RESEARCH

2017

OFFICE MARKET REPORT

Moscow

HIGHLIGHTS

- In 2017, 408 thousand sq m were completed, that 28% higher than in 2016. The main delivery volume was registered in Q4 – 312 thousand sq m, or 77% of the total volume of space completed in 2017.
- The total net take-up in Class A and B offices grew by 15% against 2016 to be equal to 657 thousand sq m.
- In 2017 the size of absorption of Class B office space surpassed the volume of completed Class B office space by 2.4 times and as a result Class B vacancy rate decreased to 11.5%.
- Average weighted asking rental rate has reached the level of 22,923 RUB/sq m/year in Class A offices and 14,074 RUB/sq m/year in Class B. Class A rental rates dropped down by 5.6% YoY and Class B rental rates dropped up by 5.2% YoY

OFFICE MARKET REPORT MOSCOW

Konstantin Losiukov
Director, Office Department,
Knight Frank

"Recently, the segmentation of the office real estate market depending on the liquidity level has become apparent. The main market indicators have changed much more quickly in the highest demand districts, and sometimes, they've simply run counter to average values throughout Moscow. For example, the average Class A rents may go down by the end of the year, but they can move up in the most liquid districts. If 17% is characteristic of Class A vacant space, but it does not exceed 10% in these districts, this is a completely different market. And the secret of success is not in the well-known proximity to the centre, but in a lucky combination of quality supply, convenient transport accessibility and developed infrastructure. These characteristics will play a key role in choosing an office in the nearest future".

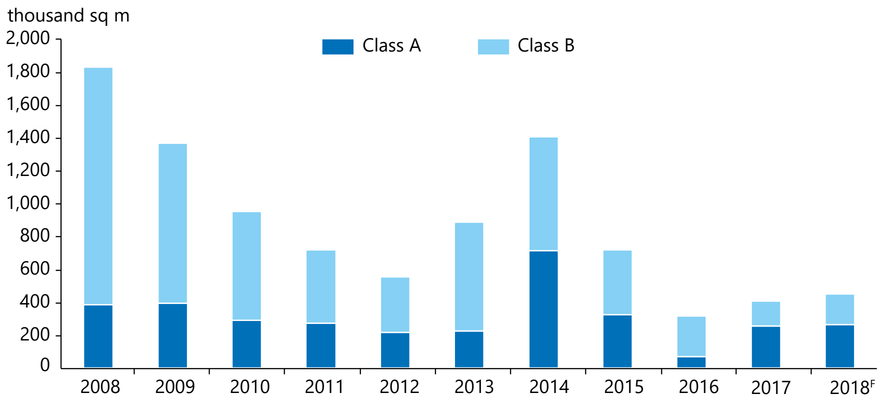
Key indicators. Dynamics*

		2016	2017
Total stock, thousand sq m		15,855	16,263
including, thousand sq m	Class A	3,891	4,149
	Class B	11,864	12,114
New delivery volume in 2017, thousand sq m		317	408 ▲
including, thousand sq m	Class A	70	258 ▲
	Class B	247	150 ▼
Net take-up volume* in 2017, thousand sq m		564	657 ▲
including, thousand sq m	Class A	308	296 ▼
	Class B	256	361 ▲
Vacancy rate, %	Class A	20.7	17.1 ▼
	Class B	15.4	11.5 ▼
Average weighed asking rental rate**, RUB/sq m/year	Class A	24,280	22,923 ▼
	Class B	13,379	14,074 ▲
OPEX rate range***, RUB/sq m/year	Class A	6,150	6,490 ▲
	Class B	3,850	4,080 ▲

* Compared to Q4 2016
** Excluding operational expenses, utility bills and VAT (18%)
*** OPEX rate does not consider change related to property tax rate increase

Source: Knight Frank Research, 2018

Class A and B new delivery volume dynamics



Source: Knight Frank Research, 2018

Supply

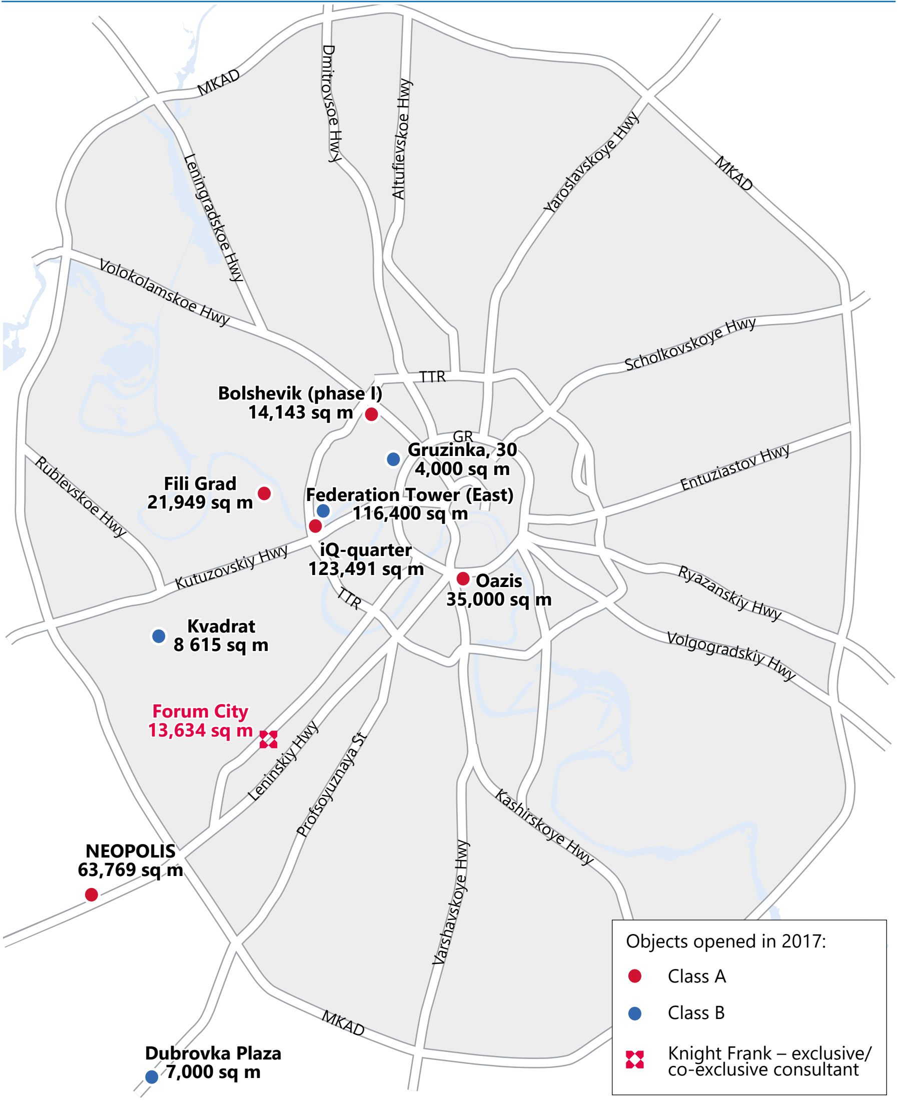
The total quality office stock of Moscow surpassed the mark of 16 million sq m and came up to 16.3 million sq m, where 25% corresponded to Class A offices and 75% to Class B.

