RESEARCH

Knight Frank

HIGHLIGHTS

- About 888 thousand sq m of Class A and B offices were delivered that year (justifying the last year's forecast). It is almost 40% more than in 2012 and is the highest value since 2010. The total volume of high-quality office space in Moscow amounted to about 13.3 million sq m, of which 20% are Class A offices and 80% – Class B.
- The lease and purchase transactions volume for Class A and B office space in Moscow amounted to about 750 thousand sq m for 2013. Throughout the year, we noted that demand has dropped compared to the previous year, and despite the traditionally high market activity in the H2, the annual decline amounted to about 20%.
- By the end of 2013, the average weighted rental rate for Class A office premises has reached a value of 800 $/sq m/year, having dropped over the year by 4%. In turn, the average asking rental rate for Class B office space has demonstrated a slight growth in the range of 2% compared to 2012 reaching a value of 492 $/sq m/year.

OFFICE MARKET RESEARCH

Konstantin Losiukov,
Director
Office Department
Knight Frank

"Today we witness a shift in balance, which was characteristic of the market in 2011–2012. Economic uncertainty of both Russia and the Western countries affected the take-up volume in the past year. The market has reached such a state when a tenant can choose from a large pool of supply available on the market, while the owners of many buildings, in turn, are willing to offer attractive commercial terms.

In the coming years we expect a large number of high-quality projects to enter the market, however, according to our forecasts, the demand will not exceed the level of 2013".

Key indicators. Dynamics

Indicator	Class A	Class B
Total stock, thousand sq m	13,336	
including, thousand sq m	2683	10,653
Delivered in 2013, thousand sq m	888	
including, thousand sq m	225	663
Vacancy rate, %	16.2	11.5
	+3.6 p.p.*	-3.0 p.p.*
Average asking rental rate**, $/sq m/year	800	492
	-3.9%*	+1.9%*
Rental rates range**, $/sq m/year	400–1,200 (1,000–1,300***)	300–1,000
Operational expenses, $/sq m/year	110–190	80–120

* Changes compared to Q4 2012
** Excluding Operational Expenses and VAT (18%) The operational expenses do not include changes associated with an increase in property tax
*** Range of asking rents for premium fitted-out space
Source: Knight Frank Research, 2014

Supply

By the end of 2013, the total volume of high-quality office space in Moscow amounted to about 13.3 million sq m, of which 20% are Class A offices and 80% – Class B.

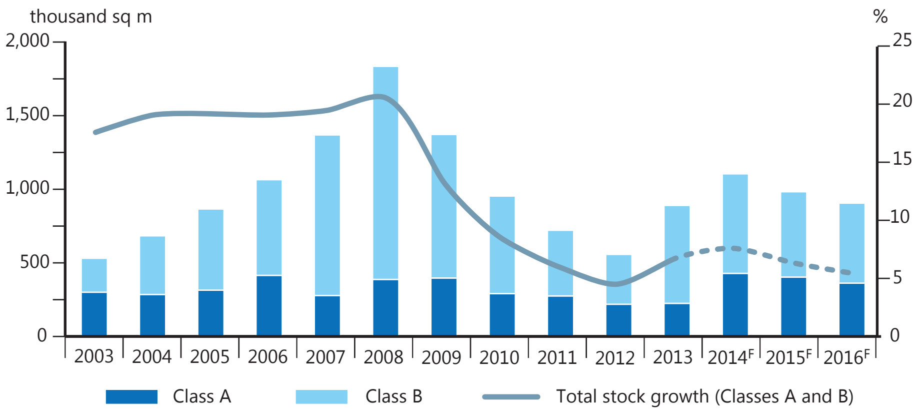
About 888 thousand sq m of Class A and B offices were delivered that year (justifying the last year's forecast). It is almost 40% more than in 2012 and is the highest value since 2010. Compared with the end of 2012, the supply stock volume of high-quality office space in Moscow grew by 7%.

The new construction volume growth in 2013 compared to 2011 and 2012 resulted from the "postponed supply effect": a drop in demand and available funding in 2008–2009, as well as the change of the Moscow administration in 2010, have resulted in suspension of delivery for many objects, in practical absence of new projects. Since the construction of an office building takes 2 to 3 years, these events have led to a drop in delivery volumes for 2010–2012.

