of the ruble. However, the market has adapted to changing conditions: we do not expect a substantial reduction of asking rental rates in the current environment and the decrease of the vacancy rate towards the end of 2016 is possible amid the reduction of new supply. We believe that the market activity will be motivated by a desire of the tenants to optimize the lease terms and upgrade the class of the leased premises.

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Moscow submarket data. Key indicators

<table>
<tr><th colspan="2" rowspan="3">Submarket</th><th rowspan="3">Lease area, thousand sq m</th><th colspan="6">Class A</th><th colspan="6">Class B</th></tr>
<tr><th colspan="4">Average rental rates</th><th colspan="2" rowspan="2">Vacancy rate, %</th><th colspan="4">Average rental rates</th><th colspan="2" rowspan="2">Vacancy rate, %</th></tr>
<tr><th colspan="2">$/sq m/ year</th><th colspan="2">rub./sq m/ year</th><th colspan="2">$/sq m/ year</th><th colspan="2">rub./sq m/ year</th></tr>
<tr><td>Boulevard Ring</td><td>Central business district</td><td>712</td><td colspan="2">947</td><td colspan="2">50,203</td><td colspan="2">10.7</td><td colspan="2">537</td><td colspan="2">28,474</td><td colspan="2">4.7</td></tr>
<tr><td rowspan="4">Garden Ring</td><td>South</td><td>918</td><td>592</td><td rowspan="4">642</td><td>31,353</td><td rowspan="4">34,010</td><td>20.2</td><td rowspan="4">16.9</td><td>555</td><td rowspan="4">487</td><td>29,432</td><td rowspan="4">25,802</td><td>8.8</td><td rowspan="4">12.3</td></tr>
<tr><td>West</td><td>273</td><td>881</td><td>46,674</td><td>13.3</td><td>533</td><td>28,259</td><td>13.6</td></tr>
<tr><td>North</td><td>660</td><td>739</td><td>39,180</td><td>7.0</td><td>550</td><td>29,160</td><td>12.6</td></tr>
<tr><td>East</td><td>401</td><td>–</td><td>20,587</td><td>25.8</td><td>386</td><td>20,473</td><td>17.1</td></tr>
<tr><td rowspan="11">Third Transport Ring</td><td>Leninskiy</td><td>278</td><td>–</td><td rowspan="10">536</td><td>28,000</td><td rowspan="10">28,088</td><td>23.0</td><td rowspan="10">33.9</td><td>–</td><td rowspan="10">349</td><td>17,536</td><td rowspan="10">18,486</td><td>21.2</td><td rowspan="10">19.2</td></tr>
<tr><td>Tulskiy</td><td>921</td><td>–</td><td>–</td><td>–</td><td>340</td><td>18,012</td><td>15.0</td></tr>
<tr><td>Khamovniki</td><td>260</td><td>966</td><td>51,186</td><td>20.8</td><td>–</td><td>25,335</td><td>5.8</td></tr>
<tr><td>Kievskiy</td><td>393</td><td>–</td><td>25,000</td><td>100.0</td><td>375</td><td>19,868</td><td>63.8</td></tr>
<tr><td>Presnenskiy</td><td>357</td><td>–</td><td>28,500</td><td>7.3</td><td>452</td><td>23,941</td><td>12.6</td></tr>
<tr><td>Prospekt Mira</td><td>162</td><td>–</td><td>22,166</td><td>32.0</td><td>326</td><td>17,276</td><td>19.6</td></tr>
<tr><td>Tverskoy-Novoslobodskiy</td><td>752</td><td>807</td><td>42,753</td><td>18.2</td><td>385</td><td>20,389</td><td>8.8</td></tr>
<tr><td>Basmanniy</td><td>512</td><td>–</td><td>–</td><td>–</td><td>344</td><td>18,250</td><td>14.6</td></tr>
<tr><td>Taganskiy</td><td>227</td><td>450</td><td>–</td><td>82.9</td><td>239</td><td>12,665</td><td>15.4</td></tr>
<tr><td>Volgogradskiy</td><td>432</td><td>–</td><td>30,000</td><td>48.0</td><td>306</td><td>16,203</td><td>19.6</td></tr>
<tr><td>MIBC Moscow-City</td><td>858</td><td colspan="2">500</td><td colspan="2">25,832</td><td colspan="2">29.4</td><td colspan="2">–</td><td colspan="2">–</td><td colspan="2">–</td></tr>
<tr><td rowspan="4">TTR-MKAD</td><td>North</td><td>692</td><td>–</td><td rowspan="4">424</td><td>29,020</td><td rowspan="4">22,463</td><td>1.9</td><td rowspan="4">24.0</td><td>247</td><td rowspan="4">268</td><td>13,102</td><td rowspan="4">13,822</td><td>17.9</td><td rowspan="4">16.4</td></tr>
<tr><td>South</td><td>1,640</td><td>383</td><td>20,279</td><td>57.1</td><td>–</td><td>13,391</td><td>18.5</td></tr>
<tr><td>West</td><td>1,144</td><td>526</td><td>27,868</td><td>15.7</td><td>366</td><td>19,395</td><td>15.3</td></tr>
<tr><td>East</td><td>658</td><td>–</td><td>19,956</td><td>51.2</td><td>209</td><td>11,088</td><td>15.9</td></tr>
<tr><td rowspan="4">MKAD</td><td>North</td><td>525</td><td>–</td><td rowspan="4">320</td><td>–</td><td rowspan="4">16,941</td><td>–</td><td rowspan="4">33.4</td><td>151</td><td rowspan="4">195</td><td>8,006</td><td rowspan="4">10,310</td><td>15.1</td><td rowspan="4">20.9</td></tr>
<tr><td>South</td><td>432</td><td>277</td><td>14,691</td><td>61.3</td><td>177</td><td>9,392</td><td>18.2</td></tr>
<tr><td>West</td><td>1,772</td><td>331</td><td>17,567</td><td>26.8</td><td>228</td><td>12,067</td><td>25.3</td></tr>
<tr><td>East</td><td>248</td><td>–</td><td>–</td><td>–</td><td>–</td><td>4,065</td><td>15.2</td></tr>
<tr><td colspan="2">Total</td><td>15,227</td><td colspan="2">506</td><td colspan="2">26,670</td><td colspan="2">25.5</td><td colspan="2">294</td><td colspan="2">15,452</td><td colspan="2">17.2</td></tr>
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Source: Knight Frank Research, 2015