In 2017, 408 thousand sq m were completed, the that 28% higher than in 2016. At the beginning of the year many developers cautiously evaluated the market outlook and did not hurry with the construction of new business centres. But, they completed the construction of planned facilities in the second part of 2017, observing the market stabilization expressed in the vacancy decrease, stable demand and rise of rental rates in separate business districts. As a result, the main delivery volume was in Q4 – 312 thousand sq m, or 77% of the total volume of space completed in 2017.

The low delivery of new office space in Moscow contrasted with stable demand had a positive effect on the vacancy rate drop. It levelled down by 3.6 p. p. against Q4 2016 getting to 17.1% or 709 thousand sq m in Class A properties. In Class B offices, the vacancy rate pulled down by 3.9 p. p. amounting to 11.5% or 1.4 million sq m. This drop was due to the major transactions in Paveletsky business district and MIBC Moscow-City.

However, the average market indicators did not always reflect the real situation of individual business districts. For example, 39% of offices close to the Moscow Ring Road were non-occupied, while the average vacancy rate of some dis-

Key office projects delivered in 2017*

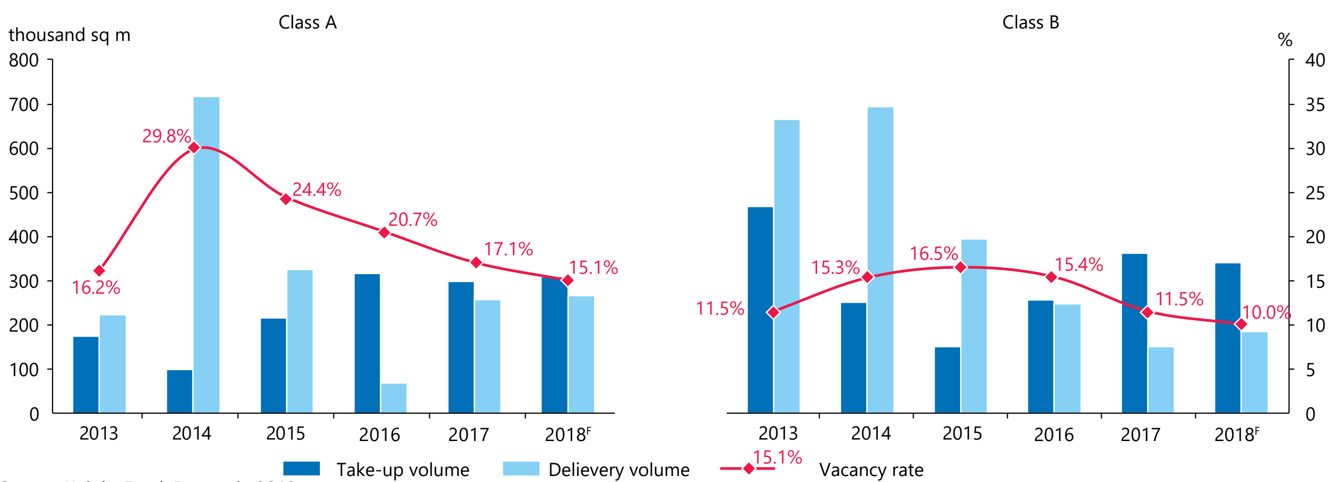


* Office properties copmleted in 2017

The building class is indicated according to the Moscow Research Forum Office Classification of 2013

