Completion volume will not exceed **300–320 000** *sq m*

The decrease of net absorption is expected to **400–450 000** *sq m*

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OFFICE MARKET REPORT. MOSCOW

Q1 2020

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«Q1 Moscow office market can be defined as active, the grow of completions and net absorption was discovered. Latest episodes with pandemic and secession of Russia from OPEC, which lead to sharp weakening of the ruble, changed the expected key indicators dynamics in 2020. The market shock could negatively influence on key indicators depending on it duration. We expect the drop of completions and net absorption due to the current uncertainty. There are possibility of key indicators to start recovering in Q2-Q3 in case of stabilization of current situation. Nevertheless, essential changes are expected to happen which will mostly influence on workplace strategy.»

Key findings

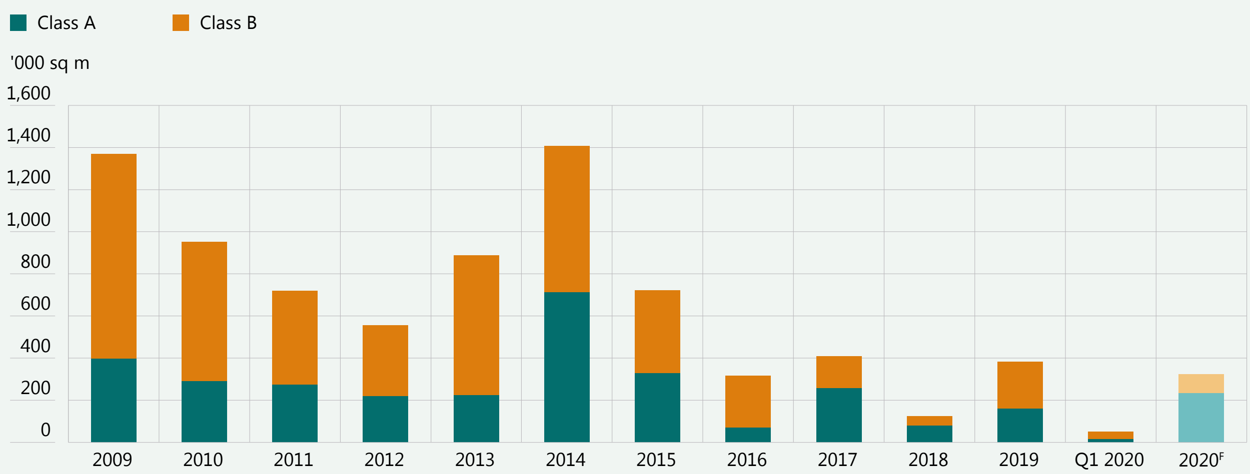
- In 2020, the completions are expected to decrease, instead of 520,000 sq m forecasted for 2020 in the end of previous year, the current expected volume won't exceed 300–320,000 sq m.
- Due to the current economy and social uncertainty the net absorption volume is forecasted to drop to 400–450,000 sq m.
- The transformation of office market in Moscow is expected this year both in terms of market practices and workplace strategy.

Key indicators, Q1 2020

		Q1 2020	Q1 2019
Total stock, '000 sq m		16,829	16,420
	Class A	4,480	4,304
	Class B	12,349	12,115
New supply in Q1 2020, '000 sq m		55.8	27.5
	Class A	15.4	0
	Class B	40.4	27.5
Net absorption in 2019, '000 sq m		187.7	180.0
Vacancy rate, %	Class A	8.6	9.4
	Class B	6.6	7.4
Average weighted asking rental rate*, RUB/sq m/year**	Class A	25,101	24,991
	Class B	16,985	16,820
OPEX rate range*, RUB/sq m/year	Class A	7,100	6,800
	Class B	4,800	4,580

* Compared to 2019 results.
** Excluding operational expenses, utility bills and VAT (20%)..
Source: Knight Frank Research, 2020

