RESEARCH

Q3 2014

OFFICE MARKET REPORT

Moscow

HIGHLIGHTS

- The volume of Class A and B office space delivered since the beginning of the year exceeded 1 million sq m, which is almost twice the amount of the same period last year.
- The vacancy rate for Class A space on the Moscow office real estate market has reached its record level of 25.7%.
- The take-up volume has dropped by 45% compared to the same period last year and amounted to about 430 thousand sq m.
- Average asking lease rates for office space have dropped by 10% in Class A and by 8% in Class B since the beginning of the year.

OFFICE MARKET REPORT

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"The office real estate market, as well as the economy of the country are currently under the influence of geopolitical tensions and the consequences of sectoral sanctions. Competition for tenant has intensified against the background of growth in vacancy rates on the market – only high-quality facilities, the owners of which are able to adapt to clients' needs and are willing to offer attractive lease terms will be able to ensure high occupancy".

Key indicators. Dynamics*

Key indicators	Class A	Class B
Total stock, thousand sq m	14,385	
including, thousand sq m	3,256	11,129
Delivered in Q1–Q3 2014, thousand sq m	1,029	
including, thousand sq m	553	476
Vacancy rate, %	25.7	13.7
	(+9.4 p. p.)*	(+2.2 p. p.)*
Average asking rental rate**, $/sq m/year	722	444
	(-10%)*	(-8%)*
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

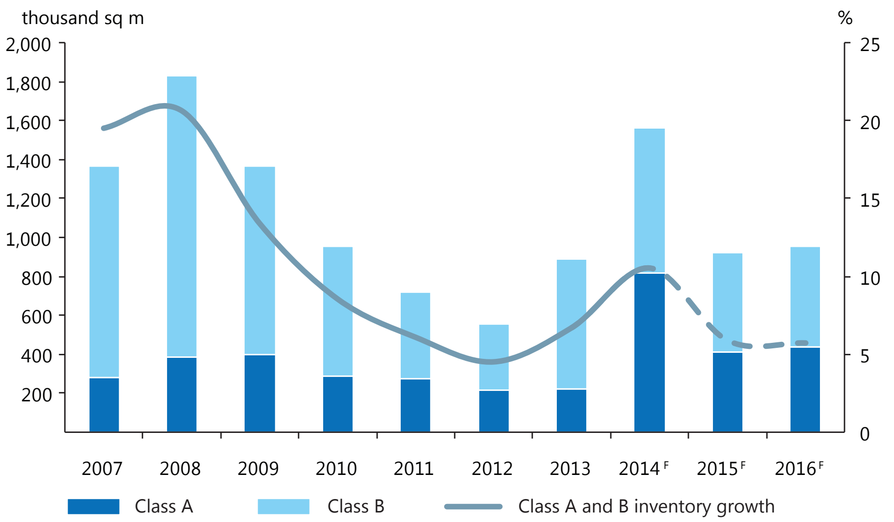
By the end of Q3 2014, the total high-quality supply stock volume on the office real estate market of Moscow has reached 14.4 million sq m, of which 3.3 million sq m (23%) correspond to Class A and 11.1 million sq m (77%) – to Class B.

In 2014, high-quality office space delivery growth proceeds at the expected rate. From January to September 2014, 553 thousand sq m of Class A and 476 thousand sq m of Class B were delivered, which in total almost doubly exceeds the new supply volume for the same period in 2013. According to our forecasts, the delivery volume of Class A and B offices in 2014 might reach 1.5 million sq m, which would be a record figure since 2008.

Such a significant growth in supply of high-quality office space is a consequence of recovering real estate development activity, as well as the stability of the key indicators of office property market in 2011–2012. During this period, the difference in construction costs for Class A and B office buildings was low, while the delta in lease rates was about 40%, therefore the developers made a choice in favor of construction of high-class objects. Thus, given the duration of construction of an office building, in 2014, the volume of delivered Class A offices may amount to about 800 thousand sq m.

