RESEARCH

Knight Frank

2018

OFFICE MARKET REPORT

Moscow

HIGHLIGHTS

The volume of new delivery of office centers amounted to 125,000 sq m in 2018, which is the market low for the past 10 years.

As of 2018, the vacancy rate reached 12.5% in Class A offices and 9.3% in Class B offices, which amounted to 1.66 million sq m in total.

The average weighted asking rent rates increased by 10% to 25,204 rub./sq m/year in Class A and by 5.6% to 14,867 rub./sq m/year in Class B, over 2018.

Konstantin Losiukov
Director Office Department
Knight Frank

" The quality offices market had quite a calm and predictable year in 2018. Similar to 2017, the correlation of new delivery and net take-up was the key driver of all the changes the market indicators were going through. Basically, it was the low new delivery volumes that set the pace of declining vacancy rates and growing rent rates, while the demand remained strong. Non-profit organizations played a noticeably smaller role in terms of demand than they did a year ago. On the contrary, the TMT sector companies once again confirmed their steady growth and need for new absorption. In general, it is safe to say that the market has become completely stable and is unlikely to show any significant changes soon."

OFFICE MARKET REPORT MOSCOW

Key indicators. Dynamics*

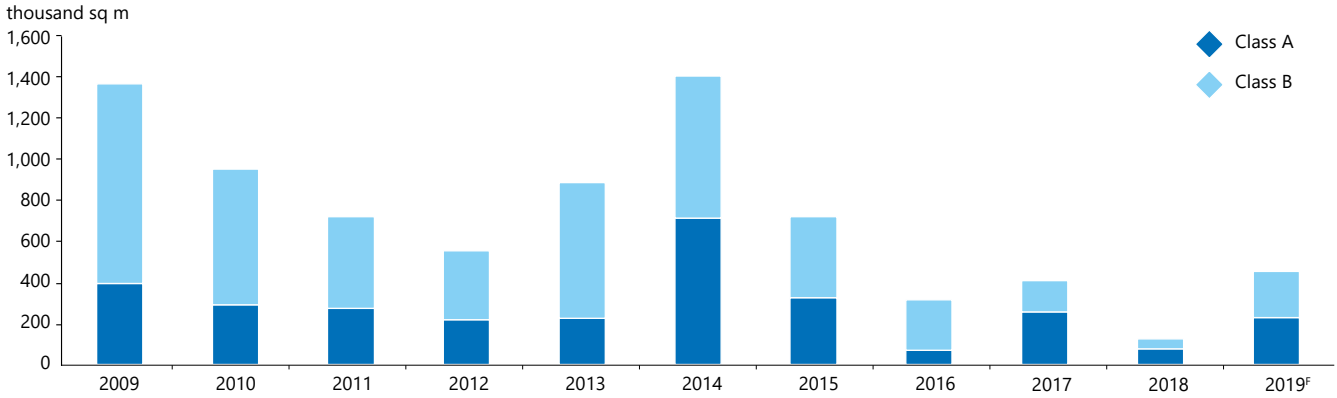
		2018	2017
Total stock, thousand sq m		16,388	16,263
including, thousand sq m	Class A	4,226	4,149
	Class B	12,162	12,114
Deliveries 2018, thousand sq m		125 ▼	408
including, thousand sq m	Class A	77 ▼	258
	Class B	48 ▼	150
Net take-up 2018, thousand sq m		604 ▼	657
Vacancy rate, %	Class A	12.5 ▼	17.1
	Class B	9.3 ▼	11.5
Average weighted asking rental rate**, RUB/sq m/year	Class A	25,204 ▲	22,923
	Class B	14,867 ▲	14,074
OPEX rate range, RUB/sq m/year	Class A	6,800 ▲	6,490
	Class B	4,580 ▲	4,080
Average weighted asking sale price, RUB/sq m	Class A	234,290	
	Class B	150,440	

* Compared to Q4 2017

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

Source: Knight Frank Research, 2019

Class A and B new delivery volume dynamics



Source: Knight Frank Research, 2019

Supply

As of 2018, the total stock of quality office premises of Moscow amounted to 16.4 million sq m, 25.7% of which refer to Class A and 74.3% to Class B.

2018 recorded the lowest new delivery figures for quality office spaces since 2009. As of 2018, 125,000 sq m were delivered to the market, which is 3.3 times lower than last year's figure. Most of the properties with the cumulative area exceeding 100,000 sq m that had been announced to be delivered in 2018 were never delivered, with their deliveries being rescheduled for 2019.