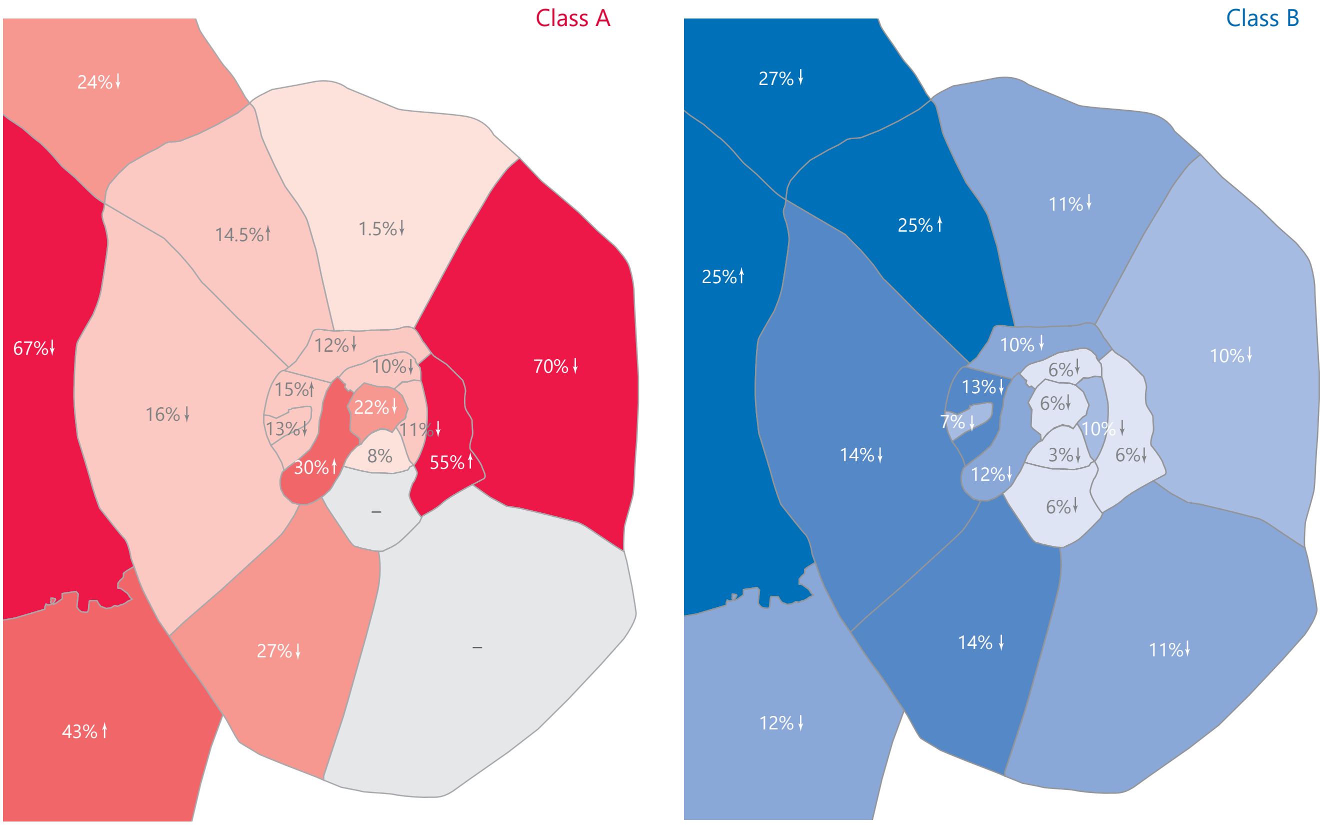
Source: Knight Frank Research, 2018

The net take-up and vacancy rate dynamics



Source: Knight Frank Research, 2018

Moscow submarket data. Vacancy rate



Source: Knight Frank Research, 2018

tricts inside the Third Transport Ring was 10%. Thus, the share of vacant space in Class A offices located in Paveletsky business district was 8% or 52 thousand sq m (11 p. p. down against Q4 2016), and in Class B - 3% or 5 thousand sq m (9 p. p. down against Q4 2016). The vacancy also dropped down by 9 p. p. in Belorussky business district as compared to the end of 2016 - till 12% or 38 thousand sq m. Such low vacancy rates in the main business districts of Moscow indicated the excess of demand over supply, which might cause a shortage of quality office space in individual locations.

In 2017, the greatest changes of the Class A vacancy share occurred in the following business districts of Moscow:

- The south of the Garden Ring reported the withdrawal of 65 thousand sq m from the market due to a number of large transactions in such business centres as Oasis and Aquamarine, as well as a number of small transactions in other business centres of the district.

Pavel Barbashev,
Head of Asset Management O1 Properties

In our opinion, the development activity of the office segment might be enhanced by the growth of rental rates by at least 10-20%. And in general, there is a feeling that the market should gradually adopt the European model, when 30 to 50% of the space is surrendered at the early stage of project readiness or even before the active construction works, which allows to attract financing on more favourable terms and increase margins. For example, PAO VimpelCom (the Beeline brand) became the anchor tenant of the second phase of Bolshevik, which O1 Properties launched in Q4 2017. The lease agreement for 17 thousand sq m was signed in December 2017, the readiness of the project and the move-in of the tenant was scheduled for mid-2019.

O1 Properties has two development projects with no decision on its implementation. They might be executed under the built-to-suit format.

- Despite the commissioning of about 77 thousand sq m of new office space in IQ-Quarter in 2017, which was almost immediately acquired by HMLA the vacancy rate of MIBC Moscow-City shrank by 5 p. p. for the year and amounted to 12.9% / 112 thousand sq m.
- Over 39 thousand sq m were put out of the market in the north of the Garden Ring, reducing the vacancy rate by 7 p. p. till 10.4%, owing to a number of transactions in Summit and Hermitage business centres.

The ultimate changes of the Class B vacancy share were highlighted in the following districts of Moscow:

- The transactions in Otradny (phase II), Sheremetyevsky, Diagonal House business centres resulted in the vacancy drop by 6 p. p. reaching 10.7%/ 80 thousand sq m in the north of Moscow, in the area between the Third Transport Ring and the Moscow Ring Road.
- The vacancy went down by 9 p. p. and 8 p. p. in the south and east of the Garden Ring, due to transactions in such business centres as Arma, Black&White, Domus. The vacancy rate in the south of the Garden Ring was 3.2% or 5 thousand sq m, in the east - 9.9% or 22 thousand sq m.
- The vacancy dropped down by 18 p. p. till 12.8%/ 41 thousand sq m as some premises in Poklonka Place and Park Pobedy business centres were withdrawn from the market in the west of the Third Transport Ring.

