RESEARCH

Q3 2017

OFFICE MARKET REPORT

Moscow

HIGHLIGHTS

- The delivery volume of new office centres in 2017 remained at the lowest level as just 96,000 sq m were put into operation within 9 months of 2017 – 2.5 times less than last year's figures.
- The average asking Class A rents rolled back to figures of the 2016 end-of-year to 24,173 rub./sq m/year – 0.4% less against the end of 2016. In Q3 2017 Class B offices evidenced a slight 0.7% growth instead, running up to 13,474 rub./sq m/year.
- The Class A vacancy share was 2.3 p. p. down from the beginning of the year reaching 18.4%. In Class B offices the 9-month decrease was 2.2 p. p. going to 13.3% at the end of Q3

OFFICE MARKET REPORT MOSCOW

Konstantin Losiukov
Director, Office Department,
Knight Frank

"Q3 2017 results support the previously stated thesis on the office real estate strengthening - the decline of average rental rates, reported since 2014, has come to a halt and the existing demand has cut the excess vacant space both in Class A and Class B offices.

Market players can handle their business proactively and plan their activities in the long term in a context of certainty. That is the main achievement of the year".

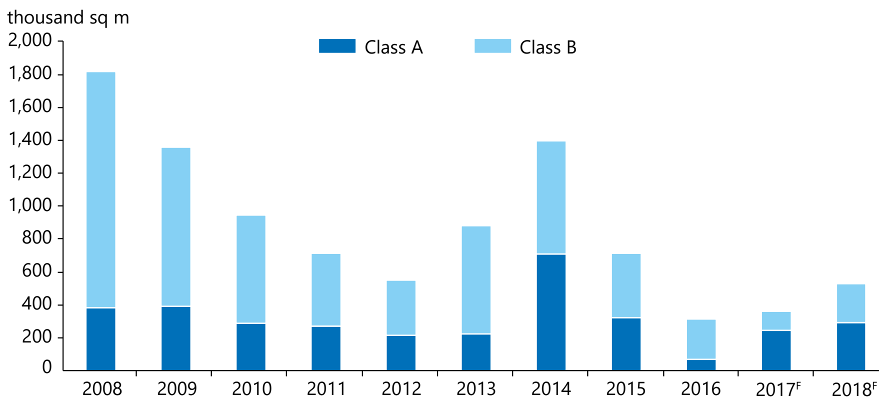
Key indicators. Dynamics*

	Class A	Class B
Total stock, thousand sq m	15,950	
including, thousand sq m	3,962	11,988
New delivery volume in Q1-Q3 2017, thousand sq m	96	
including, thousand sq m	71	25
Vacancy rate, %	18.4 (-2.3 p. p.)*	13.3 (-2.2 p. p.)*
Average weighed asking rental rate**, RUR/sq m/year	24,173 (-0.4%)*	13,474 (0,7%)*
Rental rates range** RUR/sq m/year	10,000–45,000	7,500–35,000
OPEX rate range***, RUR/sq m/year	4,000–7,500	2,500–4,500