Class A and B new supply dynamics



Source: Knight Frank Research, 2020

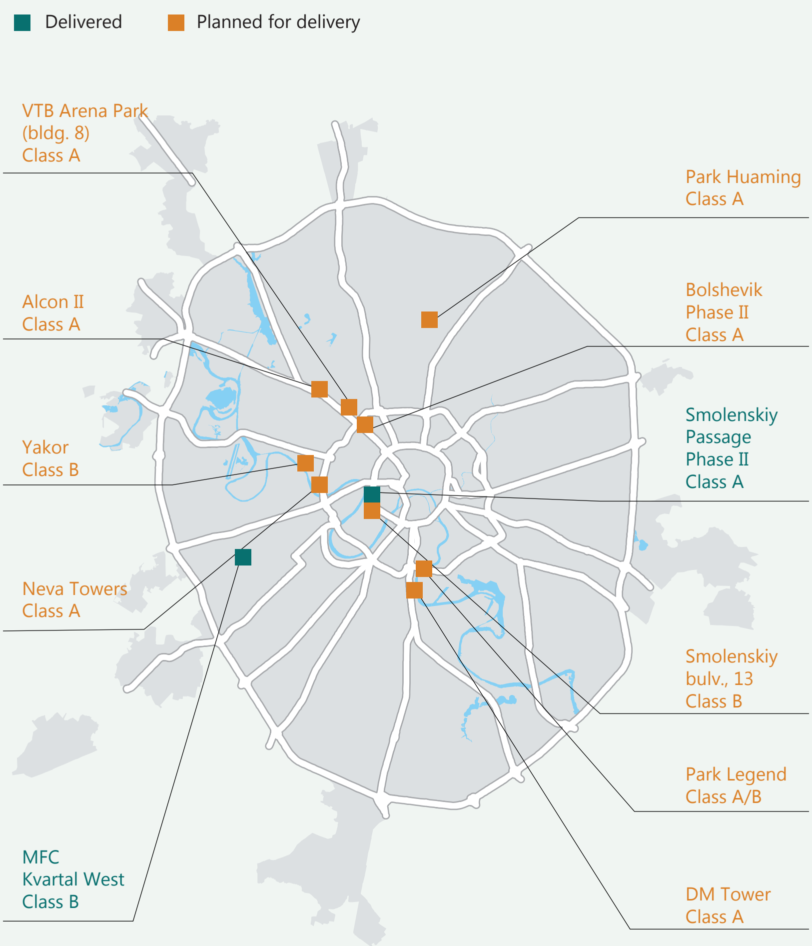
Supply

The office developer activity was reserved in Q1 2020, nevertheless the cumulative new delivery was twice as large as last year's figure. The cumulative volume of supply in the Moscow office market reached 16.8 million sq m in the office premises, 27% or 4.48 million of which accounted for Class A, while 73% or 12.35 million sq m – for Class B.

The volume of new delivery amounted to 55,800 sq m in Q1 2020 and consisted of three properties, one of which accounted for Class A. The largest of them was MFC Kvartal West (Class B, 33,944 sq m). Besides that the market grew by such properties as Smolensky Passage Phase II (Class A, 15,351 sq m) and 20 Nagornaya St., bldg. 7 (Class B, 6,500 sq m).

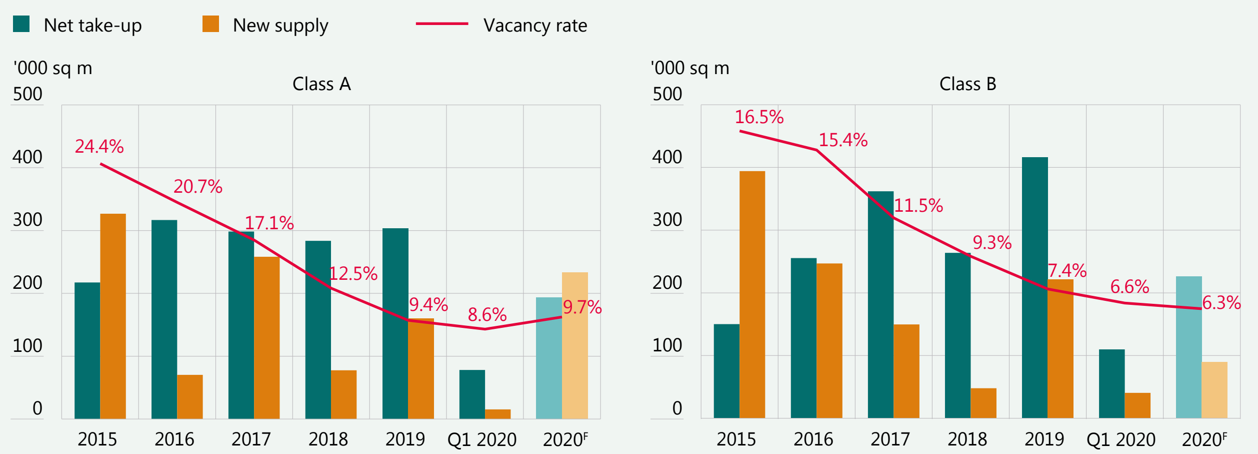
Despite the projected growth of new delivery in 2020, the latest economic and social events in Russia have corrected the forecast volume of new offices. Thus, the end users, as well as the developers, have postponed their plans to move to another office or to launch new properties in order to minimize their losses when making decisions in the situation of uncertainty. A slowdown in the growth of the key office market indicators is expected within the next few quarters. Their further movements will become clearer as the situation unfolds.