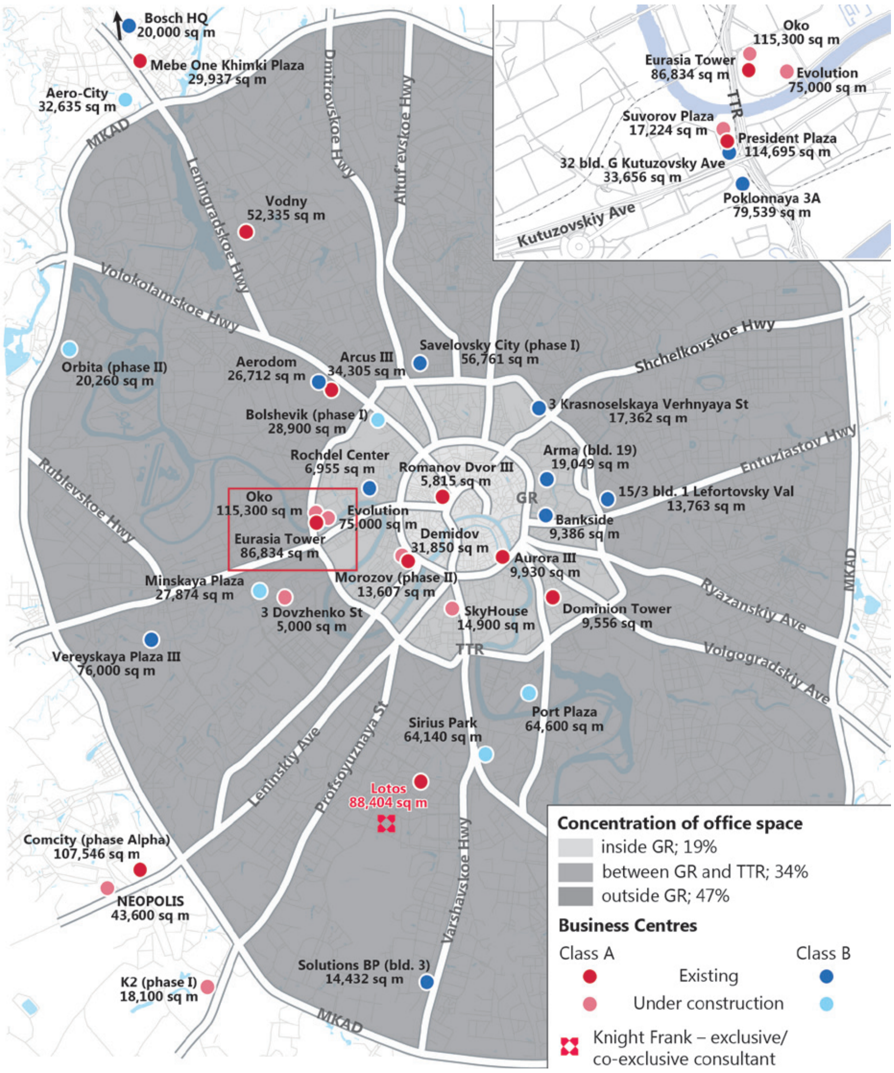
As to the territorial distribution of office space, half of the new supply stock is located in the actively emerging decentralized business districts. It is worth a notice that in Q3, a major growth of office space occurred in the Southwest, as well as in the territory of New Moscow where a large business park Comcity and MFC Lotus were delivered.

The delivery volume of Class A and B offices in 2014 will be the highest in 5 years