* 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, 2017

Class A and B new delivery volume dynamics



Source: Knight Frank Research, 2017

Supply

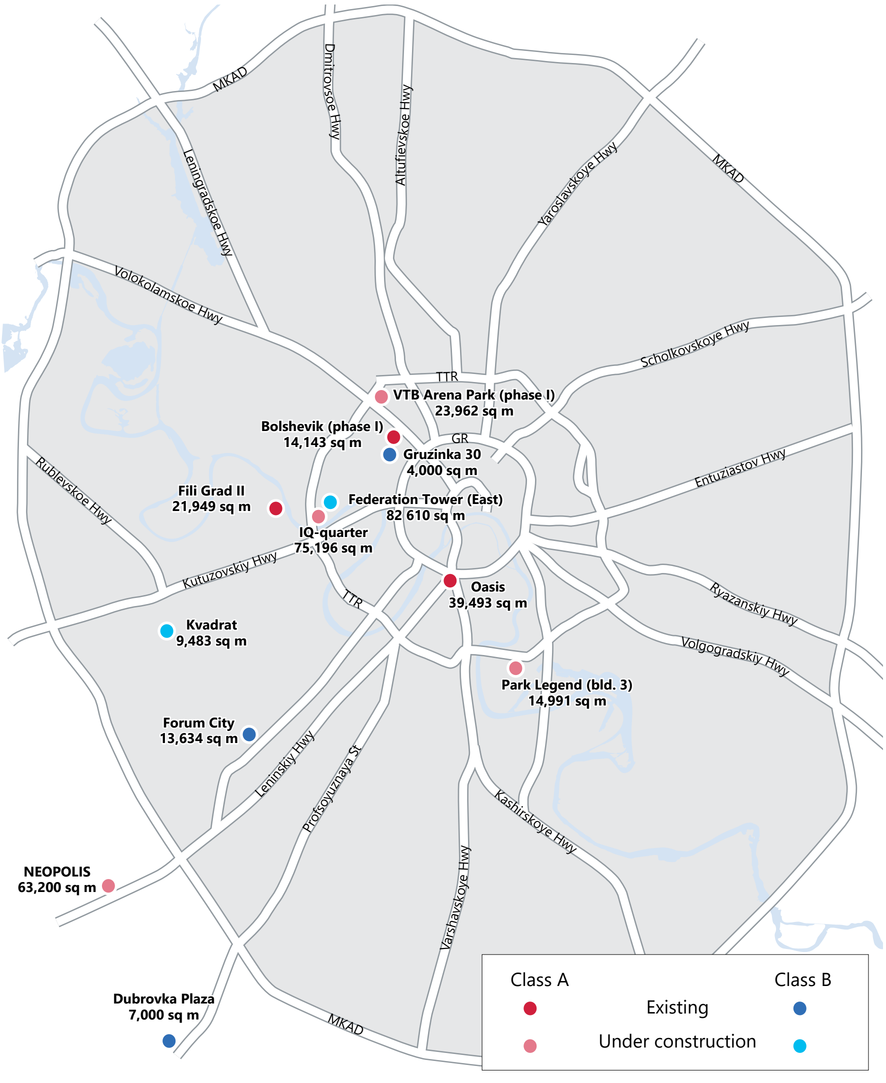
The overall office quality stock in Moscow came up to almost 16 million sq m in Q3 2017, where 25%/almost 4 million sq m corresponded to Class A offices and 75%/12 million sq m to Class B.

Almost 75 thousand sq m of new quality office space were commissioned in Q3 2017 after an all-time low new delivery of H1 2017, when only 21 thousand sq m were put into operation. The delivery volume of 9 months of the year reached 96 thousand sq m, which was still the least value for this period for the whole period of market surveillance.

About 270 thousand sq m of new office space are planned for delivery till the end of 2017, the bulk of which will be located in Neopolis (63,000 sq m), IQ-Quarter (75,000 sq m) and Federation Vostok (82,000 sq m). Lots of developers, observing the strengthening of the office real estate market in Moscow, restart their former projects and proceed to the construction of the new ones. This market stabilization is characterized by the low volatility of rental rates and vacancy rate reduction. Circa 530 thousand sq m are planned for commissioning in 2018, where 55% / 295 thousand sq m will be related to Class A offices. 239 thousand sq m of Class B offices are expected to be delivered in 2018. The planned delivery of office stock of 2018 will exceed the indicators of 2017 by 44%.

The Class A vacancy rate came to 18.4%, equivalent to 729 thousand sq m in absolute terms. 1.6 million sq m were unoccupied in Class B offices, which was 13.3% of the total supply.

