RESEARCH

H1 2014
OFFICE MARKET REPORT
Moscow

HIGHLIGHTS

- The volume of delivered Class A and B offices in H1 2014 amounted to 533 thousand sq m, surpassing the figure for the same period last year by 36%.
- Take-up of high-quality office space in H1 2014 amounted to about 305 thousand sq m.
- The vacancy has reached the level of 17.6% in Class A and 12.4% in Class B.
- Having continued to decline, the average rental rates for Class A office space amounted to 754 $/sq m/year and 457 $/sq m/year for Class B.

OFFICE MARKET REPORT

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"Office real estate market of Moscow continues to be influenced by negative dynamics of macroeconomic indicators and geopolitical tensions in connection with the conflict in Ukraine. Key market trends have only intensified in Q2: a growth of supply against the shrinking of demand resulting in the lowering of lease rates. All these factors clearly create a "tenant market" in which those companies that are beginning to search for a new office, have the greatest opportunity to optimize lease expenses, pick high-quality accommodation and negotiate comfortable lease agreement conditions".

Key indicators. Dynamics*

Key indicators		Class A	Class B
Total stock, thousand sq m		13,888	
including, thousand sq m		2,992	10,896
Delivered in H1 2014, thousand sq m		533	
including, thousand sq m		289	244
Vacancy rate, %		17.6	12.4
		(+1.4 p. p.)*	(+0.9 p. p.)*
Average asking rental rate**, $/sq m/year		754	457
		(-6%)*	(-7%)*
Rental rates range**, $/sq m/year		360–1,000 (1,000–1,300***)	250–900
Average OPEX rate, $/sq m/year		150	100

* Compared to Q4 2013
** Excluding Operational Expenses and VAT (18%)
*** Range of asking rents for premium fitted-out space
Source: Knight Frank Research, 2014

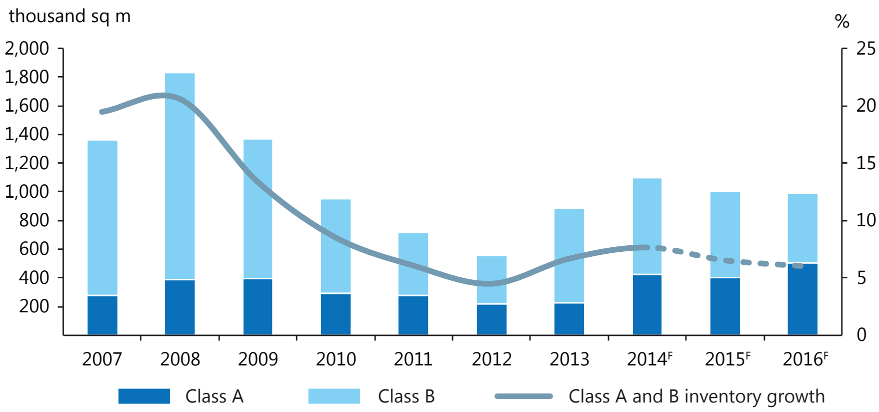
Supply

By the end of H1 2014, the total supply of high-quality office space in Moscow amounted to nearly 13.9 million sq m, of which 3 million sq m (21%) corresponds to Class A and 10.9 million sq m (79%) – to Class B.

The expected growth of new supply is observed on today's office market. During H1 2014, about 289 thousand sq m of Class A and 244 thousand sq m of class B office space were delivered. Combined, this figure is 36% bigger than that for the same period last year and is the highest since 2009. According to our forecasts, in 2014, the delivery volume will exceed the previous year by almost 20%, amounting to about 1.1 million sq m.