Properties scheduled for delivery throughout 2020



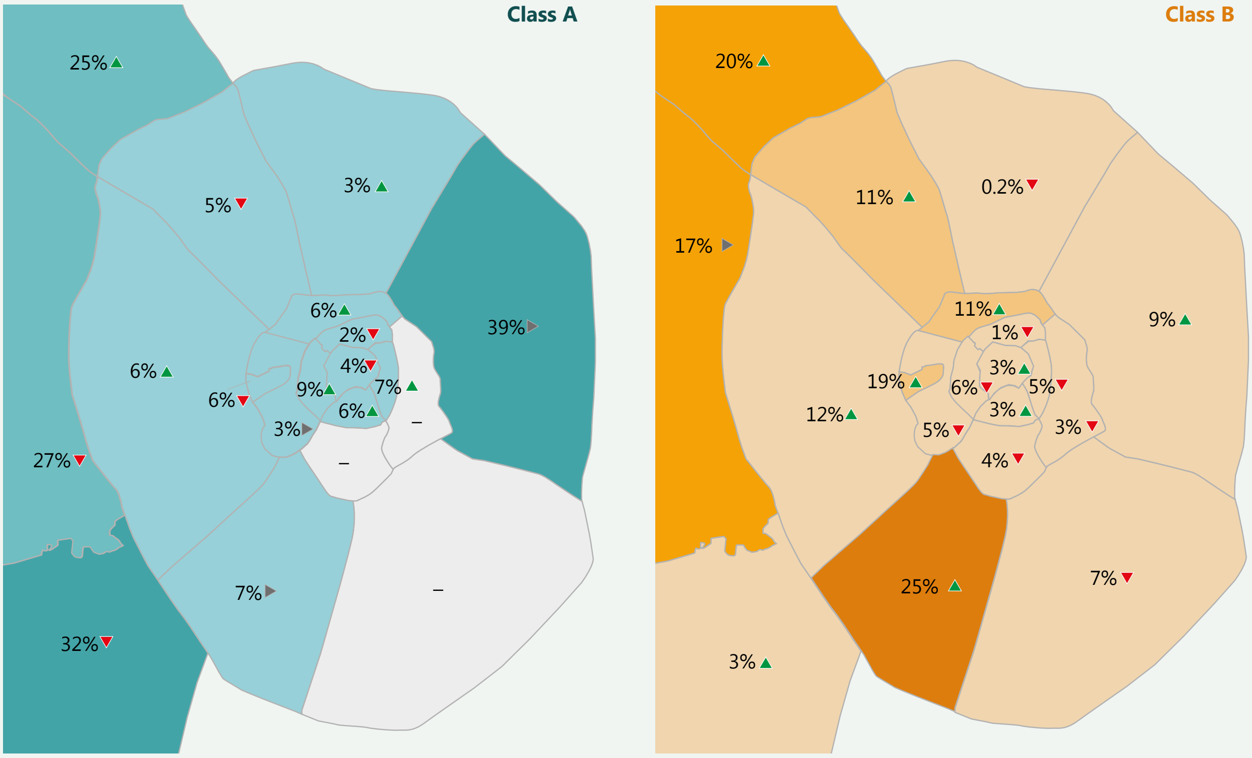
Source: Knight Frank Research, 2020

Net absorption, new supply and vacancy rate dynamics



Source: Knight Frank Research, 2020

Moscow submarket data. Vacancy rate



Source: Knight Frank Research, 2020

In spite of the doubled volume of new delivery, the stock is still insufficient to compensate the rapid take-up pace. The strong tenant and buyer activity in the office market over the first three months of the year stimulated a decline in the vacancy rate for both Class A and Class B offices, with the figure reaching 8.6% and 6.6% accordingly. Therefore, as compared to the end of last year, the decrease amounted to 0.8 p.p. for both property classes. Currently, there are 385,000 sq m of available premises in Class A and 817,000 of those in Class B.

Against the backdrop of the projected decline in the take-up volume, a slowdown in the decrease of the vacancy rate is expected, while a small growth is likely to take place in Class A. The latter if due to the fact that the forecast volume of new delivery, considering the likely reschedules of the delivery dates, will be higher than the reachable annual take-up for this property class.

Nevertheless, the final result will depend on how long the high alert mode will be on in Moscow; the longer the employees are staying at home the more lasting the recovery of the market will be after such a distress. In its turn, in case of a speedy stabilization of the current situation, no substantial changes to the market are expected, and the recovery will also happen fast.