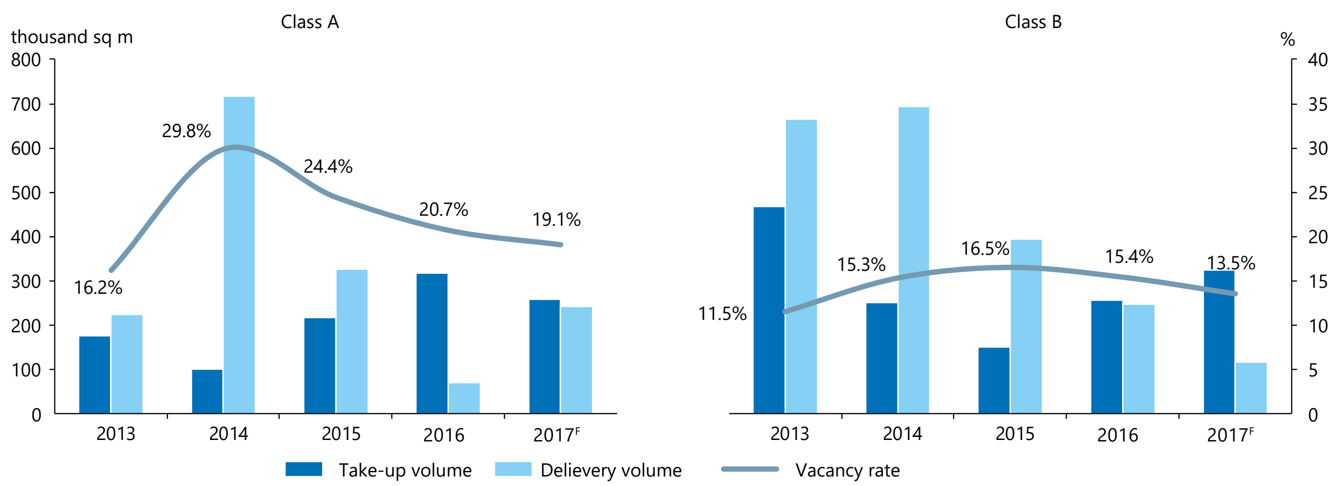
Map of projects scheduled for delivery in 2017



* Office properties that received the delivery act in Q1–Q3 2017
The building class is indicated according to the Moscow Research Forum Office Classification of 2013