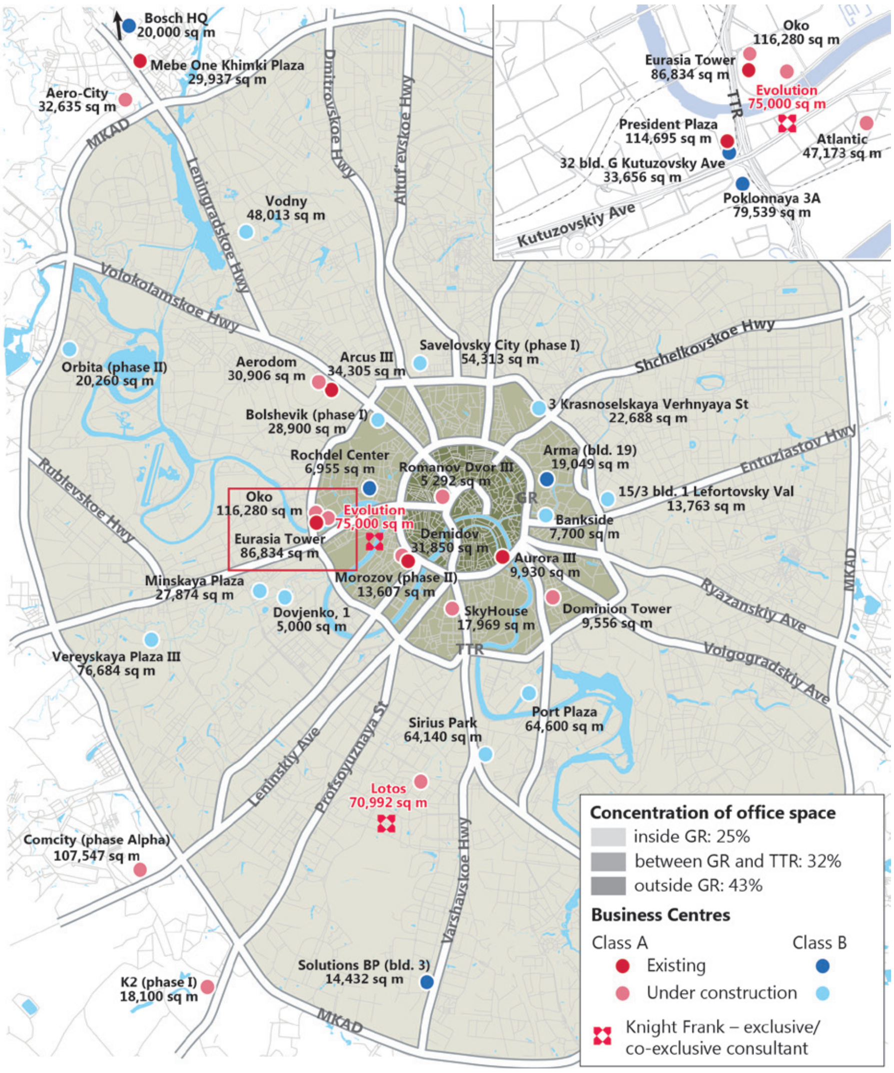
Decentralization of business life is an important feature of today's office market of Moscow. The largest volume of delivered office space in Classes A and B has taken place in the area between the Garden Ring and the Third Transport Ring (73%), while 20% was delivered outside the TTR and only 7% of new stock – inside the Garden Ring. Remote business districts continue to be actively developed in Moscow. Until the end of the year, two more objects are planned for delivery as a part of the MIBC Moscow-City, thus the supply stock of office space in the business district will exceed 850 thousand sq m. In 2014–2015, we expect the construction of BC Lotos in the southwestern business district, as well as business parks G10, Comcity and K2 on the territory of the New Moscow to be completed.

According to our estimates, the delivery volume of high-quality office space in 2014 will show the highest value since 2010



Source: Knight Frank Research, 2014

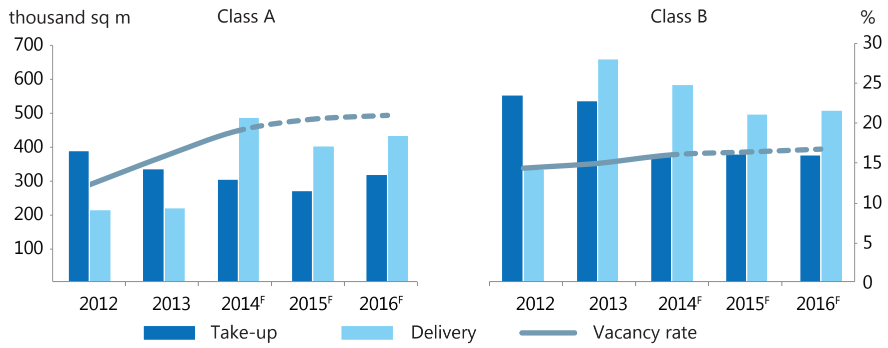
Key office projects delivered in H1 2014* and planned for delivery by the end of 2014