The former years' trend of decentralization of the demand for offices is expected further on. The largest drop in the vacancy rate for Class A was reported for the zone of the Garden Ring – the Third Transportation Ring. Thus, if the figure stood at 12.9% at the end of the year, it went down by 6.5% in Q1. Apart from that, a significant decline was recorded for the zone of the Boulevard Ring. Namely, the vacancy for Class A offices decreased by 2.6 p.p. to 3.9% at this location over the quarter. It is worth mentioning, that the office market player activity was more reserved in the other zones of the city, with the vacancy rate changes amounting to less than 1 p.p. basically throughout all the zones.

On the one hand, against the backdrop of the economic situation and the pandemic, the business was forced to face the uncertainty, namely the companies can't make decisions to move or expand, as they can't project the further way of development their enterprise or the headcount. On the contrary, the shift of the larger part of the office employees to the home office mode will inspire the management of the companies to reconsider their approach to arranging the office space. A lot of companies may further on cut their office spaces partially, therefore creating a flexible and adaptive work space that might be easily reconfigured in the future according to the changing market situation. It is

out of doubt that such a situation will not lead to massive cuts in the office spaces, however the companies' needs in expanding their offices, should it be the case in the future, will not push them to renting a larger space. The development of office spaces will begin to be rather intensive than extensive. In the future, it may become a factor limiting the take-up growth, which will immediately result in the slowdown in the pace of the vacancy decrease rate for the offices even if the volume of new office delivery is reserved.

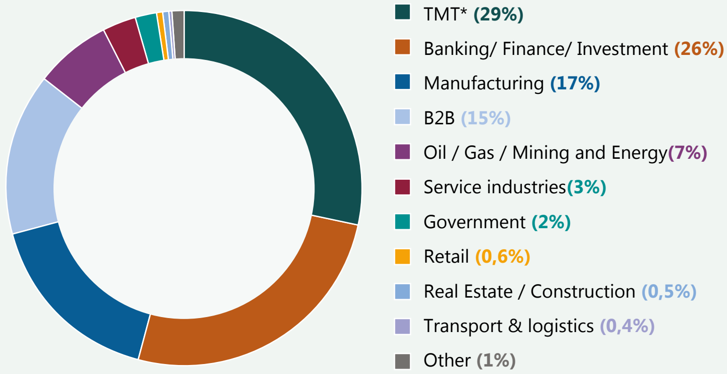
Demand

The take-up went up by 4% yoy to 187,700 sq m in Q1 2020. Despite the positive performance in the beginning of the year, the take-up will have to face a significant decline in Q2-Q3, should the social and economic factors affecting the market last. In that case, it will be possible for the figure to resume growing only by the end of the year. The one more factor influencing the further demand dynamics will be the approach companies could generate, the bulk of tenants would implement more remote working, moreover the increase of average area per employee is expected.

The Top-3 leaders in the structure of demand for the offices remained unchanged. However, the condition of some other tenant profiles has changed as of Q1. The most active market players were TMT companies, their share amounting to 29%, which is even more than the traditional leaders, namely the banks, financial and investment companies. Among the TMT companies deserving specific attention were Rostelecom and Mail.ru in Q1. The second place belonged to the banks and financial companies, with their share of 26%. The largest deal of the sector was the purchase of the premises in Park Legend Business Center (27,700 sq m, under construction) by AlphaStrakhovanie. The manufacturers came in third with their share amounting to 17%. Among them such companies as Novartis, Lokotech, Transmashkholding, and some others. Due to the current market situation the mostly active sectors in this year would be TMT, manufacturers and companies partially or fully government-owned or those who deal with government.