Experienced office real estate developers with their market-oriented approach, who have overcome more than one crises, are actively looking for new development sites in the most demanded districts of Moscow and are planning a new construction. Nevertheless, no significant growth in the volume of new construction is expected in the near future despite the several reductions of the key interest rate by the Central Bank of Russia in 2017, which led to the decline of the cost of borrowed financing. About 450 thousand sq m are planned for delivery in 2018, 60% of them or 267 thousand sq m relate to Class A offices. Over 183 thousand sq m of Class B offices are announced for delivery. As a result, the projected growth of new quality office construction in 2018 will exceed the indicators of the previous year by 10%.

Demand

Q4 2017 was quite dynamic as almost 45% of the total volume of transactions in 2017 was concluded in this period. As a result, the aggregate volume of transactions approached 1 million sq m and amounted to 964 thousand sq m. The total net take-up in Class A and B offices grew by 15% against 2016 to be equal to 657 thousand sq m. Most tenants, observing the market stabilization, sought to conclude lease agreements on favourable terms in H2 2017, until the rental rates started rising actively and other lease terms also changed after them.

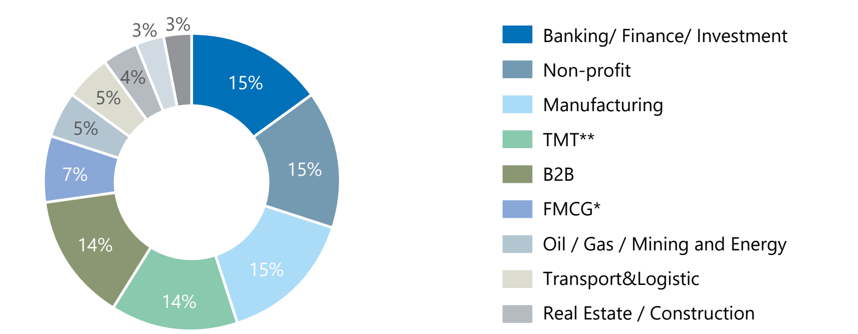
The profile of the most active companies on the market was clearly visible in previous years, but in 2017 the leasing and purchasing activity of companies from different economic sectors was distributed evenly. The share of banking and financial sectors, technology / media / telecommunications sectors and manufacturing, non-profit organizations and companies providing services for business (B2B sector) was 14–15%.

In 2017, 75% of the total volume of office transactions was completed outside the Garden Ring, increasing by 8 p. p. against 2016, when this index was equal to 67%.

New leases occurred mostly in the area close to the Third Transport Ring (more than 50% of the total volume), that became one of the most sought-after districts among tenants thanks to its good transport accessibility, improved by the launch of the Moscow Central Circle, and the availability of a sufficient stock of quality office centres. Office centres located outside the Moscow Ring Road remained in low demand among tenants, the share of transactions with these facilities held less than 10%.

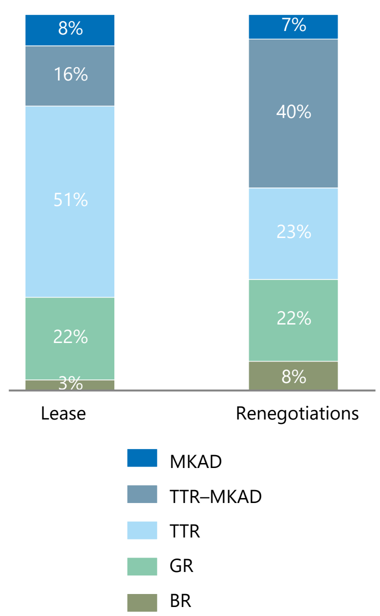
The average size of transactions in 2017 remained practically unchanged year-on-year. The number of transactions with office units of above 10 thousand sq m

Distribution of leased office space depending on the company profile



* Fast moving consumer goods
** Technology, media and telecommunications
*** Non-profit / Pharmaceutical
Source: Knight Frank Research, 2018

Distribution of transactions by type and location



Source: Knight Frank Research, 2018

grew by 2% due to a number of large transactions, which occurred primarily in Q4 2017. This process affected the average transaction size rising by 8% from the previous year to the level of 2,2 thousands sq m.

Today, more and more potential tenants, when choosing an office centre for accommodation, consider not only its location and the size of the rental rate, but also pay attention to the attractive facade and the related infrastructure as well. Therefore, the property renovation becomes a necessary condition for business success of those developers and landlords, not able to offer such conditions to their tenants.

Individual developers have already picked up on this trend and carried out renovation of their office facilities. For example, O1 Properties – the new landlord of White Stone Business Centre (formerly, Lesnaya Plaza) completely updated the fit-out of the entrance lobby, common premises and lift lobbies on each floor; reconfigured the lift equipment, replaced the food business operator, making this facility popular among tenants. Citydel Business Centre is another example, where the landlord executed the renovation of common premises, thus increasing the interest of tenants to the property.