* Office properties that received the delivery act in H1 2014
The buildings class is indicated according to the Moscow Research Forum Office Classification of 2013

Source: Knight Frank Research, 2014

We expect further vacancy rates growth in the offices of Class A and B



Source: Knight Frank Research, 2014

Demand

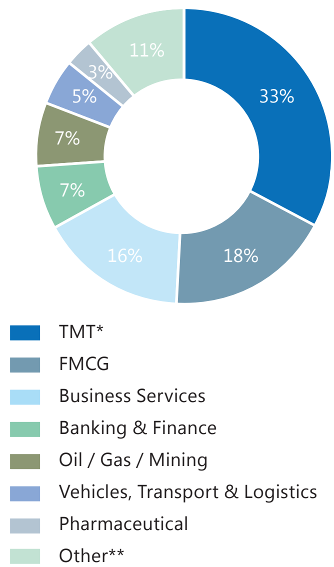
The net take-up, an indicator showing the difference in the level of occupied space in the delivered office buildings in relation to the previous period, amounted to about 305 thousand sq m.

After a period of steady demand for high-quality office space in 2011–2012, we started to note a drop in transactions volume since H1 2013. The cautiousness of tenants associated with uncertainty of both the Russian and the global economies, which was characteristic for the office market last year, as expected, has carried over to 2014. Meanwhile, Russia's involvement in geopolitical conflict in Ukraine, the risks associated with introduction of sanctions against Russia, and extremely low economic growth have intensified fears of tenants and investors on the market.

Vacancy rate in Class A and B office buildings has grown in H1 2014. In Class A offices, this growth amounted to 1.4 p. p. compared to Q4 2013, with the vacancy rate amounting to 17.6%. In Class B offices, the vacancy rate has reached 12.4%.

Despite the drop in demand, we note activity retention on the office real estate market.

By the end of H1 2014, High-Tech companies together with FMCG-sector have leased and purchased a half of Class A and B office space in the total volume of transactions



* Technology/media/telecommunications
** Manufacturing and construction companies
Source: Knight Frank Research, 2014

A number of transactions are at the negotiation stage, and we still expect the traditional growth of demand in H2. However, the structure of queries from tenants and buyers has changed. The care with which tenants are entering the market is reflected in the prolongation of transaction closing terms – the companies are starting the move project much earlier than before.