With regard to the territorial distribution of the new supply stock, we are still witnessing a growing decentralization of the market. The share of office space delivered within the Garden Ring, according to the results of 2013, did not exceed 15% of the total new supply stock volume, and we expect further shrinking of this share. However, the construction and renovation of office buildings with a total area of 200 thousand sq m within the Garden Ring is planned for completion by the end of 2015 despite the measures taken by the Moscow authorities to limit new construction in the central part of Moscow.

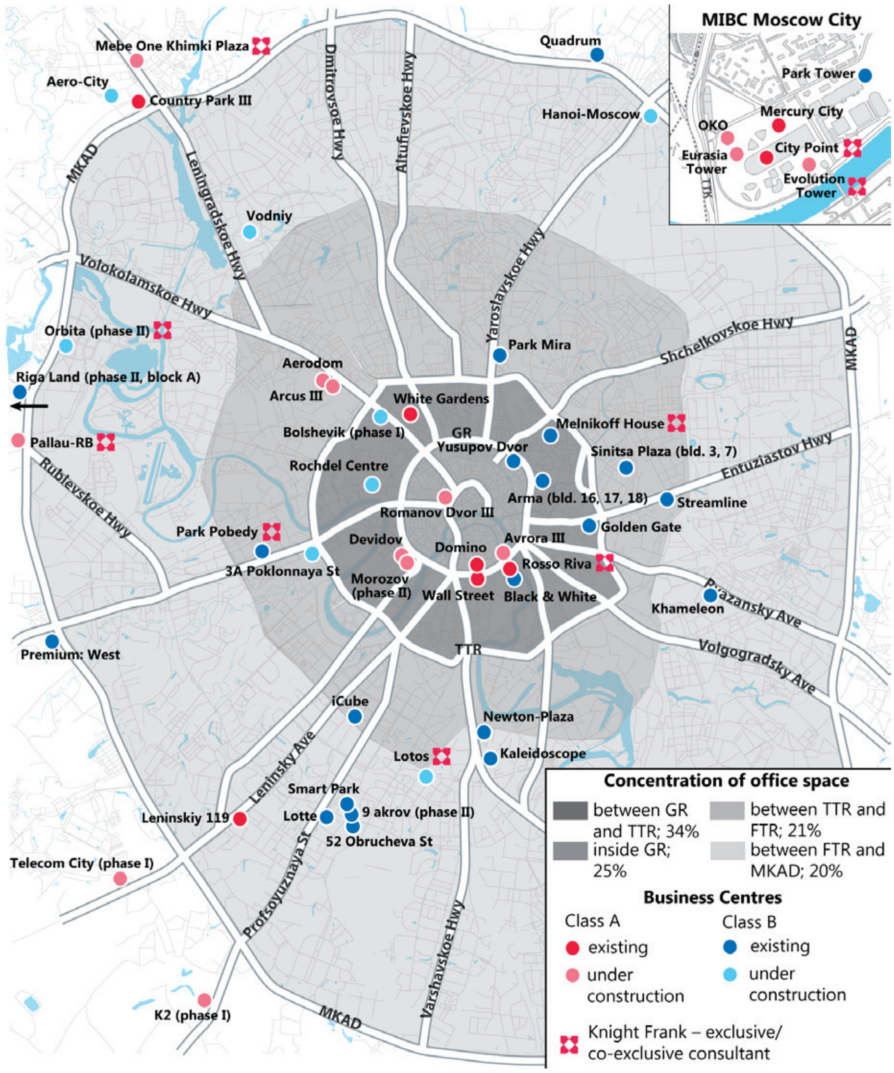
During the year developers have announced construction of a number of new projects, as well as resumption of the previously suspended ones. Areas of the most active office

In 2013, the high-quality office space delivery rate has shown a positive trend for the first time in 5 years