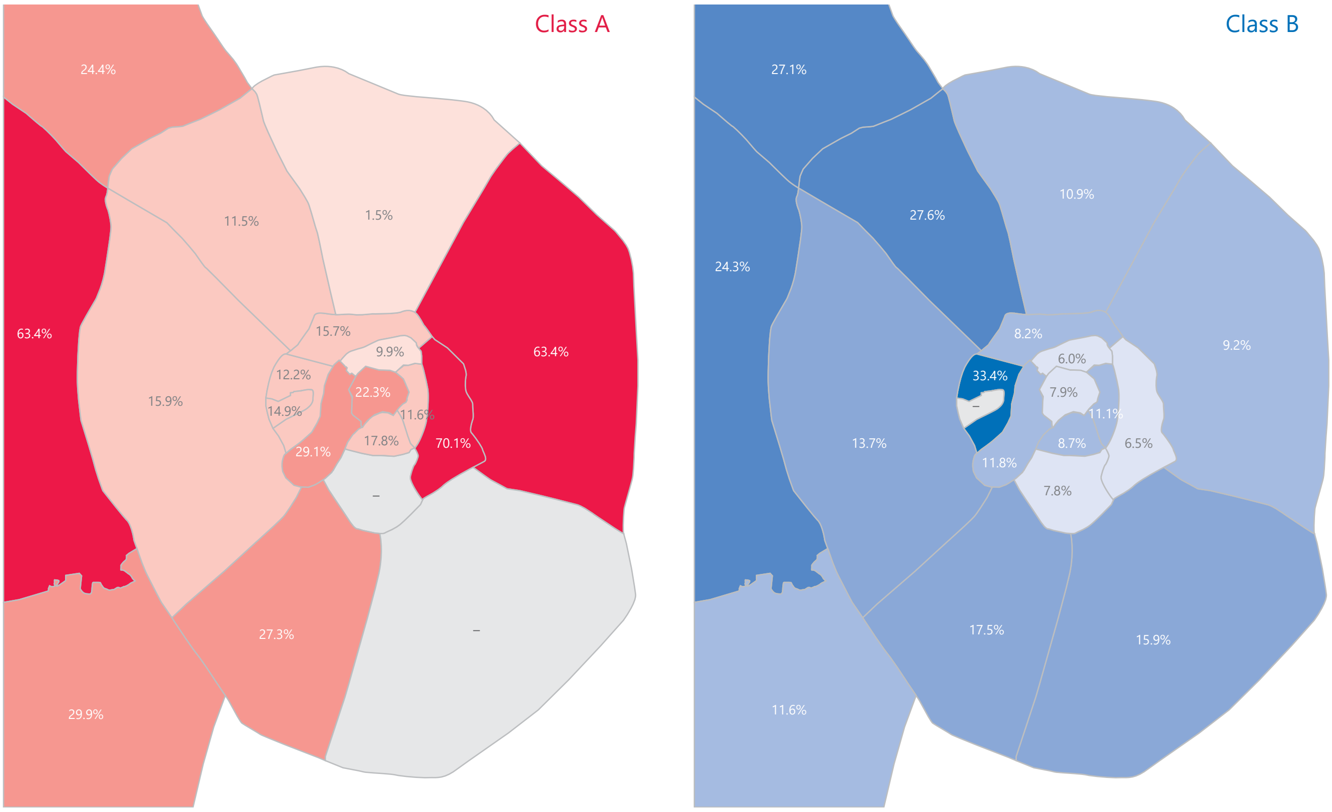
Source: Knight Frank Research, 2017

The net take-up and vacancy rate dynamics



Source: Knight Frank Research, 2017

Moscow submarket data. Vacancy rate



Source: Knight Frank Research, 2017

As determined by history, the second half of the year is top-performing in terms of the bulk of the lease transactions completed which is affected by the negotiation process and preparation for transactions taking place in the first half of the year. Therefore, the vacancy rate kept falling both in Class A and Class B offices (by 2.3 p. p. and 2.2. p. p. from the start of the year, respectively) despite the impressive delivery volume of new properties in Q3 if compared to H1 2017.

The greatest changes of the Class A vacancy share took place in the following business districts of Moscow for 9 months of the year:

- The south-west of the Moscow Ring Road witnessed a 12 p. p./20,000 sq m decrease due to a large transaction of Tele 2 company to lease office space in Comcity Business Centre.
- Circa 25,000 sq m were put out of the market in the north of the Garden Ring, which was equal to 7% of all vacant space, owing to a number of transactions in such business centres as Diamond Hall, Summit and Hermitage business centres.
- MIBC Moscow-City reported a 4 p. p./ 28,000 sq m decline of the vacancy rate.

The ultimate changes of the Class B vacancy share were highlighted in all districts of Moscow in Q3 2017:

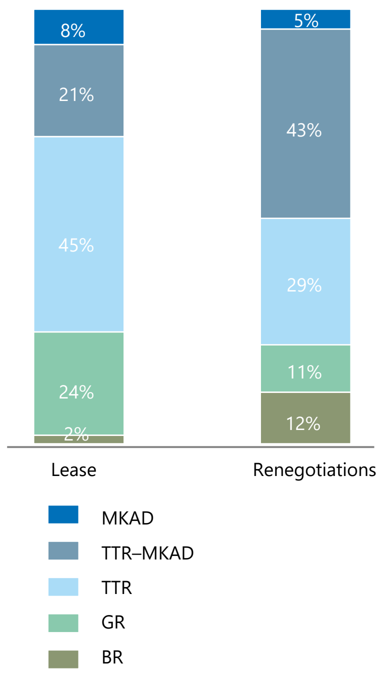
- The vacancy dropped down by 7 p. p./40,000 sq m in the north of Moscow, in the area between the Third Transport Ring and the Fourth Transport Ring.
- 34 thousand sq m/4 p. p. were withdrawn from the market of Tulsky business district located in the south of the Third Transport Ring.
- The vacancy spiraled up by 9 p. p./ 26,000 sq m in Kievsky business district in the west of the Third Transport Ring.