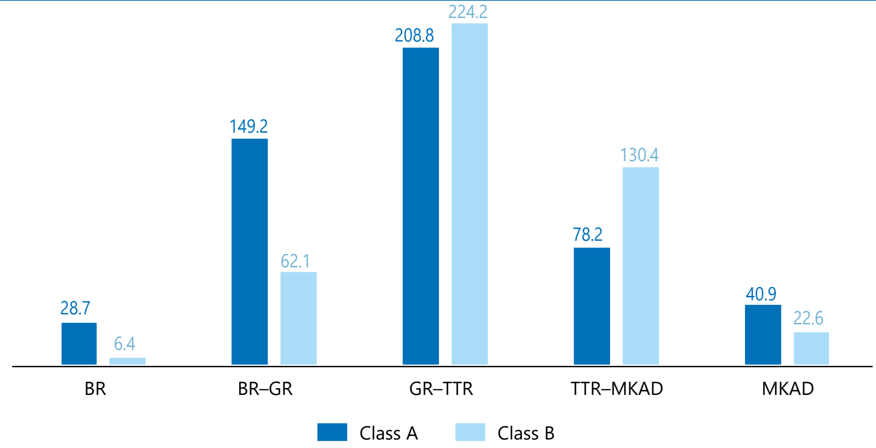
However, there are a lot of office properties in the market aged above 15 years, that become obsolete both morally and physically. As a result, in the next few years tenants of these properties can form an extra demand for quality office centres, completed in the last 5 years. 14% of the total Class B stock or about 1.7 million sq m, falls on business centres built in 1997 and earlier. Another almost 2 million sq m are situated in office centres built in 1998–2002.

Commercial terms

The rental rates for quality office space held stabley in 2017. The main changes of rents were driven by the exit of cheap facilities from the market, the market entry of a large amount of space located in remote areas of Moscow, and the closing of large transactions.

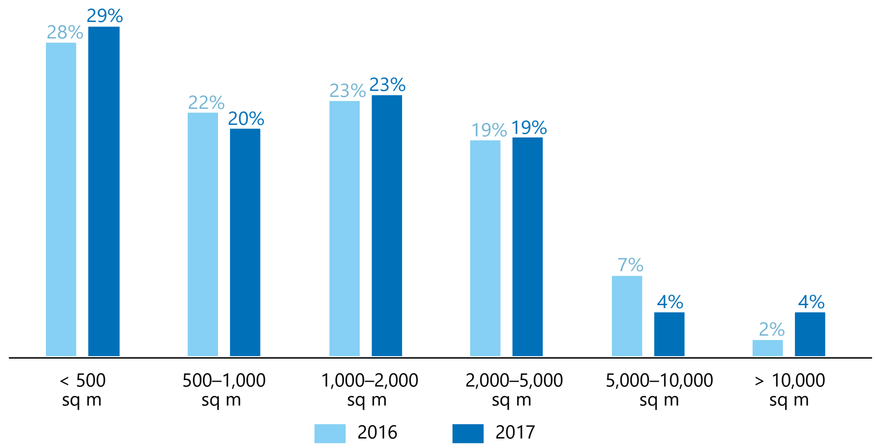
The Class A rents were 5.6% down from the previous year, reaching 22,923 RUB/sq m/year. This drop, fixed

Distribution of leased office space depending on the location of the office building, thousand sq m



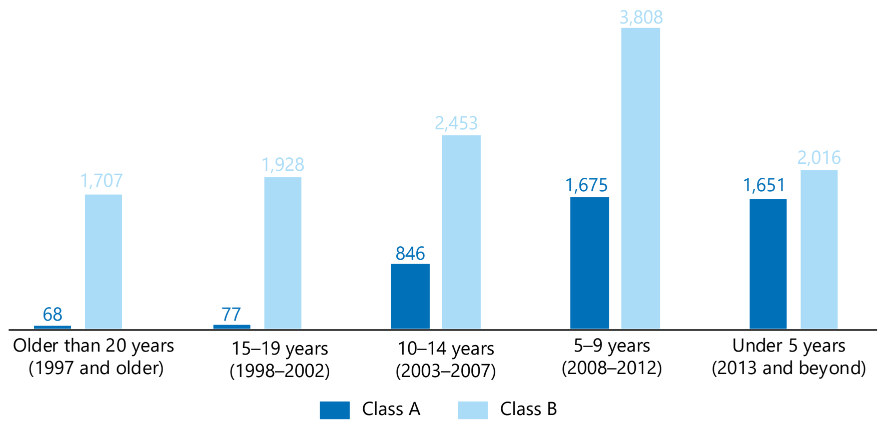
Source: Knight Frank Research, 2018

Distribution of leased office units by size



Source: Knight Frank Research, 2018

Total stock and age of quality office properties in Moscow, thousand sq m



Source: Knight Frank Research, 2018

Key lease and purchase transactions closed in 2017

Company	Area, sq m	Office building	Class	Address	Transaction type
HMLA	74,655	iQ-quarter	A	Presnenskaya Emb, 11	Sale
Gazprombank	43,364	Aquamarine III	A	Ozerkovskaya Emb, 24	Sale
Auction LLC	38,317	Poklonka Place	B+	Poklonnaya St, 3A	Lease
VimpelCom	17,004	Bolshevik	A	Leningradskiy Ave, 15	Lease
Transmashholding	14,400	VTB Arena Park	A	Leningradskiy Ave, 32	Lease
Technoserv	14,000	Novospasskiy Dvor	B+	Derbenevskaya Emb, 7	Lease
Glavgosekspertiza Rossii	13,600	B. Yakimanka St, 42	B+	B. Yakimanka St, 42	Lease
Tele2	13,053	Comcity	A	Kievskoe Hwy, 1	Lease
Sberbank-Technology	12,868	Danilovskiy Fort	B+	Novodanilovskaya Emb, 10	Lease
Freight One	12,700	Novoryazanskaya St, 24	B	Novoryazanskaya St, 24	Lease
Gazprombank	11,665	Oasis	A	Koroviy Val St, 5	Lease
BBDO	11,030	Novospasskiy Dvor	B+	Derbenevskaya Emb, 7	Lease
GroupM	10,794	Legenda	A	Tsvetnoy Blvd, 2	Lease
L'Oreal	9,686	Golutvinskiy Dvor	A	Yakimanskaya Emb, 2	Lease
Russian Agricultural Bank	9,200	Incom City	B+	Krasnogvardeyskiy 1-st Passage, 7 bld 1	Sale
STNG*	**8,765**	**Vereyskaya Plaza III**	**B+**	**Vereiskaya St, 29 bld 134**	**Lease**

* Knight Frank acted as a consultant of the transaction

Source: Knight Frank Research, 2018

at the end of the year, was primarily due to major transactions closed during the fourth quarter in facilities located within the Garden Ring and the Third Transport Ring at the rates above 25,000RUB/sq m/year, as well as the market entry of NEOPOLIS Business Centre (64 thousand sq m of leasable area), located on the territory of Novaya Moskva, where rental rates were significantly lower than the average market prices.