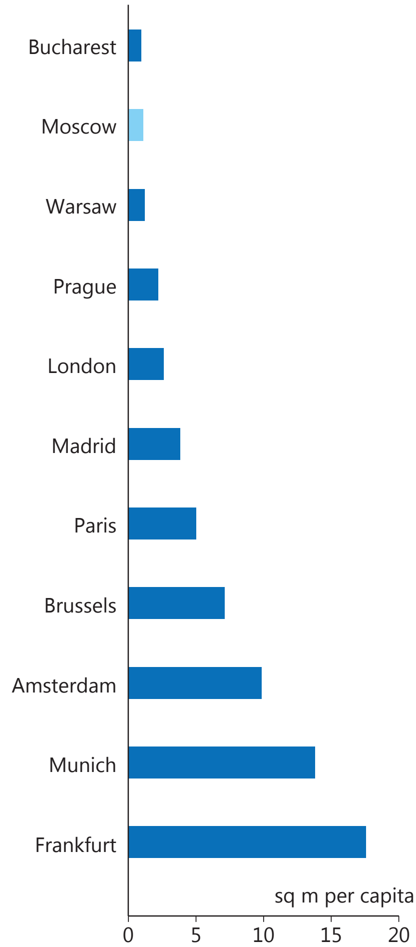
Source: Knight Frank Research, 2014

Key office facilities delivered* in 2013 and planned for delivery in 2014



* Office properties that received the delivery act in 2013
The buildings class is indicated according to the Moscow Research Forum Office Classification of 2013
Source: Knight Frank Research, 2014

Provision of office space remains low compared to European cities



Source: Knight Frank Research, 2014

construction remain those located along the Leningrad direction and the MIBC "Moscow-City". Active development of decentralized facilities in the South-West of Moscow is also worth a notice: several business parks with the total office space area of almost 250 thousand sq m are being built on the new territories near the Moscow Ring Road.

It should be emphasized that the provision of office space per capita in Moscow is still at a low level compared to the developed markets of the world capitals notwithstanding the intensive rate of development of the Moscow office market.

In 2013, thanks to the efforts of the Moscow Research Forum* the classification of office buildings developed in 2003 and refined in 2006 has been updated. Requirements for Class A office buildings have become stricter, and the buildings that failed to meet the new criteria were categorized as Class B. Thus the total supply stock of high-quality office space corresponding to Class A has dropped by about 3% in the middle of 2013 and for the year amounted to 2,683 million sq m against the 2,557 million sq m figure of 2012.

Demand

The lease and purchase transactions volume for Class A and B office space in Moscow amounted to about 750 thousand sq m for 2013. Throughout the year, we noted that demand has dropped compared to the previous year, and despite the traditionally high market activity in the H2, the annual decline amounted to about 20%.

The caution with which companies enter the market and strive to optimize office space

* The Moscow Research Forum exists since 2003, and is presently comprised of analytical subdivisions of five leading international consulting companies: CBRE, Colliers International, Cushman & Wakefield, Jones Lang LaSalle, Knight Frank. The office building classification has been created by the Forum participants in 2003, and then refined and updated in 2006 and 2013.

to cut down on lease expenses is primarily a result of uncertainty within both the global and the Russian economies. Meanwhile, the number of transactions has remained virtually unchanged and the drop in demand occurs mostly through the reduction of leased space: compared to the previous year, in 2013, the average transaction volume has shrunk by almost a quarter and amounted to 1.4 thousand sq m.

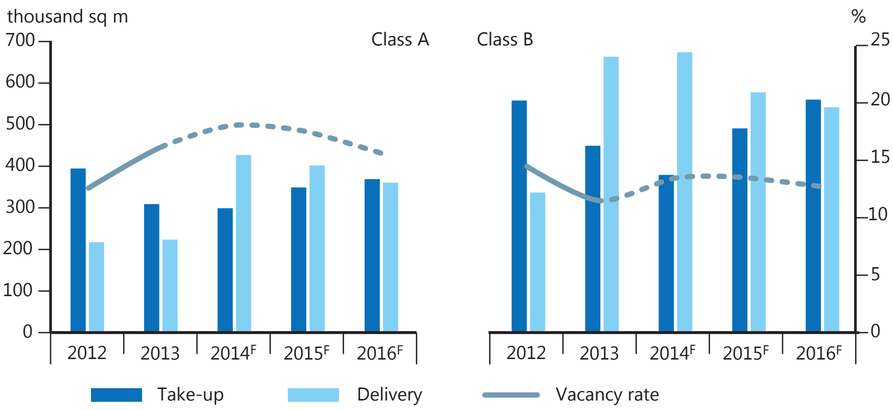
The vacancy rates dynamics for Class A and B office centers in 2013 was diverging. Compared to Q4 2012, the vacancy rate in Class A business centers has grown by 3.6 p.p. to 16.2 %. This growth resulted from delivery of several large office buildings against the backdrop of the decline in demand. Presently, the market situation is such that preliminary agreements to lease office facilities before their delivery is not a common practice, which is why addition of large objects to the total supply stock leads to an increase in vacancy rates.