The large new delivery volume of Class A office centres, scheduled for Q4 2017, will boost the vacancy share. However, the current take-up rates partially level down the pace of new delivery, and as a result, the Class A vacancy rate will rise to 19.1% in the end of 2017 but will be lower than the 2016 result. Class B offices will face a slight vacancy increase - up to 13.5% by the end of the year because of the launch of new facilities to the market at the end of the year.

Demand

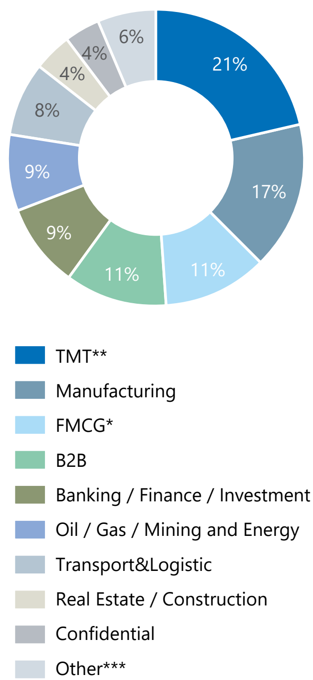
In Q3 2017, the market won back low figures of H1 2017, when the transaction volume was twice as small against the same indicators in 2016. The transaction volume with quality office real estate in Moscow amounted to 534 thousand sq m over the past 9 months of 2017, which was only 14% lower than the same indicator for 2016. Here we do not include two largest transactions in 2016, when VTB purchased Eurasia office centre and the structures of the Moscow Government were located in OKO complex, both properties were situated in MIBC Moscow-City. The volume of transactions in 2017 exceeded the indicators of 2016 by 11%. The high performance of the market in Q3 can be explained by the stabilization of the market and the rental rates as well, which affect players' sentiment who are trying to take advantage of this moment

Distribution of transactions by type and location



Source: Knight Frank Research, 2017

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, 2017

and conclude leases on the most favourable terms until rental rates begin to rise.

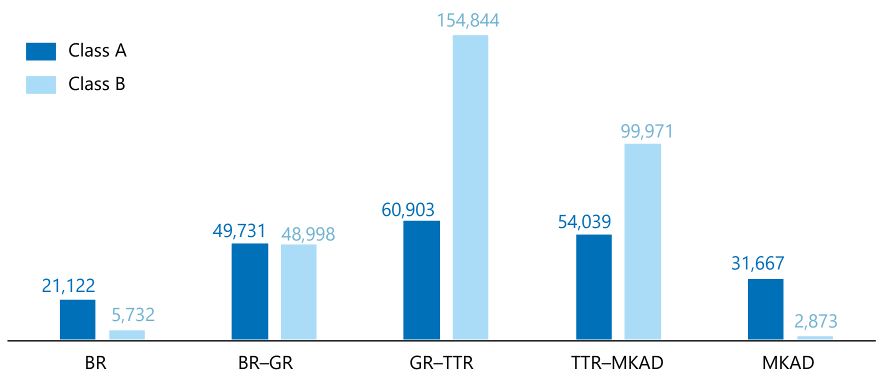
The leaders in the volume of transactions for Q1–Q3 2017 were the companies representing the Telecommunications/ Media/Technologies sector, just as in the previous year. However, their share in the overall volume of transactions went down from 30% in 2016 to 21% in 2017. The companies of the manufacturing sector of the economy were active to complete transactions with the office real estate in Moscow. Their share in the total volume of transactions was 17%.