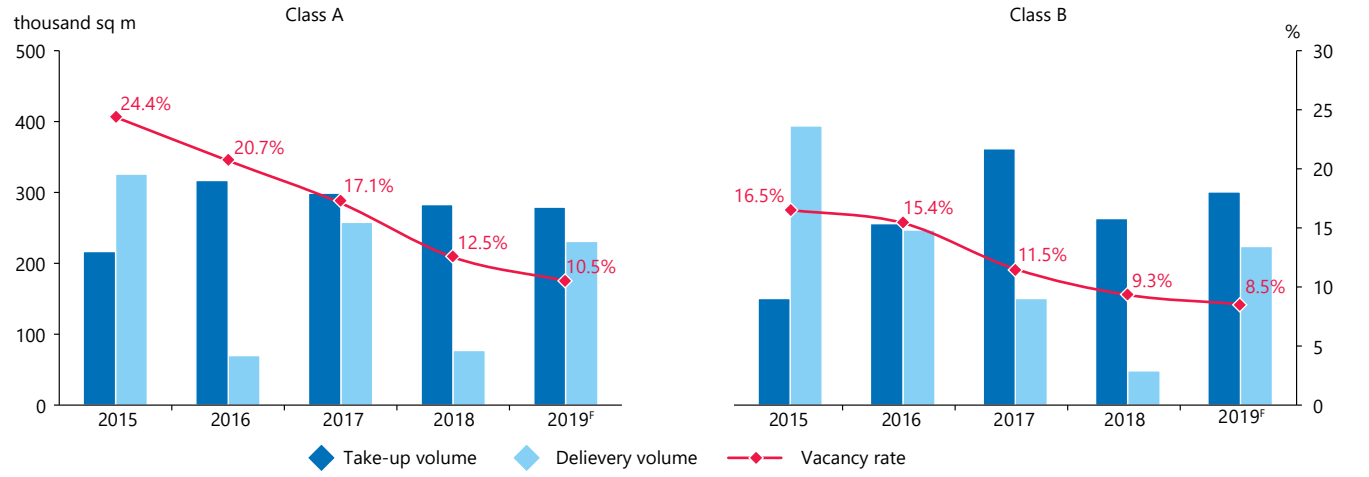
After 2014, a lot of developers preferred projects with a small office component often redesigning the announced office spaces into apartments. But 2018 has seen the projects with an office component amounting to 100,000 sq m in area, for instance Grand Tower Business Center in Moscow City business district.

Against the backdrop of strong demand, the low delivery volume of quality offices had a positive effect on declining vacancy rate. It went down by 4.6 percentage points for Class A properties throughout Moscow as compared to Q4 2017 all the way to 12.5% or 0.53 million sq m. And it decreased by 2.2 percentage points to 9.3% or 1.13 million sq m for Class B offices.