Further changes to the structure of demand

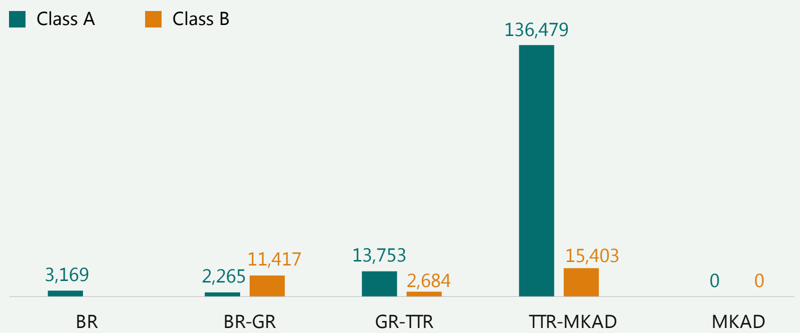
Take-up structure by business sector



* Technology, media and telecom

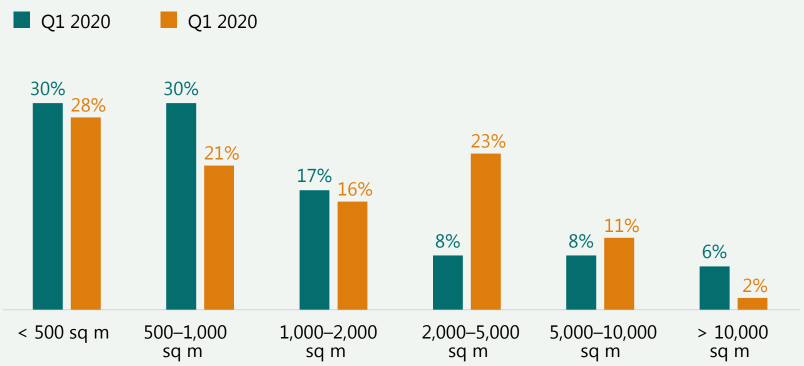
Source: Knight Frank Research, 2020

Distribution of leased space by location



Source: Knight Frank Research, 2020

Distribution of leased office units by size



Source: Knight Frank Research, 2020

that had started as far back as 2019, currently refer to the size of an office block. The medium sector of the market that contains the office blocks of 2,000-5,000 sq m and 5,000-10,000 sq m has been experiencing the decrease in its share in the total trading volume. Meanwhile, a considerable growth in demand for the smaller blocks, especially 500-1,000 sq m was recorded. An increase in the number of transactions referring to the largest market sector (over 1,000 sq m) was reported, while it is worth mentioning that the growth in this sector was due to, among other things, the restoration of the pre-lease and pre-sale market routine. Thus, two out of five major deals were signed with the properties that hadn't been officially commissioned yet.

Commercial terms

There hasn't been a significant movement in the asking rent rates over the past quarter. The figure amounted to 25,101 rubles per sq m per year (no operating expenses and VAT) for Class A, which is 0.4% more than in 2019. It stood at 16,985 rubles per sq m per year (no operating expenses and VAT) for Class B, which is a 1.0%-growth.


Neva Towers

Key lease and sale deals in Moscow office market, Q1 2020

Company	Area, sq m	Transaction type	Class	Office building
Alfa Strakhovanie	27,736	Sale	A	Park of Legends
Confidential	8,764	Lease	A	Alcon Phase II
Novartis	7,621	Lease	A	Alcon Phase II
Royal Dutch Shell	5,873	Lease	A	White Gardens
LocoTech	4,776	Lease	B	Goncharniy 1st Ln, 8 bldg. 6
Department of entrepreneurship and innovative development	2,229	Lease	A	Romanov Dvor
Transmashholding	1,805	Lease	B	Timura Frunze St, 20 bldg. 3