76% of all Q1-Q3 transactions with quality offices took place outside the Garden Ring. The complex transport situation in the city centre and high rental rates support the decentralization of the office market. The share of lease transactions within the Garden Ring decreased by 9 p. p. for 9 months of 2017 if compared to the same period in 2016. In these circumstances the share of transactions with quality office real estate located close to the Third Transport Ring grew by 13 p. p. in 2017 against last year's figure.

The structure of demand for office units depending on their size remained practically unchanged within 9 months of 2017 against the same period in 2016. Q1–Q3 2017 demonstrated the increase of the share of transactions with office units of 1,000–|2,000 sq m and 2,000–5,000 sq m by 3 p. p. This growth was due to a decrease in the share of transactions with office units of 500–1,000 sq m.

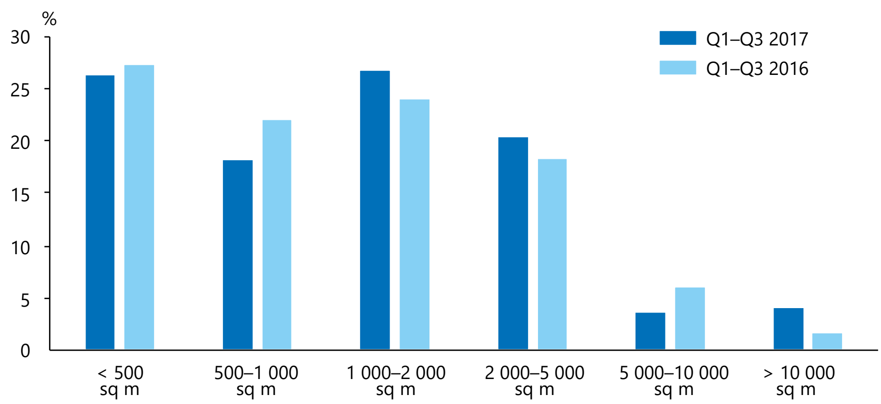
The market-share gain of transactions with office units of more than 1,000 sq m in 2017 is also supported by the average transaction size – 1,816 sq m of the average value for 9 months of 2017 – 10% higher than the same period last year if excluding the 2 major transactions of VTB and the Moscow City Government in MIBC Moscow-City.

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



Source: Knight Frank Research, 2017

Distribution of leased office units by size



Source: Knight Frank Research, 2017

Key lease and purchase transactions closed in Q1–Q3 2017

Company	Area, sq m	Office building	Class	Address	Transaction type
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
BBDO	11,030	Novospasskiy Dvor	B+	Derbenevskaya Emb, 7	Lease
GroupM	10,794	Legenda	A	Tsvetnoy Blvd, 2	Lease
Russian Agricultural Bank	9,200	Incom City	B+	Krasnogvardeyskiy 1-st Passage, 7 bld 1	Sale
Sberbank	7,046	Danilovskiy Fort	B+	Novodanilovskaya Emb, 10	Lease
DHL	6,143	Kulon	B	8 Marta St, 14	Lease
AO "Stroytransgaz"*	**5,714**	**Northern Tower**	**A**	**Testovskaya St, 10**	**Lease**
RN-Shelf-Arktika and RN-Exploration	5,500	Atlantik	A	Mozhayskiy Val St, 8	Lease

* Knight Frank acted as a consultant of the transaction

Source: Knight Frank Research, 2017

Commercial terms

Q3 witnessed the adjustment of rates when the average Class A rents in Moscow returned to the level of the end of 2016 after their decrease mainly in Q1 which continued in Q2. Q3 rental rates amounted to 24,173 rub./sq m/year, which was only 0.4% less than the similar figure at the end of 2016.

The growth of Class A rents in Q3 2017 was caused by several factors:

- Several inexpensive office units were excluded from the market, in particular, in MIBC Moscow-City and Northern Tower.
- The Q3 delivery of new quality office centres located in the most demanded districts of Moscow, for example, Oasis Business Centre in Paveletsky business district, which is offered for lease at a rate of 29,000 rub./sq m/year.