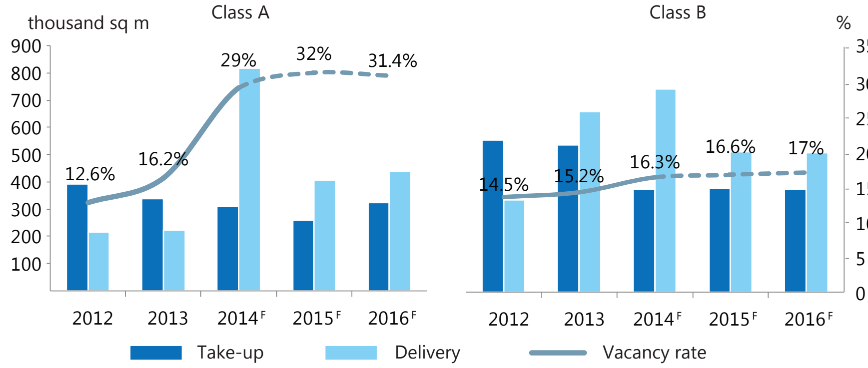
Source: Knight Frank Research, 2014

A map of office buildings delivered* in Q1–Q3 2014 and planned for delivery by the end of 2014



* Office properties that received the delivery act in Q1-Q3 2014
The buildings class is indicated according to the Moscow Research Forum Office Classification of 2013
Source: Knight Frank Research, 2014

By the end of 2014, the vacancy rate may reach 30%



Source: Knight Frank Research, 2014

Demand

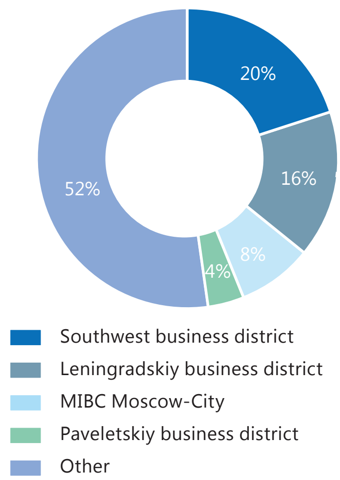
Office space take-up volume from January to September 2014 amounted to about 430 thousand sq m, which is almost 45% less than for the same period of the previous year.

Despite the decline in demand volume for high-quality office space, the office property market is still active, however, the structure of inquires has changed and is now mainly determined by the desire of companies to reduce lease expenses. One can observe growth in the number of requests for lease terms renegotiation: companies that moved to new offices in 2011–2012, now seek to revise the terms and conditions of their lease. Among the priorities for potential tenants looking for office space, besides the proximity of the building to a subway station, one can name the low lease rate denominated in rubles, the willingness of the landlord to carry out finishing works in the premises as well as the efficient floor layout.

Today, due to the negative dynamics of macroeconomic indicators, as well as high degree of uncertainty on the commercial real estate market, a number of companies are considering the purchase of office space for their own accommodation. In turn, more objects where owners are willing to sell office space are entering the market.

Vacancy rate continued to grow over the first three quarters of 2014. However, while in Class A the vacancy rate exceeded the level of 2008–2009 recession, reaching the highest

Delivered office space according to business districts



Source: Knight Frank Research, 2014

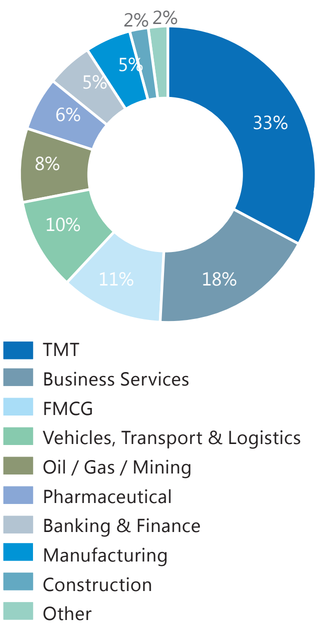
rate for office real estate market of Moscow – 25.7% (+9.4 p. p. YTD); for Class B office space, since the beginning of 2014, the growth was only 2.2 p. p. – to the rate of 13.7%.

During the period from January to September 2014, the largest volume of lease and purchase transactions of high-quality office space fell to High-Tech and Media companies. Since 2011, the TMT sector companies are highly active within the total transactions volume leasing and buying 20–30% of Class A and B office space. The companies of financial and banking sector, providing the lowest activity in the history of the office market in 2013, remained cautious against the background of current situation in Q1–Q3 2014: in total demand volume, they leased and purchased only 6% of office space.