Key office projects delivered in 2018

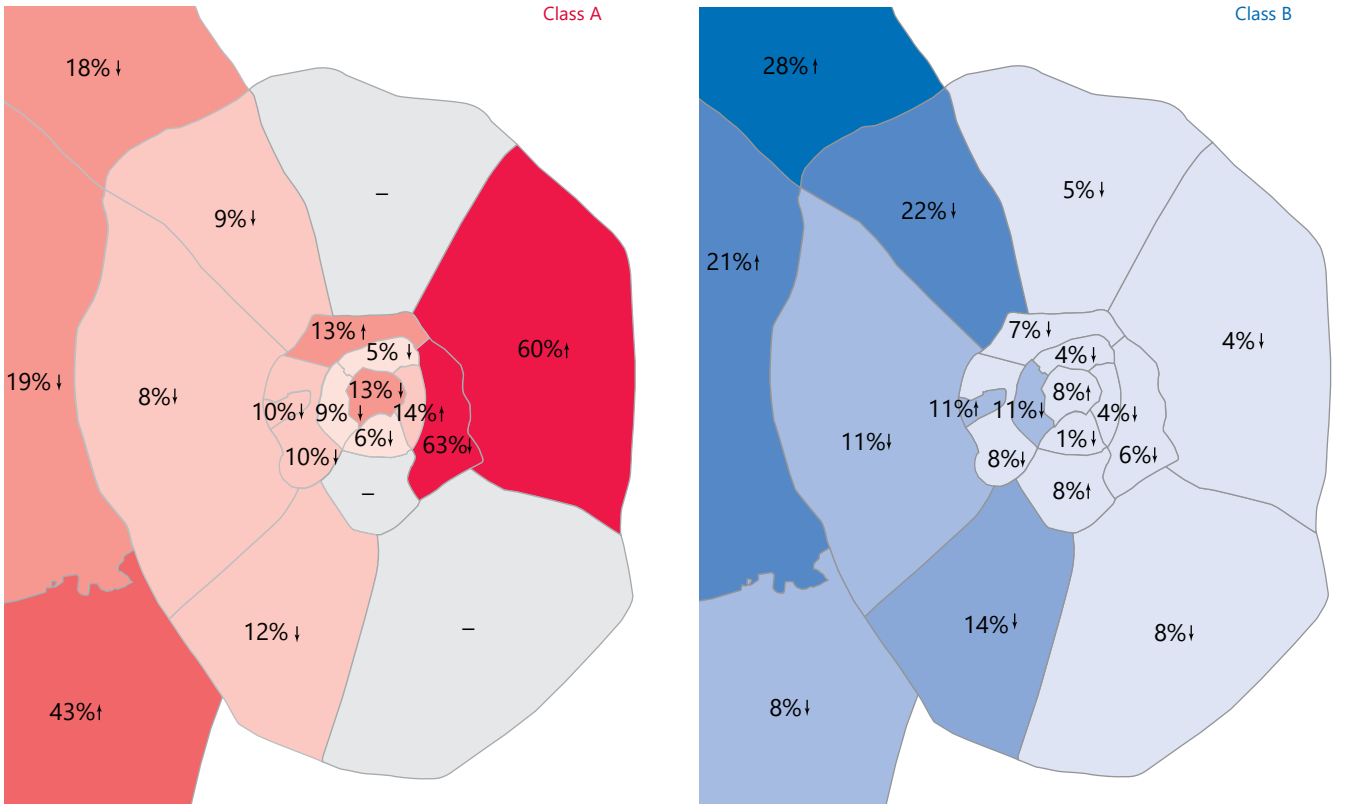
Source: Knight Frank Research, 2019

The net take-up and vacancy rate dynamics



Source: Knight Frank Research, 2019

Moscow submarket data. Vacancy rate



Source: Knight Frank Research, 2019

In 2018, the most striking changes of Class A vacancy rates among all Moscow business districts took place as follows:

- Due to a sizeable transaction with Arbat 1 Business Center, about 18,500 sq m of office premises went off the market in the west part of the Garden Ring. The vacancy rate in this location is currently 2.8% or 2,500 sq m.
- Thanks to the transactions with Lotos Business Center and ICube Business Center, the vacancy rate in the southwest of Moscow between the Third Transportation Ring and the Moscow Ring Road went down by 20 percentage points to 9,300 sq m or 7.3%.
- Despite the delivery of about 27,000 sq m of quality offices in Almatea Business Center in 2018, the vacancy rate in the western part of Moscow around the Moscow Ring Road declined by 10 percentage points to 7.2% or 18,200 sq m over a year due to the sale of Pallau RB Business Center and a number of smaller transactions.

The most significant changes of vacancy rate in Class B offices throughout Moscow over 2018 were reported as follows:

- Because of the transactions with Alekseyevskaya Bashnya, Savyolovskiy City, and Faktoriya business centers, the vacancy rate in the north of Moscow between the Third Transportation Ring and the Moscow Ring Road decreased by six percentage points to 35,000 sq m or 5.6%.
- Several transactions with Krasnoselskiy Business Center and Lefort Business Center in the east of Moscow in between the Third Transportation Ring and the Moscow Ring Road lead to the vacancy rate in Class B offices declining by nine percentage points to 11.2% or 22,600 sq m.
- As a result of a largescale transaction with 'Efremova, 10' Business Center in the west of the Garden Ring in Khamovniki district, the vacancy rate in the location dropped by seven percentage points to 4% or 9,900 sq m.

As of 2018, some business districts of Moscow experienced a lack of quality office premises. This can be attributed to such locations as Paveletsky business district (the vacancy rate in Class A is 6%, in Class B – 1%), and the district in the north of the Garden Ring (the vacancy rate in Class A offices is 5%, in Class B offices – 4%). Thus, when seeing the backlog of demand along with the lack of supply, multiple experienced developers were inspired to search for new sites for constructing offices in most popular locations.

About 450,000 sq m are expected to be delivered in 2019, about half or 230,000 sq m of which are Class A offices. Around 220,000 sq m of Class B offices are planned to be delivered over the same period. Thus, the growth of new quality offices construction in 2019 is forecast to exceed the figures of 2018 by 3.5 times.

Demand

As of 2018, the cumulative trading volume amounted to 787,000 sq m. The total net take-up of Class A and B offices declined insignificantly as compared to 2017 and amounted to 604,000 sq m.

The Telecom/Media/Technology companies were leading the way by the volume of transactions in 2018. Their share amounted to 19% of all transactions. Manufacturers

are as well engaged into the deals with office property of Moscow, with their share of all transactions amounting to 13%.

Co-workings are becoming a new tenant type that is winning ground and has already closed an array of sizeable rent deals. There have been several major office rent deals in 2018. First of all, it is worth singling out WeWork, the international co-working operator, that came to the Moscow market and signed three transactions with the cumulative area of over 13,000 sq m.

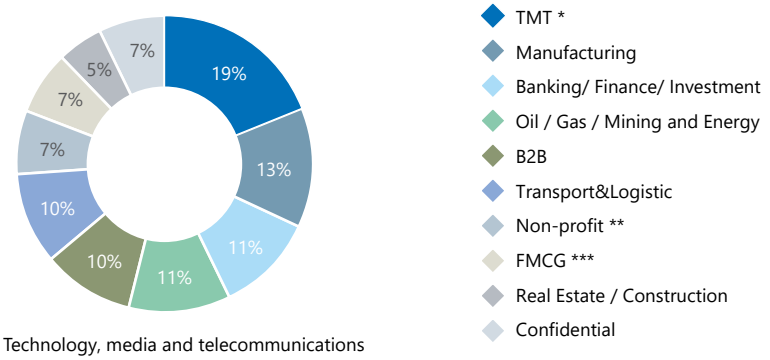
As of 2018, 73% of all deals with quality office spaces were signed outside the Garden Ring, which is similar to the figure of 2017.