The Class B average rental rate has settled down: it has ranged within 1% for 4 consecutive reporting periods starting from Q3 2016. The Q3 2017 figure was 13,474 rub./sq m/year – 0.7% higher than the last year's index.

No drastic changes of rental rates are estimated by the end of 2017 and, in general, they will remain on par with the end of 2016: 24,000 rub./sq m/year for Class A offices and 13,500 rub./sq m/year for Class B.

The most landmark changes of Class A rents occurred in the following business districts of Moscow for 9 months as compared to the end of 2016:

- Several main premium business centres (Berlin House, Geneva House, Moskva) put down the asking rental rates in Central Business District. Therefore, the average rents of the district changed by 19%.
- The asking rents sank by 12% as a result of the withdrawal of expensive offices from the market in Comcity Business Centre in Novaya Moscow in the south-west of the Moscow Ring Road.
- The rental rate in Khamovniki district showed a 6% increase as some inexpensive office units were removed from the market in Japanese House Business Centre.

The most significant changes of Class B rents occurred in the following districts during the same reporting period:

- The average rental rate grew by 15% in Presnensky business district as several low-cost office units were excluded from the market in Apelsin Business Centre, the rents in Park Tower Business Centre were increased, as well as the launch of new office units in Rassvet Business Centre and RochDel Centre.
- The average asking rental rate was 20% down in Zamoskvorech'e as expensive and liquid premises were removed from the market in Domus, Legion I, Riverside Towers and a number of others.