In turn, the vacancy rate in Class B by the end of 2013 has shown the lowest figure for the last 6 years: over the year, the indicator has dropped by 3.0 p.p. reaching the rate of 11.5% by the end of the considered period. This situation is explained by the desire of some companies to relocate to the more attractive in terms of the "price to quality" ratio Class B business centers, resulting in the uptake growth for office space in this Class. Besides the lower rental rates, such objects attract tenants with a possibility to lease office blocks with finish and a greater choice of options than in Class A. Furthermore, due to the somewhat unstable economic situation, some private investors who wish to diversify their assets portfolio consider the option of purchasing small-sized office properties for the purpose of leasing them out. They also generate demand for properties precisely in Class B objects, as in Class A business centers small-sized office facilities purchase is practically impossible.

According to the results of 2013, the IT and telecommunications industry companies were the most active tenants and buyers on the office real estate market, with a 30% share of total transactions. The share of these companies has not fallen below 20% for the past three years. On the contrary, the financial sector companies have shown the lowest activity in the history of the office real estate market, which may be associated with uncertainty and slowdown of economic growth of the country. The share of financial institutions, traditionally absorbing 15–25% of office space has dropped from 24% in 2012 to 9% in 2013. The companies providing B2B services, representatives of FMCG and manufacturing companies have shown strong demand for office space, resulting in a total share of just over 30% of all office space leased and purchased in 2013. The transactions volume of companies operating in the field of natural resources extraction and processing, has shrunk almost by half compared to last year. However, the deals of exactly the companies in this segment were the largest in 2013. A subsidiary of the company Gazprom has leased an office with the total area of almost 25 thousand sq m in the business center Varshavka-SKY, while the mining and metallurgical company Norilsky Nickel has signed a major lease deal for office facilities in the Mercury-City tower.

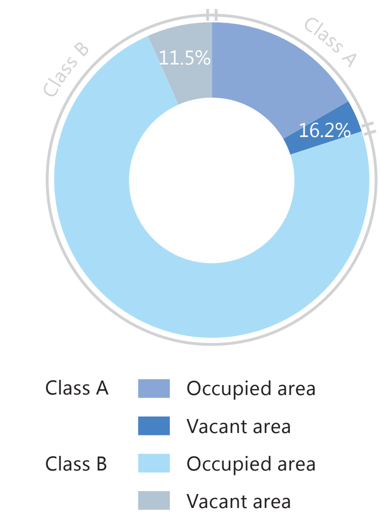
In terms of geographic distribution, more than a half of the total lease and purchase transactions fell with the objects located within the Third Ring Road.

The vacancy rates dynamics in Class A and B was diverging



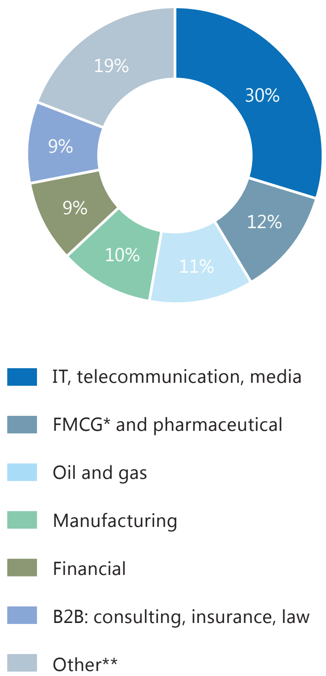
Source: Knight Frank Research, 2014

The total supply stock to vacancy rate ratios by the class of facilities



Source: Knight Frank Research, 2014

The office space uptake distribution structure by the tenants and buyers profiles



*Fast Moving Consumer Goods
** Marketing, construction, trade, automobiles, logistics
Source: Knight Frank Research, 2014

Office facilities in the Central business district are the most popular with the banking sector and B2B companies. Prestigious location and developed infrastructure are important for these organizations. However, despite the high demand in the city center, the share of leased and purchased office space in business centers in decentralized districts grows. For instance, in 2013 almost 40% of the total office space located between the Third Ring Road and the Moscow Ring Road was leased or purchased. The tenants are attracted by the more affordable commercial terms, as compared with those in the Central district facilities, as well as an opportunity to find spacious office blocks.