The business districts located close to the Third Transportation Ring remain in high demand. Thus, 35% of all new rent deals in 2018 refer to the districts around the Third Transportation Ring. It is due to the great transport accessibility of these districts provided by the Moscow Central Circle and Bolshaya Koltsevaya line, the stations of which have been opening their doors one by one throughout 2018.

As before, the districts outside the Moscow Ring Road and the business district inside the Boulevard Ring report modest demand. Thus, each of these districts' share of all new rent deals is less than 10%. The share of rent renewals has also dropped from 8% to 2% in the business centers within the Boulevard Ring in 2018. The complicated accessibility by car and the appreciation of parking make tenants consider alternative districts for locating their offices.

As of Q1-Q4 2018, the structure of deals by size hardly changed as compared to 2017. The demand for office blocks of 500 to 1,000 sq m in area grew by two percentage points. The number of deals with the area varying from 5,000 to 10,000 sq m also went up by two percentage points. The growth of the number of transactions with the area 5,000 through to 10,000 sq m affected the average deal area, which amounted to 2,050 sq m in 2018, and that is 5% higher than the average deal area in 2017.

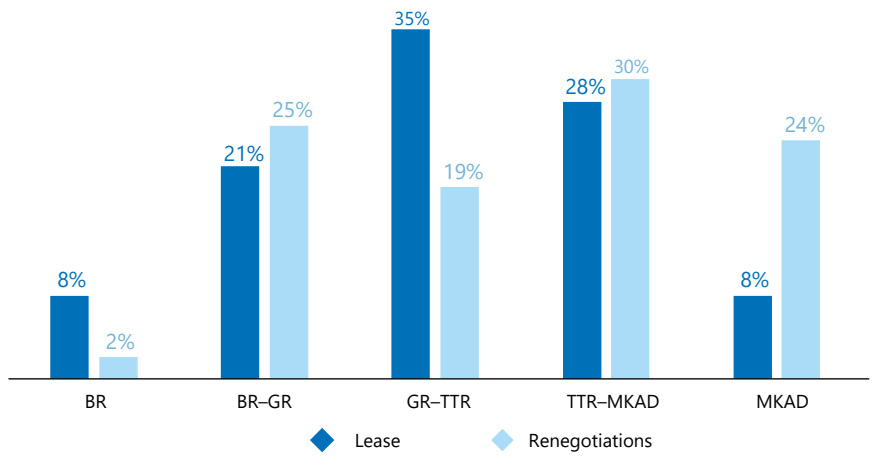
Distribution of leased office space by sector



* Technology, media and telecommunications
** Government sector
*** Fast moving consumer goods

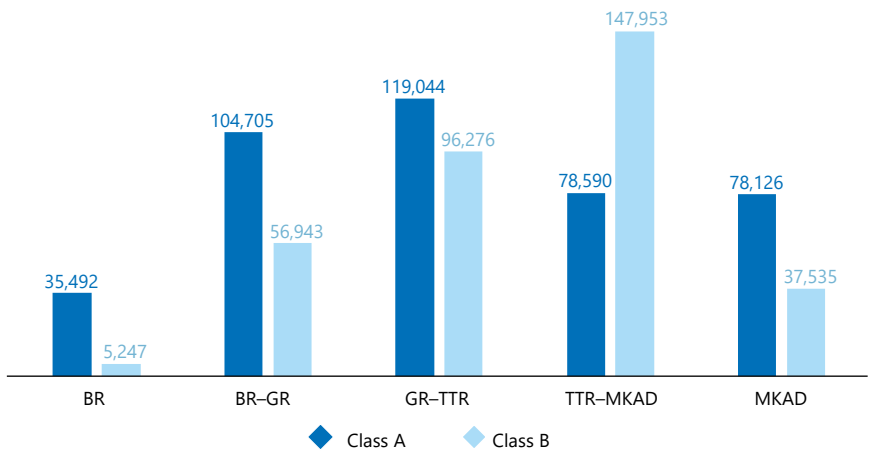
Source: Knight Frank Research, 2019

Distribution of transactions by type and location



Source: Knight Frank Research, 2019

Distribution of leased office space by location



Source: Knight Frank Research, 2019

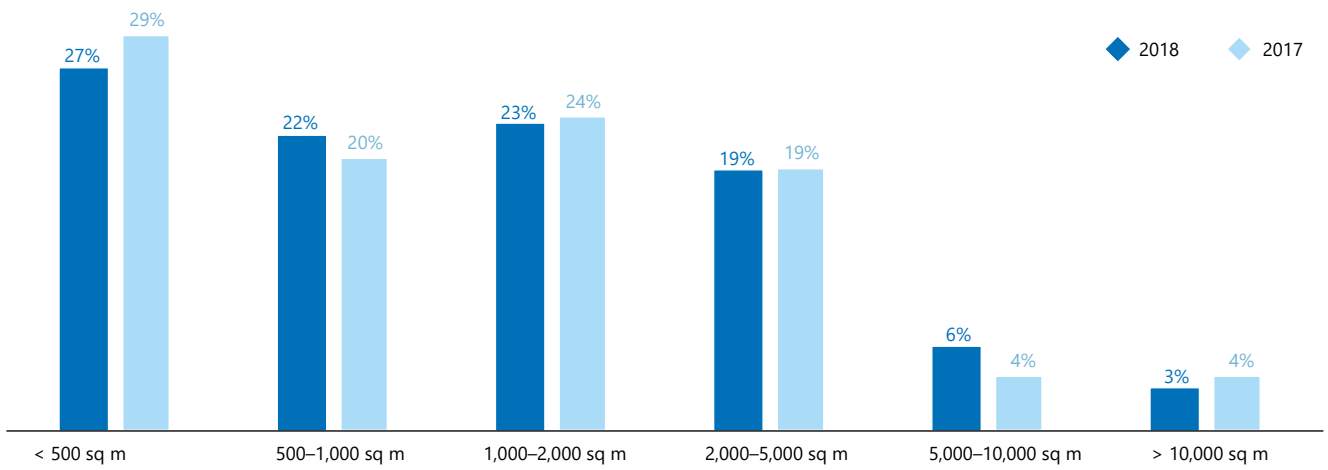
Key lease and purchase transactions closed in 2018