Commercial terms

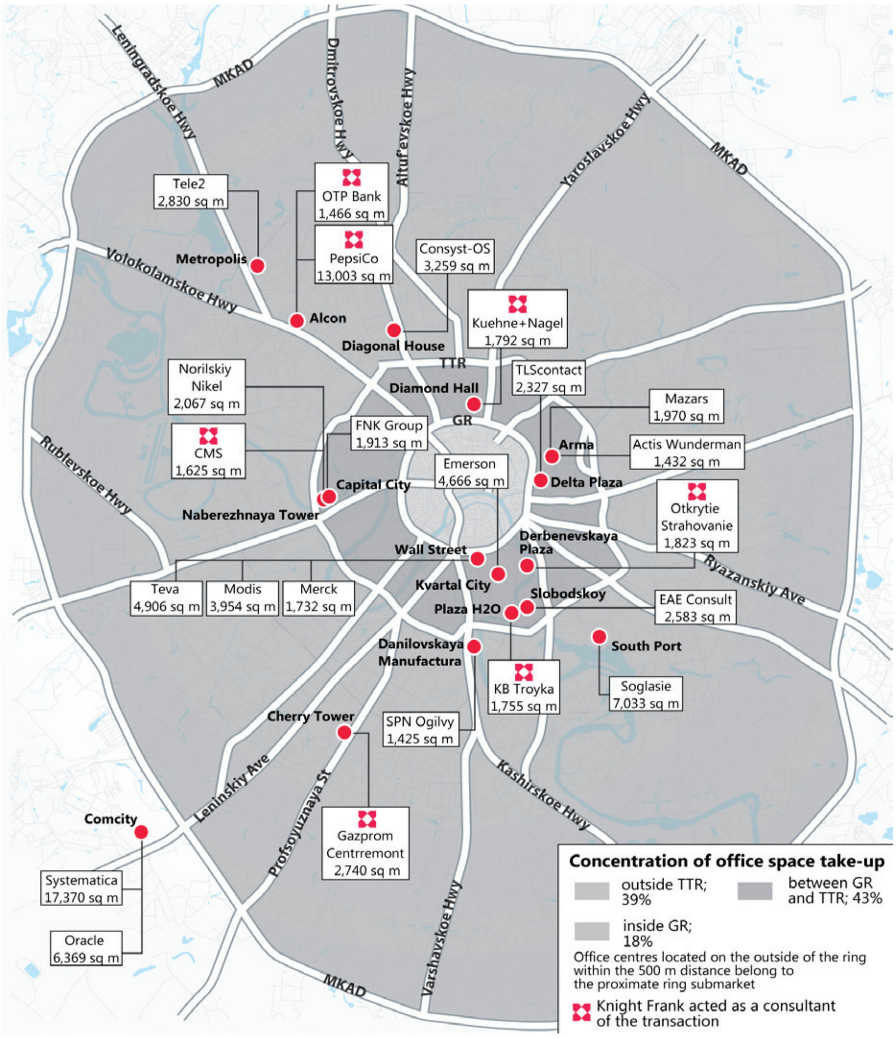
During the first 9 months of 2014, asking lease rates for Class A and B office space exhibited downward dynamics. Trying to minimize vacancy rate, landlords were reviewing commercial terms and conditions offering more attractive lease terms.

Over Q1–Q3 2014, financial sector companies have demonstrated the lowest lease and purchase activity in the history of office market