The office real estate market is entering a phase of growth and the period of low rental rates is coming to the end, which is confirmed by the withdrawal of offices priced higher than the market average in the most in-demand business districts of Moscow.

The Class A rents faced the most considerable changes from previous year in the following business districts of Moscow:

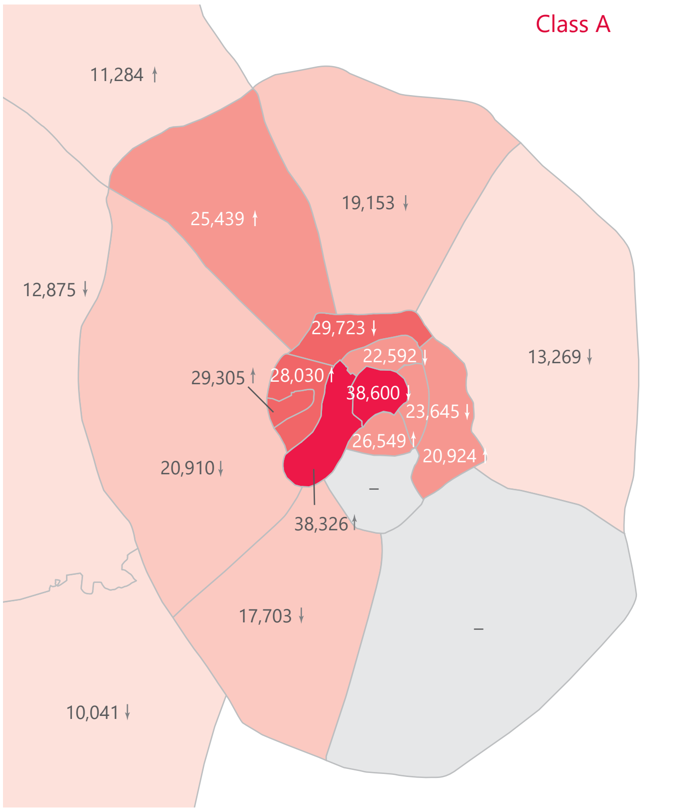
- The demand for offices in Central business district was gradually slowing. As a result, several major premium business centres - Berlin House, Geneva House, Moskva, and Vozdvizhenka - put down the asking rental rates, leading to the change of the average index of the district by 16%.
- The asking rents dropped down by 16% in Novaya Moscow in the south-west of the Moscow Ring Road as a result of the withdrawal of expensive offices from the market in Comcity Business Centre and the market release of considerable volume of office space in Neopolis Business Centre.
- The rental rate increased for 6% in Zamoskvorech'e owing to the withdrawal from the market of low-priced office units in Central City Tower, Concord.

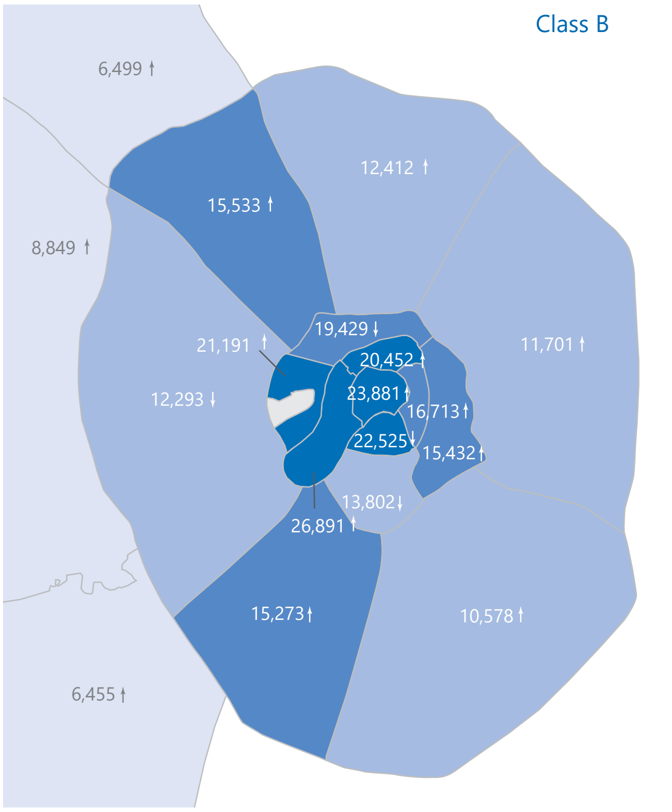
Class B offices evidenced an upward trend in rental rates as a result of 2017, totaling 14,074 RUB/sq m/year – 5.2% higher over the previous year. The growth of rates was ensured by the exit of inexpensive office units from the market, which were present practically in every business district of the city.

The most significant changes of Class B rents occurred in the following districts:

- The rents in the west of the Garden Ring rose by 12% due to the exit of inexpensive office units from the market in Dom Helsinki, Premier Plaza, Riverside Station.
- The average asking rental rate was 17% down in Zamoskvorech'e as expensive and liquid premises were removed from the market in Domus, Legion I, Riverside Towers and others.