Company	Area, sq m	Office building	Class	Address	Transac-tion type
Structures of the Government of the Moscow Region	29,900	Pallau-RB	A	Rublevo-Uspenskoe Hwy, 1 km	Sale
FGC UES	19,600	Samarskaya St, 1	A	Novion	Lease
Aeroflot	18,447	Arbat St, 1	A	Arbat St, 1	Lease
Ozon.ru	17,402	Naberezhnaya Tower	A	Presnenskaya Emb, 10	Lease
Bank "Avangard"	14,000	Lesnaya St, 6	B	Lesnaya St, 6	Lease
Bank "ZENIT"	12,817	Lotos	A	Odesskaya St, 2	Sale
Transneft-technology	12,666	VEB Arena	B+	Peschanaya 3-rd St, 2A	Lease
TMHolding	11,360	Efremova St, 10	B+	Efremova St, 10	Lease
Etalon Invest	9,174	VTB Arena Park	A	Leningradskoe Hwy, 36	Lease
X5 Retail Group	9,701	Oasis	A	Koroviy Val St, 5	Lease
STNG* Knight Frank	8,766	Vereiskaya Plaza III	B+	Vereiskaya St, 29 bld 134	Lease
Lamoda	7,060	One Zhukov	B+	Marshala Zhukova Ave, 1	Lease
Bank "Russian capital"	7,000	Vozdvizhenka Centre	A	Vozdvizhenka St, 10	Lease
FSUE "Russian Post"* Knight Frank	6,785	Parizhskaya Kommuna	B-	Kozhevnicheskaya St, 7 bld 1	Lease
Sreda	6,000	Federation Tower (East)	B+	Presnenskaya Emb, 12	Lease
Zolla	6,000	Kuntsevo Plaza	A	Yartsevskaya St, 19	Lease
Zolla	6 000	Кунцево Плаза	A	Ярцевская ул., д. 19	Аренда

Knight Frank Knight Frank acted as a consultant of the transaction

Source: Knight Frank Research, 2019

Distribution of leased office units by size



Source: Knight Frank Research, 2019

Rents

The growth of rent rates that started in 2017 continued throughout 2018. By the end of the year, the average weighted asking rent rate increased by 10% to 25,204 rub./sq m/year triple net for Class A offices and by 5.6% to 14,867 rub./sq m/year triple net for Class B offices. The positive rent rate movements are primarily due to the low pace of new delivery as well as the strong demand for quality office premises. Meanwhile, the growth of the average weighted asking rent rates is due to both affordable office blocks going off the market as well as the increasing of rent rates on the part of numerous owners such as Enka, O1 Properties, Capital Group, etc.