Commercial terms

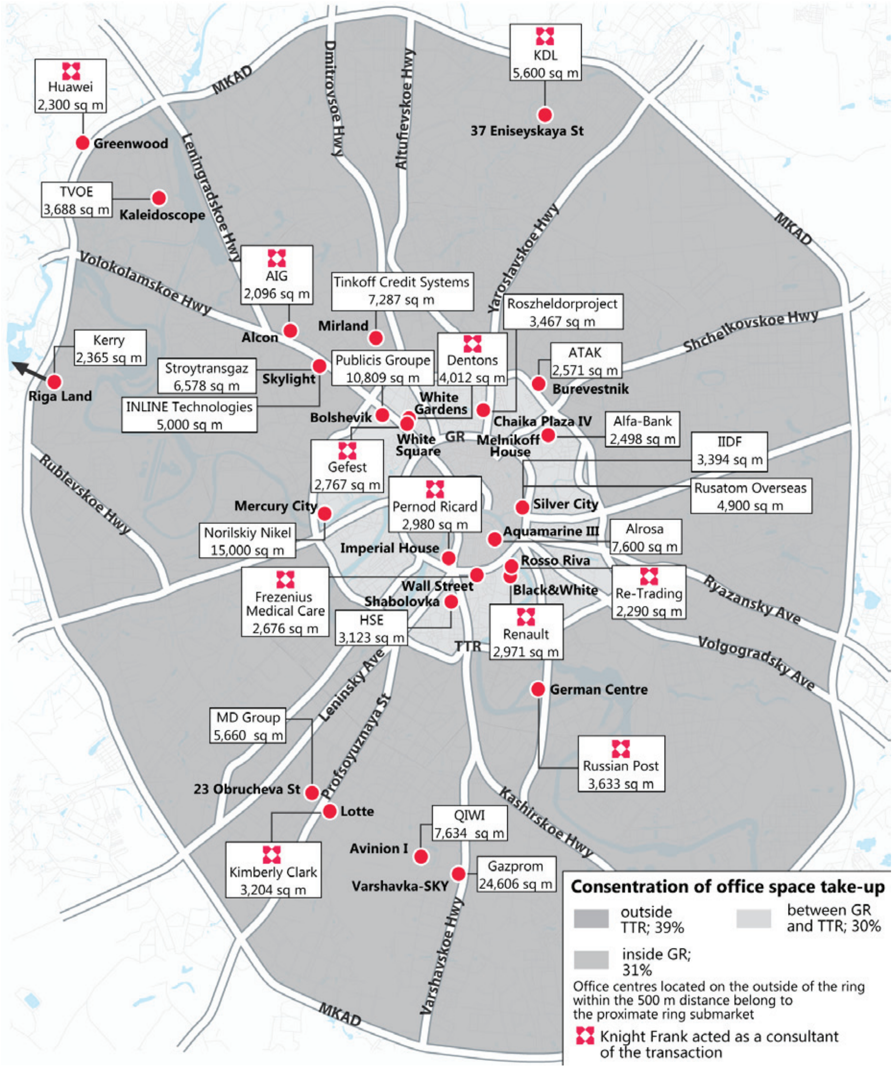
By the end of 2013, the average weighted rental rate for Class A office premises has reached a value of 800 $/sq m/year, having dropped over the year by 4%. The index adjustment has occurred largely due to the changes in the office space supply structure: namely, an increase in the total supply of Class A facilities located in remote areas of the city. In addition, a downward pressure on the index value is exercised by the reduced demand for Class A office space and an increase in vacancy rates. Compared with the end of 2012, the range of asking rental rates for Class A offices has expanded and now amounts to 400–1,200 $/sq m/year (earlier it was 650–1,200 $/sq m/year).

In turn, the average asking rental rate for Class B office space has demonstrated a slight growth in the range of 2% compared to 2012 reaching a value of 492 $/sq m/year. It is worth noting that in 2013 a new classification of office space was adopted resulting in a number of former Class A properties with high rental rates getting added to the total supply stock of Class B facilities. The rental rates range for Class B office space has expanded to 300–1,100 $/sq m/year (previously 260–650 $/sq m/year).