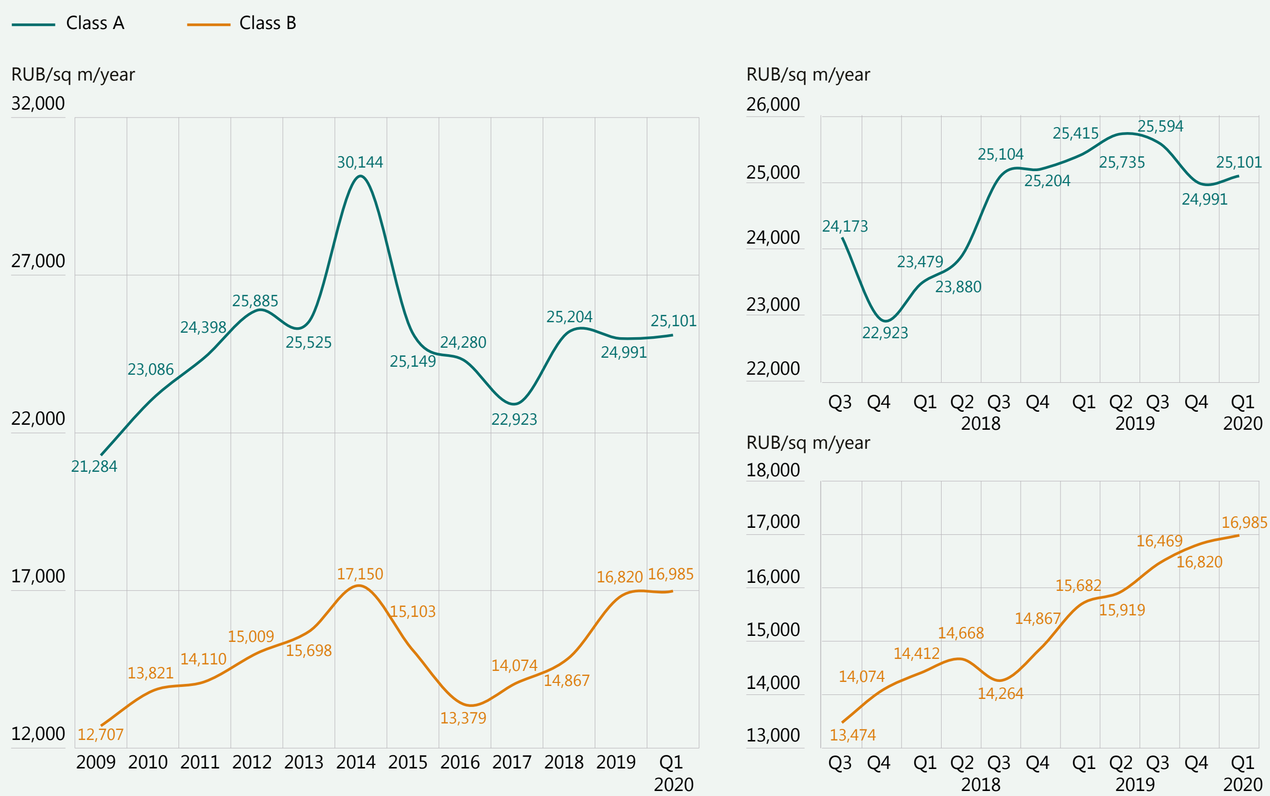
Source: Knight Frank Research, 2020

The further movements of the rent rates for the offices are not so clear at this point. The vector of this indicator will depend on several factors. Firstly, the tenant behavior. Currently, the office users are in negotiations with the landlords regarding their lease cuts or rent free periods for the time when the employees are forced to stay home. In case of quality properties, the termination of the contracts will lead to a lot of fines and penalties even in the present situation, which will prevent the tenants from opting out and moving to another building. That is why the businesses will keep trying to have their current commercial terms reconsidered. Therefore, no particular growth in the demand, set against the backdrop of the companies moving to cheaper properties, is expected. Secondly, the dramatic exchange rate fluctuations and the ruble devaluation have affected adversely on the rental payments due in foreign currencies. In spite of the fact that most of the buildings that had marketed the offices in foreign currencies switched to rubles or set an exchange rate band after 2014, a number of developers are still offering foreign currency based commercial terms. The current situation is likely to end US dollar settlements in terms of the office leases in the future, except for the cases of the tenant himself preferring it otherwise. This can also affect the annual performance of the asking rent rates. At the same time, there is no point in expecting the current rent rates to drop as a result of the decline in demand. Even considering the small vacancy rate throughout the market, only single properties still have a large number of available spaces. In general, the market situation in this respect is that the occupation rate in quality properties is high, which means that the owners have no reason to be flexible with the prospective tenants. Therefore, the asking rent rates are mostly expected to move upward.

The existing practices of the market remain unchanged. The average term of an office lease contract is still within five 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.

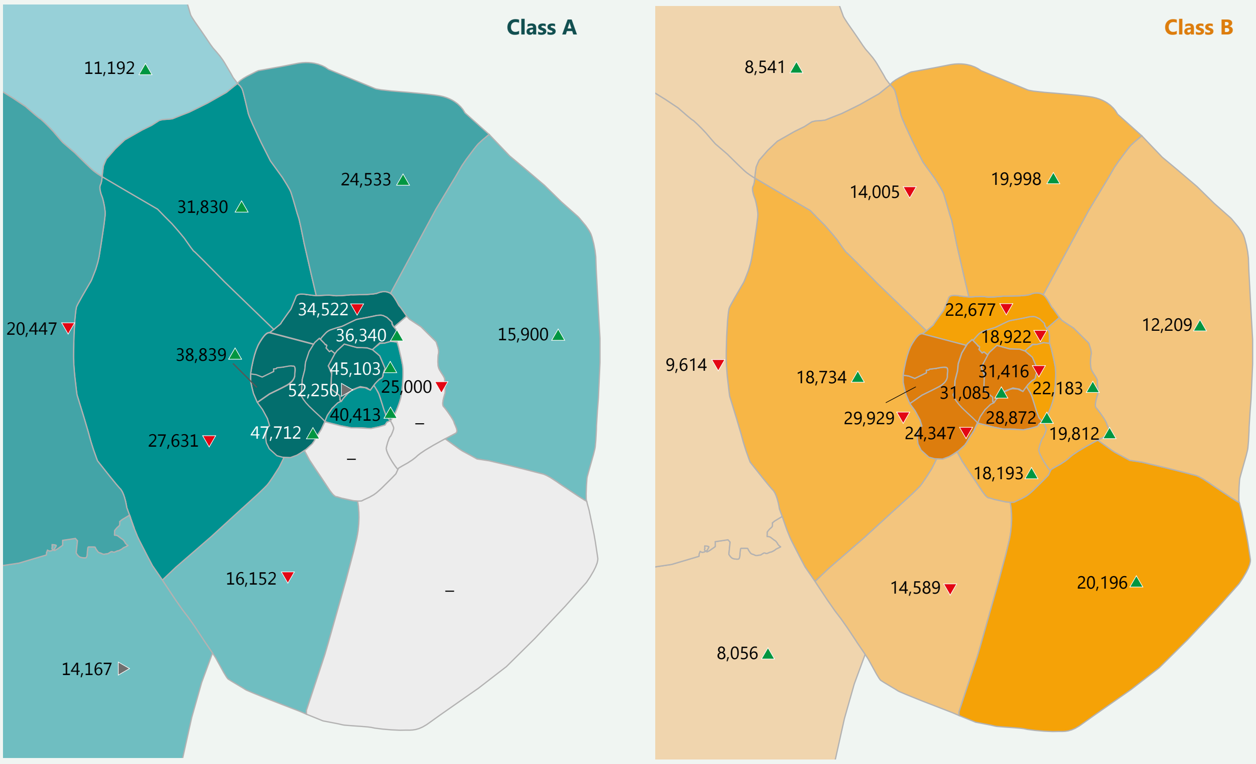
The size of a rental office block is the key factor causing the final rent rate of the transaction to shift from the asking rent rate. The developers often prefer to