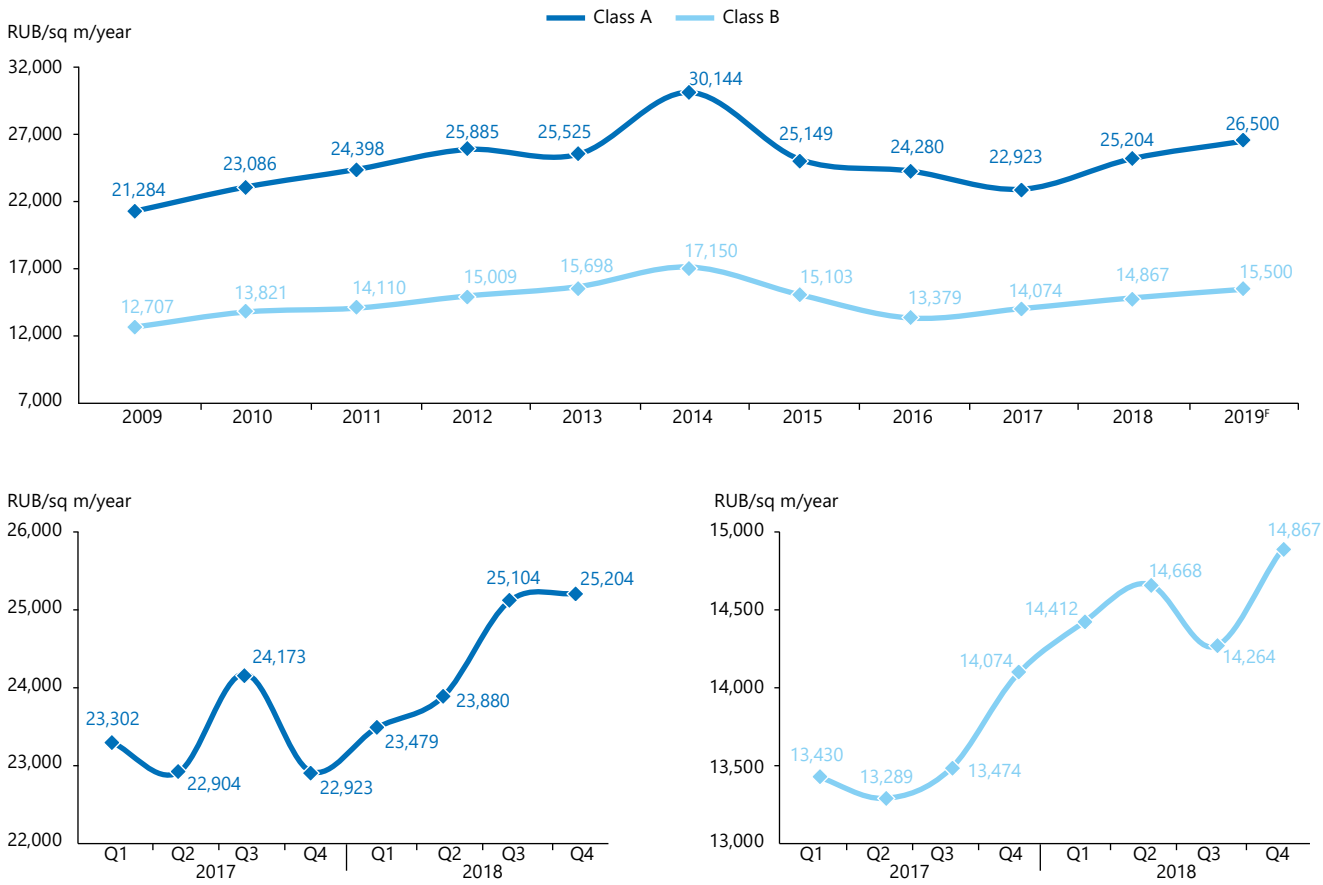
The most significant changes of the average weighted rent rate in Class A offices took place in the following business districts of Moscow in 2018 as compared with 2017:

- The average weighted rent rate in the north of the Garden Ring rose by 38% to 31,144 rub./sq m/year. There was an increase in rent rates in Ducat III Business Center, Sadovaya Plaza and Ermitazh Plaza.
- The rate in Moscow City business district went up by 25% to 36,557 rub./sq m/year thanks to the high-level demand for the location and the decrease in the vacancy rates as well as the growth of the rent rates in Oko Business Center and Embankment Tower Business Center.
- A 24% increase of the rent rate to 32,936 rub./sq m/year was reported for Paveletsky business district due to the rise in the rent rates in Paveletskaya Plaza Business Center and Rosso Riva Business Center as well as due to the affordable blocks of Central City Tower Business Center having gone off the market.

The most striking changes in the rent rates for Class B offices happened in the following locations:

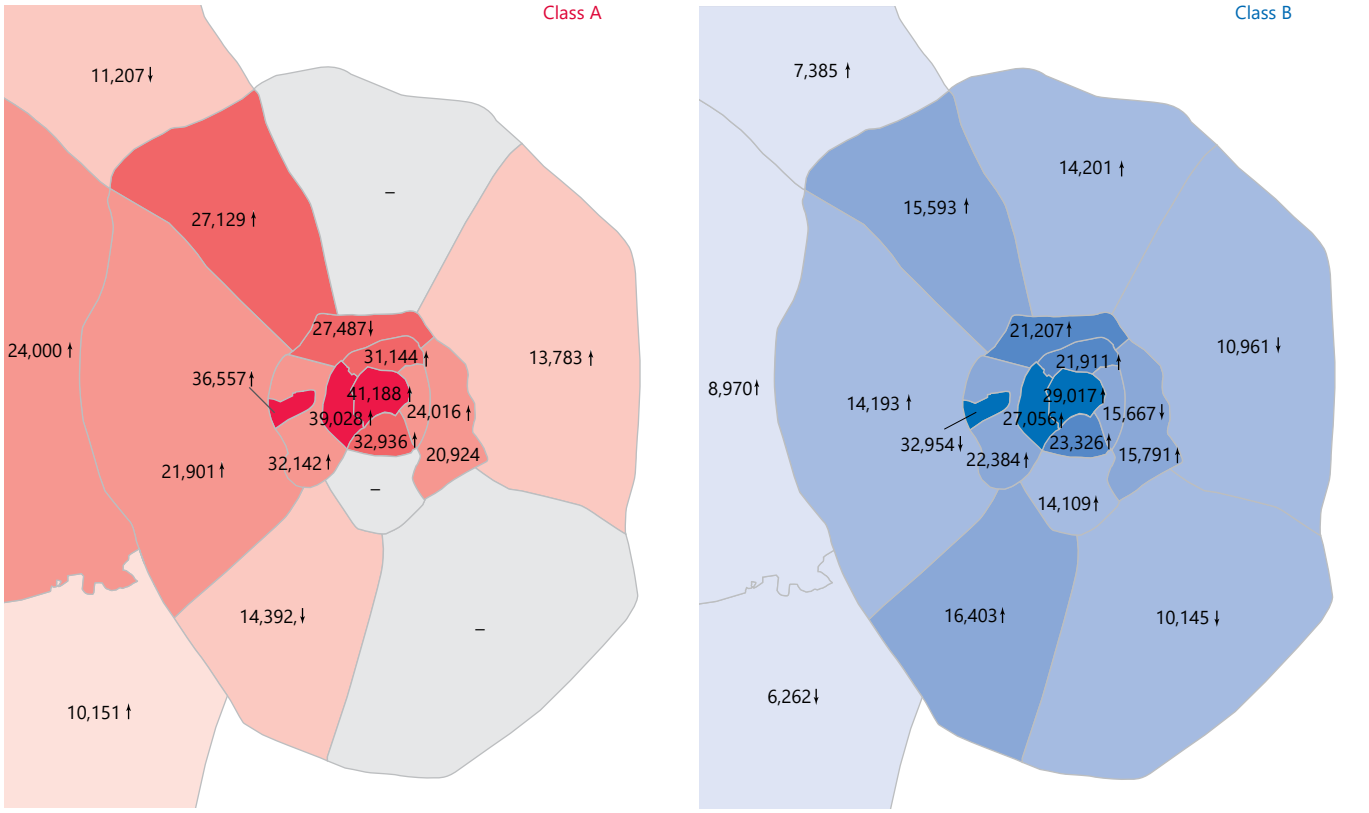
- The average weighted rent rate rose by 12% to 14,859 rub./sq m/year in Tulsky business district due to the growth in rent rates in Danilovskaya Manufaktura business district as well as the blocks of Ina House Business Center having come to the market.
- A 9% rise in the average weighted rent rate to 21,207 rub./sq m/year was recorded for Belorusskiy business district thanks to the rent rate growth in Ducat II and Severnoye Siyaniye business centers and due to the liquid premises of Brigantina Hall Business Center and Monarkh Business Center having gone off the market.

Average weighted asking rental rates for Class A and B offices, RUB/sq m/year



Source: Knight Frank Research, 2019

Moscow submarket data. Average weighed rent



Source: Knight Frank Research, 2019

No particular changes in other commercial terms of lease contracts were noted. The companies remain interested in signing lease contracts for the period of five to seven years, with an early termination possibility.

The indexation of rent rates in most contracts is linked to the consumer price index, but it remains subject to negotiating, since both the tenants and the owners of business centers realize that the rent rates and the inflation rate might grow over the five-year period.

When negotiating, landlords differentiate clients quite substantially according to the leasable area, company name, or the significance of this particular company for the business center. While in the years 2015–2017, business center owners were happy to accommodate any tenant, right now landlords are prepared to discuss flexible rent conditions only with major and/or unique tenants for the particular business center.

The owners of business centers tend to avoid investing into finishing and pass the premises to tenants 'as is'. Apart from that, a lot of major tenants being in the middle of their search for new office space budget finishing expenses and are ready to consider the properties of any state.

The optimization of expenses forces a lot of tenants to consolidate their office premises in the same spot placing their office in a good location and creating a highly efficient environment for their employees. The example of such is Ozon.ru, who consolidated its premises and occupied Embankment Tower Business Center in Moscow City business district.

Forecast

2018 saw a record low volume of new deliveries. The time of low rent rates and unique affordable offers of office blocks has passed by. The office property market of Moscow is coming to a balance; some locations have already reported a lack of quality office spaces. 2019 is forecast to maintain the balance in the overall market, while specific districts will keep their status of most sought-after.

We expect to see a growth in the volume of new deliveries in 2019 at the level of about 450,000 sq m. Further on we forecast an increase in the pace of new quality office property deliveries in Moscow, provided that the demand remains strong.

The key properties that are expected to be delivered in 2019 are Iskra Park Business Center (GLA – 56,000 sq m), Vereyskaya Plaza IV Business Center (GLA – 50,000 sq m), Akademik Business Center (GLA – 47,000 sq m), 'Stratos. Skolkovo Innovation Center' Business Center (GLA – 30,000 sq m), Bolshevik Business Center, phase II (GLA – 25,000 sq m), and Smolensky Passage Business Center, phase II (GLA – 11,000 sq m).

Some developers who have properties in highly liquid locations have moved from a frozen stage to active construction. Alcon II and Alcon III business centers are among such. The construction of new office skyscrapers in Moscow City business district has also been announced.

A 2018 trend, when many developers started to come back to the quality office property market now seeing it as a secure and relatively profitable instrument of return on their investments after the long years of alternative investments into other

sectors of the property market, is expected to maintain in 2019.