Source: Knight Frank Research, 2014

Key office space lease and purchase transactions concluded in Q1–Q3 2014



Source: Knight Frank Research, 2014

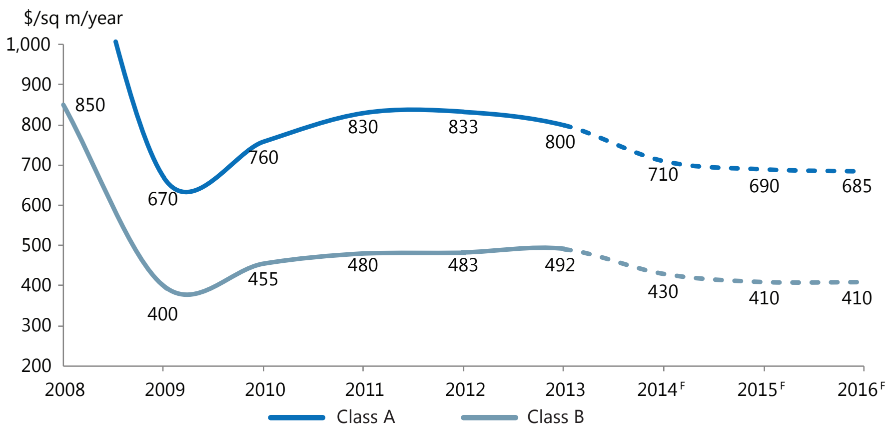
The average asking lease rate in Class A offices decreased by 10% since the beginning of the year and amounted to 722 $/sq m/year. A drop in the weighted average has also resulted from the delivery of a number of large office complexes located remotely from the center.

In turn, the average asking lease rate for Class B office space has dropped to 444 $/sq m/year, which is 8% lower than the figure at the beginning of the year. However, it should be noted that during the quarter, the average weighted lease rate has changed slightly (under 3%). This is a result of changes within the supply structure: expensive premises became vacant during Q3, while office space with lower lease rates has experienced higher demand.

Forecast

According to the adjusted forecast of the Ministry of Economic Development, Russia's GDP growth in 2015 will amount to 1%. Besides the weak economic growth, next year we may experience the delayed effect of the sanctions implemented in 2014 and of the further decline in oil prices. Due to the unfavorable economic and geopolitical situation, the companies will continue to

The lease rates decline for Class A and B premises will continue in 2015



Source: Knight Frank Research, 2014

revise their development plans, as well as attempt to optimize their expenditure – a number of large companies have already announced staff downsizing.

The vacancy rates will continue to grow. By the end of 2014, taking into account facilities planned for delivery before the end of the year (Oko and Evolution Towers, BC Bolshevik, as well as business parks Neopolis and K2), the vacancy rate for Class A in Moscow can reach 30%. The growing competition on the office market against the background of unstable demand will force the landlords to continue downward lease adjustments. We forecast a drop in asking lease rates by 2–3% by the end of 2014 and by about 10% in 2015.

Moscow submarket data. Key indicators

Submarket		Lease Area, thousand sq m	Class A: Average Rent, $/sq m/year		Class A: Vacancy Rate, %		Class B: Average Rent, $/sq m/year		Class B: Vacancy Rate, %	
Boulevard Ring	Central business district	711	1,068		14.8		578		11.3	
Garden Ring	South	839	767	803	13.8	10.9	717	654	13.5	13.6
	West	275	1,000		4.5		879		10.4	
	North	574	913		4.9		754		12.8	
	East	355	803		20.2		537		18.8	
Third Transport Ring	Leninskiy	258	–	810	0	34	618	486	12.4	13.8
	Tulskiy	1,035	–		0		521		11	
	Khamovniki	242	–		0		876		2.5	
	Kievskiy	376	850		100		570		59.8	
	Presnenskiy	327	772		11.6		754		4.6	
	Prospekt Mira	163	527		43		443		7.6	
	Tverskoy-Novoslobodskiy	737	903		26		495		3.9	
	Basmanniy	445	–		0		322		17	
	Taganskiy	228	–		0		442		13.3	
	Volgogradskiy	376	731		100		433		3.5	
	MIBC Moscow-City	661	804		36.7		693		6.4	
TTR-MKAD	North	581	–	625	0	35.6	341	419	10.8	12.5
	South	1,668	610		58.8		409		14.4	
	West	1,195	681		33.4		533		12	
	East	632	522		44.4		402		10.1	
MKAD	North	654	–	392	0	21	270	315	15.5	16.5
	South	289	–		0		338		17.5	
	West	1,516	392		23.1		332		20.4	
	East	248	–		0		213		9.8	
Total		**14,385**	**722**		**25.7**		**444**		**13.7**	

Source: Knight Frank Research, 2014

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