A strong differentiation in rental rates depending on the office center location remains notable: the rental rates for Class B office space with premium placement can match the level of Class A offices with similar placement despite the difference in the quality of the projects.

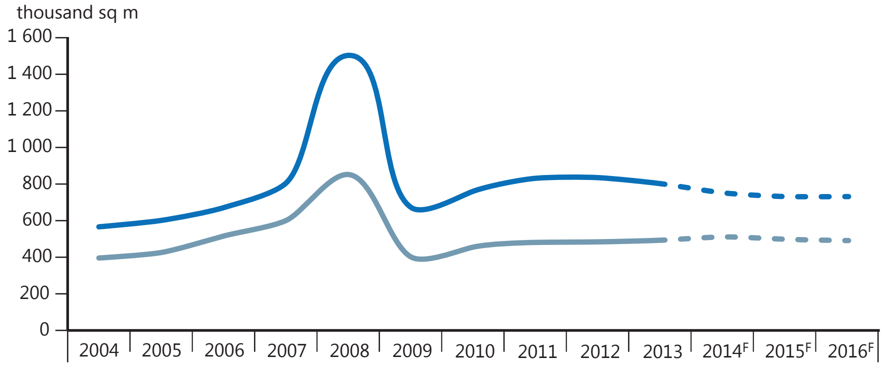
The diverging rental rates dynamics in Class A and B office space has occurred for the first time and is a result of both: technical correction due to the reclassification of office centers and the dynamics of demand. While the demand for Class A is shrinking, Class B segment is quite stable in this regard.

Key office space lease and purchase transactions of 2013



Source: Knight Frank Research, 2014

For the first time in the history of the office property market of Moscow, the rental rates for Class A and B offices show diverging dynamics



Source: Knight Frank Research, 2014

BC ALCON
72 Leningradskiy Ave

Forecast

About 1.25 million sq m (of which about 430 thousand sq m is Class A), have been announced for delivery in 2014. In a situation of relatively low demand and lack of a preliminary agreement to lease, the object owner can stretch the construction period, as the tax burden increases once the object is delivered. Thus, the new supply volume will be regulated to some extent by the presence of demand and the actual amount of new supply may be smaller.

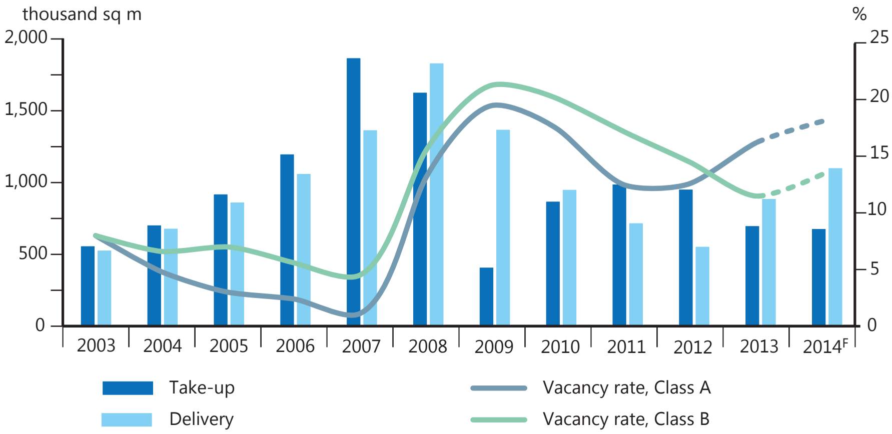
In 2013, the demand for high-quality office properties was rather moderate and its volume in 2014 will largely depend on the economic situation. In 2013, the GDP growth in Russia has shrunk to 1.4 %, according to the preliminary estimates of the Ministry of Economic Development. In 2014, the Ministry of Economic Development of the Russian Federation forecasts a gradual growth of GDP to 2.5% per year. However, we do not expect higher demand for high-quality office space in 2014: most likely, the companies will remain cautious about the lease and purchase of new office space. Presently, we expect the demand in 2014 to remain at the current level with a negative growth trend of about 10%, i.e. will be about 650–700 thousand sq m.

Thus, the supply and demand volumes will be balanced to a certain extent and the vacancy rates will either demonstrate weak growth (2–2.5%) or remain at the current level (around 16.2% for class A and 11.5% in Class B at the end of 2013).