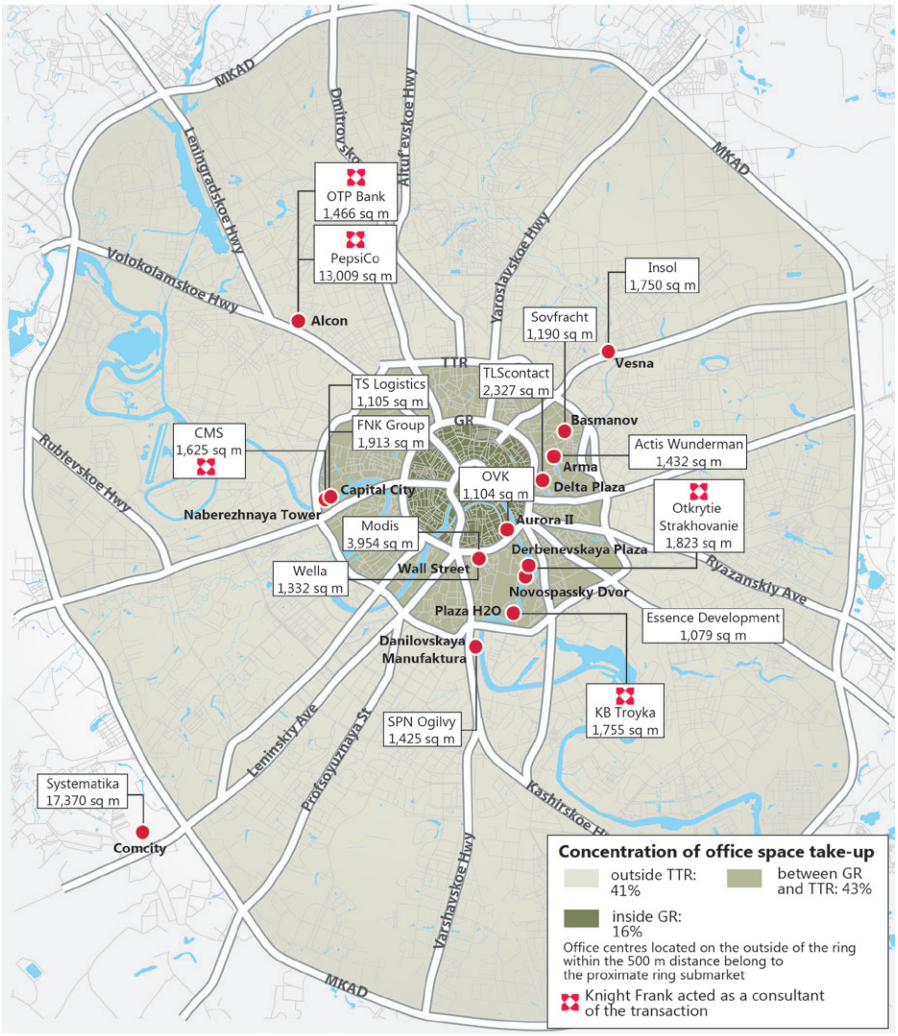
Wishing to optimize office space and reduce lease expenses, companies are trying to move their back offices in the buildings, where rental rate is lower. If the company business profile does not require having an office in the city center, companies seek to consolidate all business units in a facility, with decentralized location. In H1 2014, only 15% of office space was leased and purchased within the Garden Ring. The largest transactions volume of 43% fell with office buildings located near the Third Ring Road.

We note a drop in the share of companies that decided to move in the total transactions volume. If in H1 2014 the share of lease terms renegotiation transactions was a fourth of the total lease transactions volume, by the end of H1 2014, the share of such transactions reached 45%. The volatility of currency exchange rates, as well as instability of the office market today are the reasons for which the tenants whose leases expire prefer to postpone the move and stay in the occupied building.

The average transaction size in Q2 2014 has dropped to 1.1 thousand sq m (1.4 thousand sq m based on the results of 2013 and 1.2 thousand sq m in Q1 2014). In total, only two office lease transactions, with size exceeding 5 thousand sq m occurred in H1 2014.

According to H1 2014 data, like for the same period last year, representatives of TMT-sector (technology/media/telecom) were the most active in terms of lease and purchase of office space. Following a slight growth, the share of high-tech companies in the total transactions volume has reached 33%. We also notice shrinking in the shares of oil and gas companies and financial institutions. However, while the case of oil and gas companies share decrease in H1 2014, results mainly from a large-scale lease transaction by Gazprom in H1 2013. The drop in activity of financial sector, for which the share in the total volume of transactions has not fallen below 20% for 2 years, results from heightened carefulness of the companies following from the high degree of uncertainty of the country's economy. A major lease transaction of 13 thousand sq m by the Pepsi Co Company, which took place within the office complex Alcon, whereby brining the share of FMCG-sector companies to 18% of total transactions on lease and purchase of office space is worth a notice.

Key office space lease and purchase transactions concluded in H1 2014



Source: Knight Frank Research, 2014

Commercial terms

Today's office real estate market is under pressure from unfavorable dynamics of macroeconomic indicators, as well as from the negative geopolitical setting in connection with the events in Ukraine. Having started in H1 2013, the decline in average lease rates against the background of high degree of uncertainty continues in 2014. Having shrunk by almost 6% compared to the end of 2013 and by 3% compared with Q1 2014, average asking lease rates for Class A offices amounted to 754 $/sq m/year.