We also expect co-workings to continue their development in Moscow. The supply of chain co-workings is likely to grow by about 30,000–35,000 sq m. However, as the competition grows in this market and despite the strong demand for this type of office premises, a significant increase in rent rates is not expected. It may come up to 3-5%, taking the rent rate for one working space in a chain co-working to 24,100 rubles per month, no VAT included, by the end of 2019.

In spite of the rise in new delivery volume, the vacancy rate will gradually decline by one to two percentage points annually. The net take-up will amount to 600,000–650,000 sq m in 2019.

The average weighted rent rates for the office property market of Moscow will continue growing in 2019 by 3–5% in average taking the average weighted asking rent rate to 26,500 rub./sq m/year for Class A offices and to 15,500 rub./sq m/year for Class B offices by the end of the year.

Office investment

The low volumes of new construction of quality office premises along with the strong demand resulted in the decrease in the volume of supply available for sale.

As of 2018, the vacancy rate for Class A offices went down by 4.6 percentage points to 12.5% and for Class B offices – by 2.2 percentage points to 9.3%. At the same time, the rent rates for Class A increased by 10% and for Class B – by 5.6%. Only 94,000 sq m of quality office premises are forecast to be delivered to the sales market by the end of 2019.

Inspired with the above-mentioned trends, multiple major companies as well as private investors consider investing into office property.

Over 2018, the office market has become the most attractive property market for investing; its share of all investment transactions has amounted to 47% and the figure showed a 23% increase as compared with 2017.

Thus, the cap rates for office spaces purchased for rental businesses are 10% for Class A offices and 12% for Class B offices.

Key office projects due to be commissioned in 2019

Source: Knight Frank Research, 2019

Akademik

Among the supply of office properties for sale currently under construction, the buyers now prefer office spaces of 100-400 sq m in area located in Class A business centers.

Apart from end user purchases, there is a rise in demand on the part of private investors. The most popular request is for 100 to 300 million ruble investments into a ready-to-go rental business in a new Class A or Class B+ office building or purchasing office spaces for further lease in order to receive regular income.

The trading volume of office spaces has been rising during the past two years. As of 2018, the share of sale transactions amounted to 12% of all deals or 84,200 sq m.

The prices for quality office spaces that were listed on the Moscow market for sale in 2018 have grown as compared to the end of 2017. Thus, Class A office spaces have recorded an 8% increase.

The average weighted prices amounted to 234,290 rubles per sq m for Class A office blocks, 150,440 rubles per sq m for Class B, and 226,386 rubles per sq m for mansions. The average weighted price for general purpose premises on the ground floors of residential complexes amounted to 256,818 rubles per sq m.

Moscow submarket data. Average weighted sale price*

	Class A, RUB/sq m	Class B, RUB/sq m	Mansion, RUB/sq m	Premises for free use, RUB/sq m
Boulevard Ring	–	381,356	327,077	377,815
Garden Ring	257,239	212,642	247,778	443,610
Third Transport Ring	228,251	172,851	207,457	322,771
MIBC Moscow-City	359,986	–	–	–
TTR–MKAD	243,421	125,703	125,561	164,725
Out MKAD	139,831	111,515		122,556
Total	**234,290**	**150,440**	**226,386**	**256,818**

* Excluding VAT (18%)
The price calculated for delivered properties.

Source: Knight Frank Research, 2019

KRUNIT, Nagornaya St, 3 bld 1

Moscow submarket data. Key indicators*

Submarket		Lease Area, thousand. sqm	Class A				Class B			
			Average rent, RUR/sq m/year*		Vacancy rate, %		Average rent, RUR/sq m/year*		Vacancy rate, %	
Boulevard Ring	Central business district	712	41,188		13.0		29,017		7.9	
Garden Ring	South	985	32,936	32,074	5.6	6.6	23,326	23,485	1.0	5.0
	West	546	39,028		9.1		27,056		11.4	
	North	660	31,144		5.2		21,911		3.5	
	East	407	24,016		13.6		15,667		4.0	
Third Transport Ring	South	1,263	–	31,892	–	11.0	14,109	17,482	7.6	7.8
	West	785	32,142		9.7		22,384		7.6	
	North	975	27,487		13.1		21,207		7.2	
	East	1,121	20,924		62.7		15,791		5.5	
	MIBC Moscow-City	1,153	36,575		9.9		32,954		10.8	
TTR-MKAD	North	1,003	–	19,076	–	13.7	14,201	13,796	5.5	13.0
	Northwest	741	27,129		9.3		15,593		22.0	
	South	1,997	21,901		7.9		14,193		11.2	
	West	1,412	–		–		10,145		8.4	
	Southwest	591	14,392		12.1		16,403		13.9	
	Preobrazhenskiy	992	13,783		60.4		10,961		4.1	
Out MKAD	Khimki	266	11,207	11,534	18.4	31.7	7,385	8,216	27.6	23.0
	West	435	24,000		18.7		8,970		21.3	
	New Moscow	345	10,151		43.5		6,262			
Total		**16,388**	**25,204**		**12.5**		**14,867**		**9.3**	

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

Source: Knight Frank Research, 2019

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