As for the rental rates, we expect them to drop by 5–7% in Class A, while in Class B, they are likely to be adjusted to a lesser extent (by about 2–3%) or remain stable. However, in addition to the market factors (supply and demand balance and vacancy dynamics) the value of rental rates will be influenced by the exchange rate of the ruble against the dollar. Since the majority of owners of high-quality office facilities specify their rental rates in U.S. dollars, further weakening of the ruble will lead to the rates adjustment.

Furthermore, the changes in tax legislation that have come in force since January 2014 will have impact on the base rental rates. From now on, according to the Federal Law number 307 of November 2, 2013 "On amending Article 12 of the first part and chapter 30 of the second part of the Tax Code of the Russian Federation", the real estate tax will be calculated on the basis of the cadastral value of the property and not the carrying value. This can lead to several times higher tax burden on the office and retail properties owners. Since the property tax is commonly accounted for as part of the operating costs, its growth will also increase their value. Under conditions of a fairly moderate demand, it could lead to a drop in base rental rate value rents in favor of an increase in operating costs.

In 2014, the planned delivery volume is likely to exceed the uptake amount resulting in a slight growth of vacancy rate



Source: Knight Frank Research, 2014

RESEARCH

Europe
Austria
Belgium
Crech Republic
France
Germany
Ireland
Italy
Monaco
Poland
Portugal
Romania
Russia
Spain
Switzerland
The Netherlands
UK
Ukraine

Africa
Botswana
Kenya
Malawi
Nigeria
Tanzania
Uganda
Zimbabwe
Zambia
South Africa

Middle East
Bahrain
UAE

Asia Pacific
Australia
Cambodia
China
India
Indonesia
Malaysia
New Zealand
Singapore
South Korea
Thailand
Vietnam

Americas & Canada
Bermuda
Caribbean
Canada
USA

Newmark Knight Frank Global

Offices
Konstantin Losiukov
Director
konstantin.losiukov@ru.knightfrank.com

Warehouse and land
Viacheslav Kholopov
Partner, Director, Russia & CIS
viacheslav.kholopov@ru.knightfrank.com

Retail
Sergey Gipsh
Partner, Director, Russia & CIS
sergey.gipsh@ru.knightfrank.com

Residential
Elena Yurgeneva
Director, Russia & CIS
elena.yurgeneva@ru.knightfrank.com

International Investments
Heiko Davids
Partner
heiko.davids@ru.knightfrank.com

Investment and Sales
Evgeniy Semyonov
Partner, Director, Russia & CIS
evgeniy.semyonov@ru.knightfrank.com

Business Development
Andrey Petrov
Partner
andrey.petrov@ru.knightfrank.com

Strategic Consulting
Konstantin Romanov
Partner, Director, Russia & CIS
konstantin.romanov@ru.knightfrank.com

Valuation
Olga Kochetova
Director, Russia & CIS
olga.kochetova@ru.knightfrank.com

Property Management
Dmitry Atopshev
Partner, Director
dmitry.atopshev@ru.knightfrank.com

Project Management
Andrew Zakrewsky
Partner
andrew.zakrewsky@ru.knightfrank.com

Marketing, PR
Maria Danilina
Director, Russia & CIS
maria.danilina@ru.knightfrank.com

Market Research
Olga Yasko
Director, Russia & CIS
olga.yasko@ru.knightfrank.com

Saint Petersburg
Nikolai Pashkov
General Director
nikolai.pashkov@ru.knightfrank.com

Established in London more than a century ago, Knight Frank is the renowned leader of the international real estate market. Together with Newmark Company, Knight Frank's strategic partner, the company encompasses 370 offices in 48 countries across six continents.

Knight Frank has been a symbol of professionalism for tens of thousands of clients all over the world for 117 years. After 17 years, Knight Frank has become the leading company in the commercial, warehouse, retail and residential real estate segments of the Russian real estate market. More than 500 large Russian and international companies in Russia have already made use of the company's services.

This and other Knight Frank overviews can be found on the company website www.knightfrank.ru

MOSCOW

Russia, 115054,
26 Valovaya St
Lighthouse BC

Phone: +7 (495) 981 0000
Fax: +7 (495) 981 0011

ST. PETERSBURG

Russia, 191025,
3B Mayakovskogo St
Alia Tempora BC

Phone: +7 (812) 363 2222
Fax: +7 (812) 363 2223