Class A and B average weighted asking rents dynamics



Source: Knight Frank Research, 2020

Moscow submarket data. Average weighed rent



Source: Knight Frank Research, 2020

lease the building to several large tenants instead of a single tenant or to divide the space into much smaller blocks. It creates a solid rental income, which is less dependent on the rotation, on the one hand, and is not so complicated to administer, on the other hand.

The offices are rented mainly ‘as is’, while the reimbursements for the finishing expenses from the owners are minimal or missing.

Forecast

Due to the current economic and market situation, the key office market indicator forecasts through to the end of 2020 have been subject to an adjustment.

A slowdown in the construction activity is expected during the coming two quarters, with the developers being unlikely to deliver to the market all the previously announced properties due by the end of the year. While the previously projected figure stood at 520,000 sq m, the annual performance is currently forecast at about 300,000-320,000 sq m, which will be below the figure of last year. Nevertheless, a better annual performance might be reached, provided the business activity is restored within the next six to eight weeks.

Despite the busy Q1, which has already contributed 187,000 sq m to the annual take-up, the performance of this indicator will slow down in Q2 and Q3, provided the economic and social situation lasts. Instead of the 700,000-750,000 sq m having been forecast at the end of last year, the maximum take-up limit is expected at not more than 400,000-450,000 sq m in 2020. The structure of new supply in 2020 includes 72% of Class A properties, which, given the low take-up, will result in an increase in the vacancy rate for this class offices, that has been declining for a long while so far and causing a deficit in certain locations of the city. Thus, the vacancy rate is forecast to reach 9.7% for Class A offices by the end of the year. As for Class B offices, where the take-up is also expected to decline but the announced volume of the offices is small, the decrease will be reserved, namely about 6.3%.

Office sales

The office sales market of Moscow can be subdivided into two sectors, namely that of the sales transactions of so-called 'retail offices' of smaller areas (under 500 sq m) and that of the major sales of whole buildings. The latter have not occurred too often as of lately. In both cases, the premises can be targeted by end users as well as for further lease to other companies. Also, the transaction price is close to the asking price in case of purchasing smaller offices, while it is likely to be cut significantly in case of larger sales both for Class A and Class B offices. The average weighted prices amounted to 245,638 rubles per sq m for Class A offices, 149,584 rubles per sq m for Class B properties, and 300,866 rubles per sq m for mansions. The average weighted price for general purpose premises on the ground floors of residential complexes currently stands at 145,872 rubles per sq m.

Moscow submarkets. Average weighted sale price*.

	Class A	Class B	Mansion	Premises for free use
Boulevard Ring	-	376,955	379,594	454,283
Garden Ring	311,987	192,361	340,720	371,127
Third Transport Ring	256,563	175,668	215,409	146,469
TTR-MKAD	199,552	125,821	208,793	112,905
Outside MKAD	129,600	85,957	-	98,794

* Excluding VAT (20%).