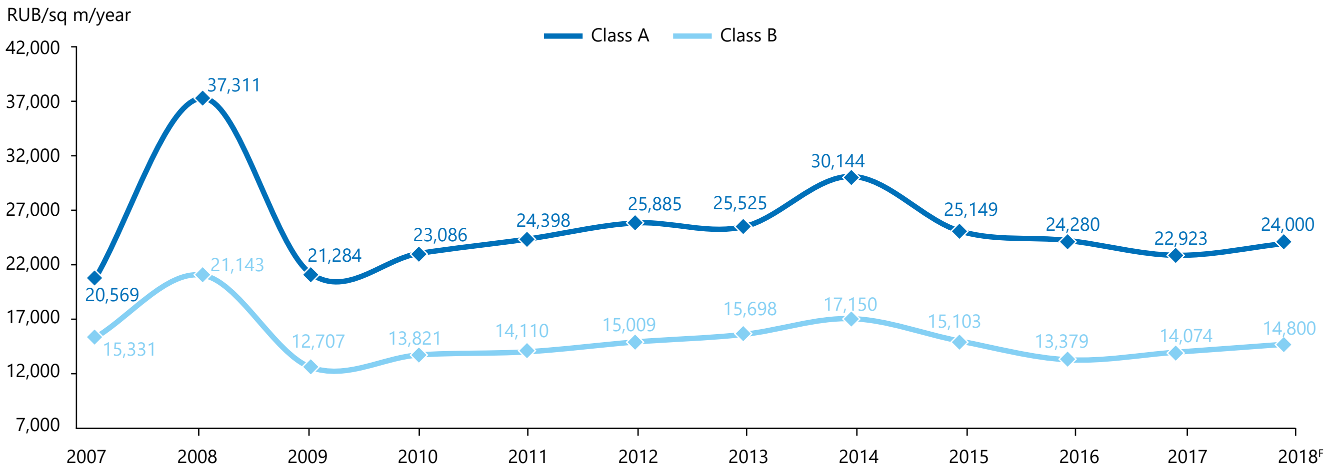
Moscow submarket data. Average weighed rental rate

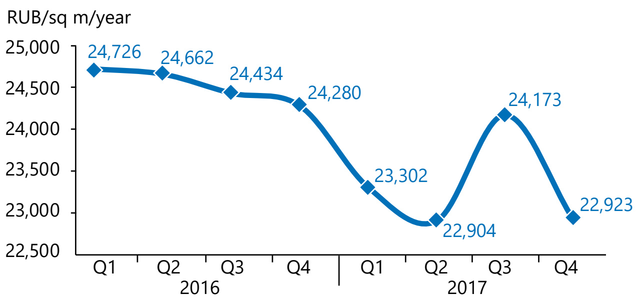


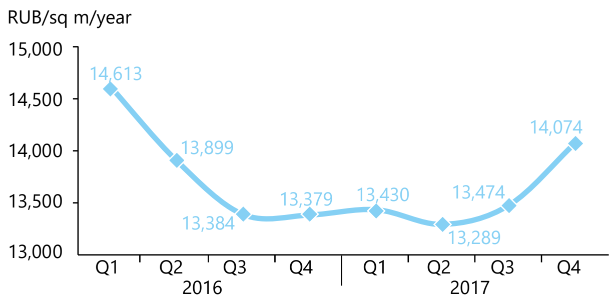


Source: Knight Frank Research, 2018

Average asking rental rates dynamics for Class A and B offices denominated in RUB/ sq m / year







Source: Knight Frank Research, 2018

Other commercial lease terms were also changing along with the growth of rents in the most liquid office buildings. The landlords took a hard line when negotiating the leases. For example, they were not ready to exhibit fit-out of office space, forcing tenants to make it either at their own expense or advance an annual rent. These changes became particularly obvious by the end of 2017.

In 2017, the duration of leases remained unchanged from the previous year – 3–5 years with the early termination right after the 3-year term. However, as early as 2018, certain developers, witnessing a good demand for their facilities, are ready to revise upward the terms of the fixed guaranteed lease terms. As far as the consumer price index falls to 3–4%, the rental rate indexation will also go down, but will remain the subject of discussion.

The Russian ruble is still the dominant currency in the agreements. Office properties, where landlords still nominate the rents in dollars, will stick to their leasing policy. However, there unlikely be new properties with dollar rental rates, as the strengthening of the ruble against the dollar does not contribute to the nomination of rental rates in dollars.

Forecast

The period of low rental rates and unique low-cost office premises is coming to an end. The Moscow office real estate market is entering a phase of growth, that is especially apparent in Paveletsky and Belorussky districts – the most liquid business districts of Moscow. In 2018, we do not expect considerable market increase, but the market switched to a phase of systematic growth last year and this trend will be strengthened this year.

In 2018, developers can go ahead with the implementation of new office projects, improving their quality in a highly competitive market. The delivery volume of new properties is projected to rise to the level of over 450 thousand sq m. In the future, we anticipate the growth of new quality construction of office centres in Moscow, subject to stable demand.

The vacancy rate will go down gradually by 1-2 p. p. annually, despite the rise of the new construction volume. The companies, occupying today the office premises in business centres built about 20 years ago, can become additional drivers of demand.

Key office projects due to be commissioned in 2018

Source: Knight Frank Research, 2018

Pavel Barbashev,
Head of Asset Management O1 Properties

By the end of 2017, the vacancy rate of O1 Properties portfolio fell down to 12% in general and to 7% in facilities located in Central business district. This year the company plans to gradually increase rental rates for new contracts and extend the fixed guaranteed lease term with no break option for the tenant, since both vacancy indicators are below the market average.