When it comes to Class B offices, average asking lease rate for H1 2014 amounted to 457 $/sq m/year, which is 7% lower than in Q4 2013. It is worth a notice that the average-weighted lease rate for Class B office space remained unchanged compared to Q1 2014.

Forecast

A growth in delivery of high-quality office space against the background of cautious attitude of investors and tenants will continue to put pressure on the dynamics of core indicators. In 2014–2015, a number of high-quality projects in rapidly developing business districts is planned for delivery. This will lead to a growth of competition on the market and will allow tenants to choose office space of various formats with more attractive commercial terms.

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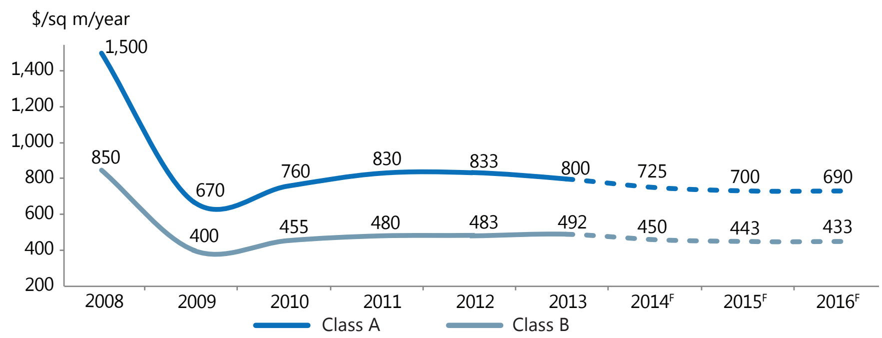
Average asking lease rates dynamics for Class A and B office space



Source: Knight Frank Research, 2014

While the slowdown in economic development of the country, as well as geopolitical tensions remain limiting factors for the formation of demand, we expect some activity growth of tenants and buyers in H2 2014.

According to our forecasts, lease rates for Class A offices will continue to decline, while Class B promises stable performance. Should this trend persevere, we will observe a situation where premium segment offices will experience no major changes, while Class B tenants will have the opportunity to move to higher class offices without significant increases in commercial terms.

Moscow submarket data. Key indicators

Submarket		Lease Area, thousand sq m	Class A				Class B			
			Average Rent, $/sq m/year		Vacancy Rate, %		Average Rent, $/sq m/year		Vacancy Rate, %	
Boulevard Ring	Central Business District	746	1,079		14.6		584		9.2	
Garden Ring	South	1,044	771	812	15.3	11.9	707	642	10.4	16.2
	West	551	1,043		7.1		880		4.5	
	North	775	879		5		783		11.7	
	East	311	833		18.9		549		37.6	
Third Transport Ring	Leninskiy	137	-	798	0	15.5	648	488	11.4	10.3
	Tulskiy	728	-		0		443		9.2	
	Khamovniki	302	730		0.4		881		3.1	
	Kievskiy	362	850		0		555		39.3	
	Presnenskiy	379	760		0		683		2.4	
	Prospekt Mira	371	529		45.5		525		12.5	
	Tverskoy-Novoslobodskiy	697	903		26.4		520		4.9	
	Basmanniy	466	-		0		449		9.7	
	Taganskiy	322	-		0		444		14.9	
	Volgogradskiy	203	-		0		441		2.6	
	MIBC Moscow-City	661	812		20.3		825		10.7	
TTR-MKAD	North	752	-	650	0.8	25.6	306	422	8.9	12.2
	South	1381	702		46		432		14.6	
	West	641	689		37.2		553		12	
	East	472	522		44.4		363		8	
MKAD	North	533	-	403	0	24.1	258	355	11.5	14.9
	South	618	-		95.4		336		19.9	
	West	1,231	403		23.1		334		16.3	
	East	205	-		0		228		10.6	
Total		**13,888**	**754**		**17.6**		**457**		**12.4**	

Source: Knight Frank Research, 2014

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