Source: Knight Frank Research, 2020

MFC Kvartal West

Moscow submarket data. Key indicators*

Район		Lease Area, thousand. sqm	Class A				Class B			
			Average rent, RUB/sq m/year*		Vacancy rate, %		Average rent, RUB/sq m/year*		Vacancy rate, %	
Boulevard Ring	Central business district	712	45,103		3.9		31,416		3.1	
Garden Ring	South	999	40,413	37,213	5.7	4.1	28,872	24,984	3.4	3.7
	West	561	52,250		9.2		31,085		6.3	
	North	667	36,340		1.6		18,922		1.0	
	East	407	25,000		7.1		22,183		5.0	
Third Transport Ring	South	1,280	–	36,257	–	6.5	18,193	22,511	4.3	5.0
	West	797	47,712		3.0		24,347		5.4	
	North	975	34,522		6.1		22,677		10.7	
	East	1,133	22,216		90.4		19,812		3.2	
	MIBC Moscow-City	1,173	38,839		5.9		29,929		18.7	
TTR-MKAD	North	1,032	24,533	19,772	3.4	8.3	19,998	14,882	0.2	9.5
	Northwest	816	31,830		4.8		14,005		10.7	
	South	2,048	27,631		6.2		18,734		11.7	
	West	1,440	–		–		20,196		6.5	
	Southwest	662	16,152		6.8		14,589		24.7	
	Preobrazhenskiy	999	15,900		39.0		12,209		9.3	
Out MKAD	Khimki	266	11,192	14,980	25.2	28.9	8,541	9,149	20.0	15.6
	West	515	20,447		26.8		9,614		17.5	
	New Moscow	345	14,167		32.0		8,056		3.2	
Total		**16,829**	**25,101**		**8.6**		**16,985**		**6.6**	

* Excluding OPEX and VAT (20%)

Source: Knight Frank Research, 2020

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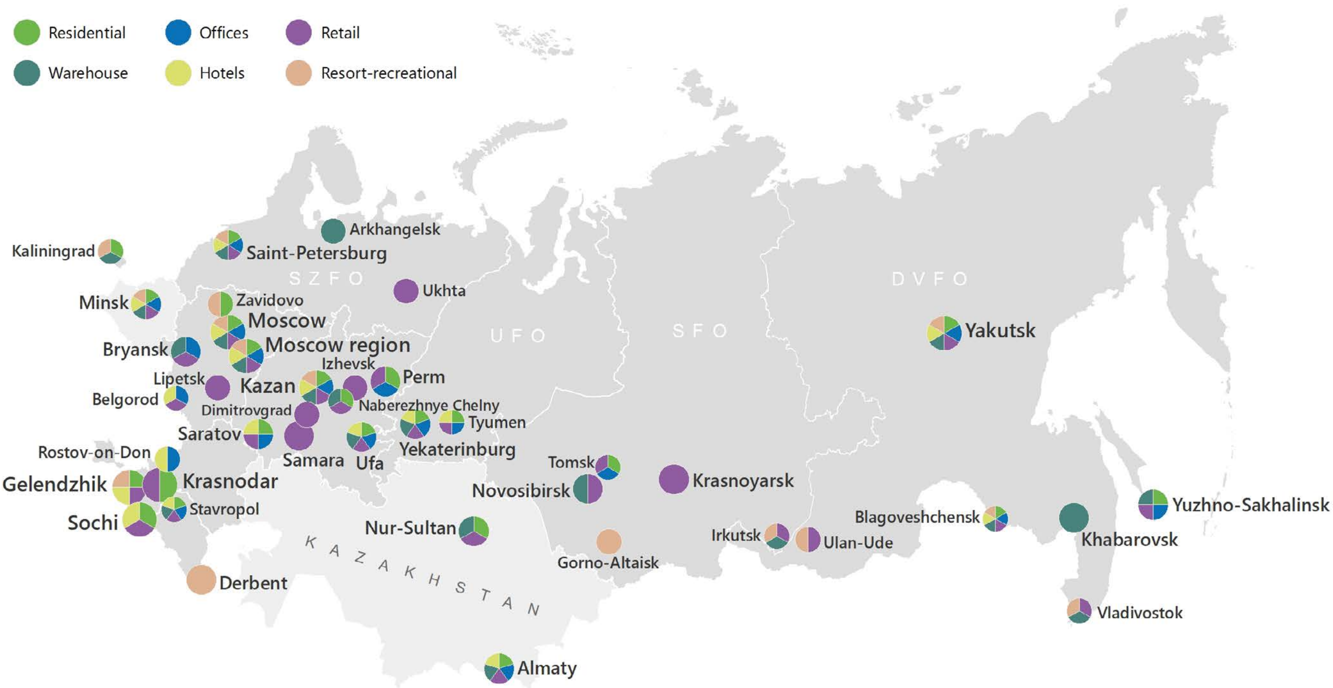

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