Nevertheless, O1 Properties still shows flexibility in the negotiations, in particular in such articles as the fit-out execution by efforts of the landlord. O1 Properties with its expert evaluation and the team for a quick and qualitative solution of the tasks, has a competitive advantage in a situation when an absolute majority of tenants want their premises to be fitted out by the landlord.

The net take-up volume of 2018 may run up to about 600 thousand sq m. The state-owned companies might form an additional demand if the trend of purchasing/leasing large-sized office units of 2015–2017 is strengthened.

The average rents of the Moscow office real estate market can grow by 3–5% in 2018, mainly because of a shortage of vacant space. The top requested districts in Moscow are Paveletsky, Belorussky, office centres along Leningradsky and Leninsky Avenues, and MIBC Moscow-City.

The demand for business centres adjacent to the Moscow Ring Road will be poor, staying within 5–10% of the total transaction volume, which will result in the minimal vacancy rate drop and zero growth of rental rates.

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">USD/ sq m/ year</th><th colspan="2">RUR/ sq m/ year</th><th colspan="2">USD/ sq m/ year</th><th colspan="2">RUR/ sq m/ year</th></tr>
<tr><td>Boulevard Ring</td><td>Central business district</td><td>712</td><td colspan="2">702</td><td colspan="2">38,600</td><td colspan="2">17.8</td><td colspan="2">451</td><td colspan="2">23,881</td><td colspan="2">6.4</td></tr>
<tr><td rowspan="4">Garden Ring</td><td>South</td><td>985</td><td>483</td><td rowspan="4">489</td><td>26,549</td><td rowspan="4">26,920</td><td>7.9</td><td rowspan="4">12.0</td><td>425</td><td rowspan="4">438</td><td>22,525</td><td rowspan="4">23,208</td><td>3.2</td><td rowspan="4">8.5</td></tr>
<tr><td>West</td><td>546</td><td>697</td><td>38,326</td><td>30.2</td><td>–</td><td>26,891</td><td>11.5</td></tr>
<tr><td>North</td><td>660</td><td>–</td><td>22,592</td><td>10.4</td><td>386</td><td>20,452</td><td>5.7</td></tr>
<tr><td>East</td><td>401</td><td>–</td><td>23,645</td><td>10.8</td><td>315</td><td>16,713</td><td>9.9</td></tr>
<tr><td rowspan="5">Third Transport Ring</td><td>South</td><td>1,263</td><td>–</td><td rowspan="4">529</td><td>–</td><td rowspan="4">29,114</td><td>–</td><td rowspan="4">13.3</td><td>–</td><td rowspan="4">341</td><td>13,802</td><td rowspan="4">18,083</td><td>6.8</td><td rowspan="4">7.8</td></tr>
<tr><td>West</td><td>785</td><td>–</td><td>28,030</td><td>15.0</td><td>–</td><td>21,191</td><td>12.8</td></tr>
<tr><td>North</td><td>928</td><td>540</td><td>29,723</td><td>11.8</td><td>367</td><td>19,429</td><td>10.2</td></tr>
<tr><td>East</td><td>1,114</td><td>–</td><td>20,924</td><td>70.1</td><td>291</td><td>15,432</td><td>6.1</td></tr>
<tr><td>MIBC Moscow-City</td><td>1,153</td><td colspan="2">533</td><td colspan="2">29,305</td><td colspan="2">12.9</td><td colspan="2">–</td><td colspan="2">–</td><td colspan="2">–</td></tr>
<tr><td rowspan="6">TTR–MKAD</td><td>North</td><td>1,003</td><td>–</td><td rowspan="6">356</td><td>19,153</td><td rowspan="6">19,564</td><td>1.5</td><td rowspan="6">20.7</td><td>–</td><td rowspan="6">243</td><td>12,412</td><td rowspan="6">12,872</td><td>10.7</td><td rowspan="6">13.0</td></tr>
<tr><td>Northwest</td><td>734</td><td>463</td><td>25,439</td><td>14.5</td><td>–</td><td>15,533</td><td>24.7</td></tr>
<tr><td>South</td><td>1,997</td><td>380</td><td>20,910</td><td>15.7</td><td>232</td><td>12,293</td><td>14.1</td></tr>
<tr><td>West</td><td>1,412</td><td>–</td><td>–</td><td>–</td><td>–</td><td>10,578</td><td>10.9</td></tr>
<tr><td>Southwest</td><td>583</td><td>–</td><td>17,703</td><td>26.3</td><td>–</td><td>15,273</td><td>14.1</td></tr>
<tr><td>Preobrazhenskiy</td><td>992</td><td>–</td><td>13,269</td><td>55.4</td><td>–</td><td>11,701</td><td>9.6</td></tr>
<tr><td rowspan="3">MKAD</td><td>Khimki</td><td>266</td><td>–</td><td rowspan="3">–</td><td>11,284</td><td rowspan="3">10,804</td><td>24.4</td><td rowspan="3">39.9</td><td>–</td><td rowspan="3">–</td><td>6,499</td><td rowspan="3">7,968</td><td>26.8</td><td rowspan="3">23.0</td></tr>
<tr><td>West</td><td>388</td><td>–</td><td>12,875</td><td>66.8</td><td>–</td><td>8,849</td><td>24.7</td></tr>
<tr><td>New Moscow</td><td>342</td><td>–</td><td>10,041</td><td>42.9</td><td>–</td><td>6,455</td><td>11.6</td></tr>
<tr><td colspan="2">Total</td><td>16 263</td><td colspan="2">417</td><td colspan="2">22 923</td><td colspan="2">17,1</td><td colspan="2">266</td><td colspan="2">14 074</td><td colspan="2">11,5</td></tr>
</table>

* Excluding operational expenses, utility bills and VAT (18%)

Source: Knight Frank Research, 2018

RESEARCH

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