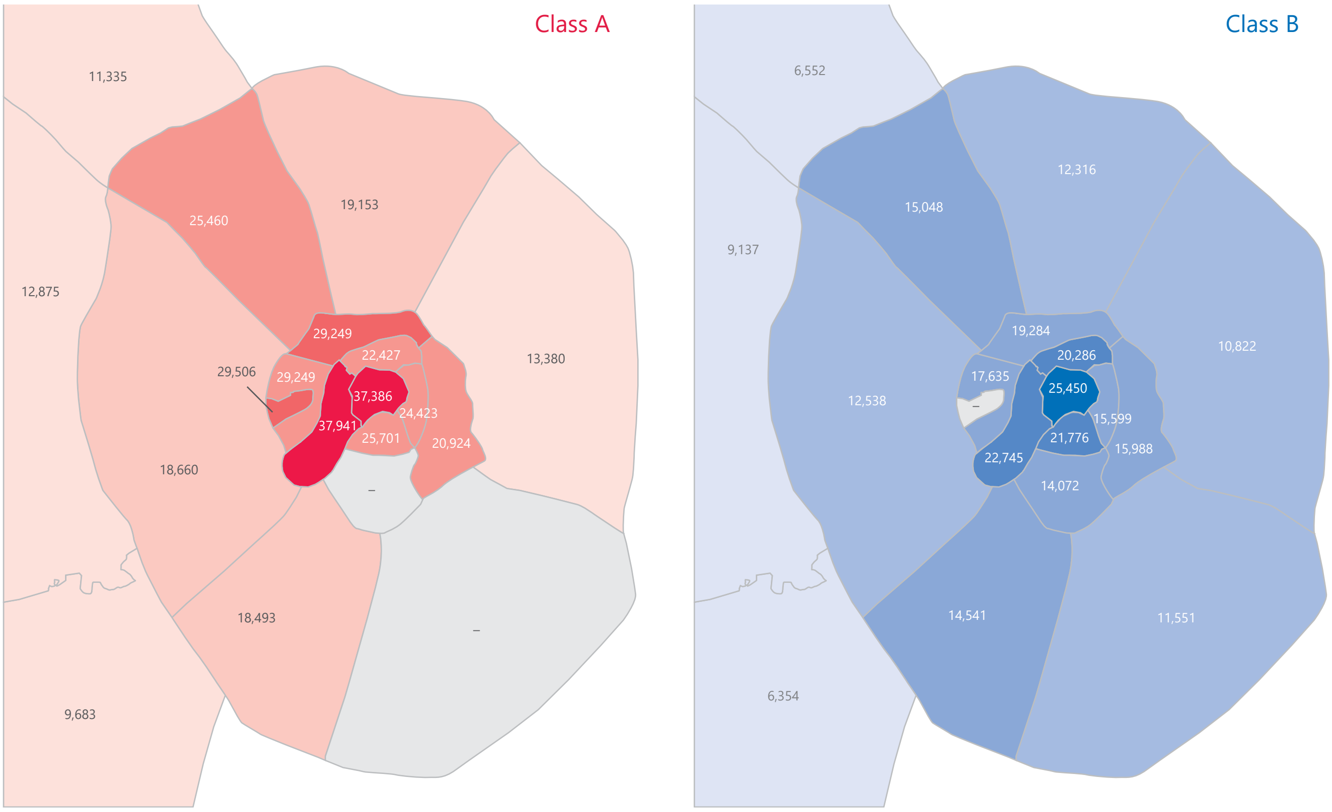
Forecast

According to our prediction, all the properties planned for delivery in 2017 will be commissioned by the end of the year. According to the forecasts of the Ministry of Economic Development, GDP growth is expected at 1.8–2% in 2018. A small economic revival will have a positive impact on the market of quality office real estate in Moscow. An increase in the new construction volume is forecasted in 2018, which may amount to more than 500 thousand sq m of quality business centres.

The fourth quarter has always been the most dynamic period in terms of the conclusion of major part of transactions, so we expect the demand growth by the end of the year. The net take-up rate of quality office real estate in Moscow will get to 550 thousand sq m. Next year it will remain at 550–600 thousand sq m, and perhaps the take-up will be even higher due to a number of major transactions, which are already under discussion in 2017. For example, the relocation of several ministries of the Russian Government from their old buildings in the city centre and their consolidation in one or several towers in MIBC Moscow-City. The estimated transaction volume will be more than 70 thousand sq m.

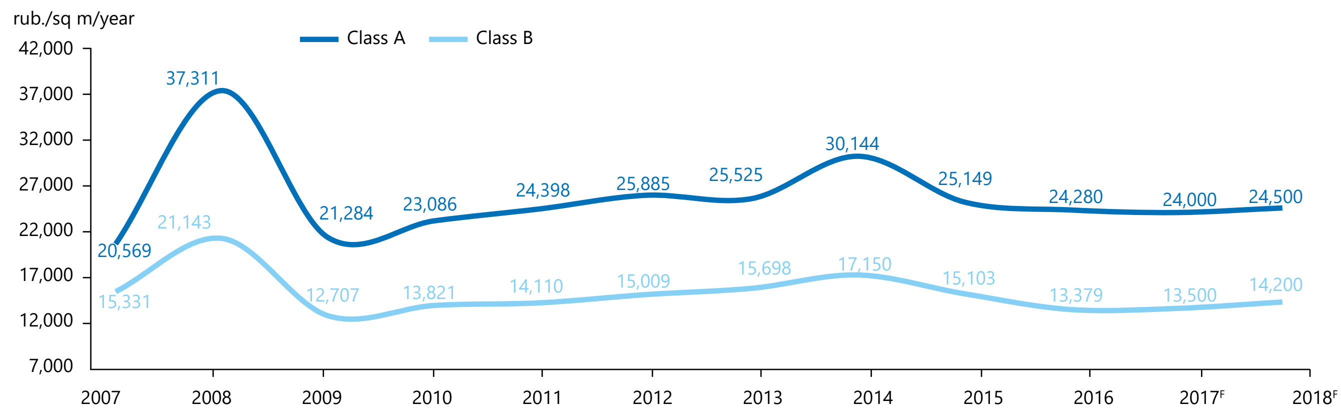
The vacancy share in quality office centres of Moscow will grow slightly by the delivery of new office centres until the end of 2017:

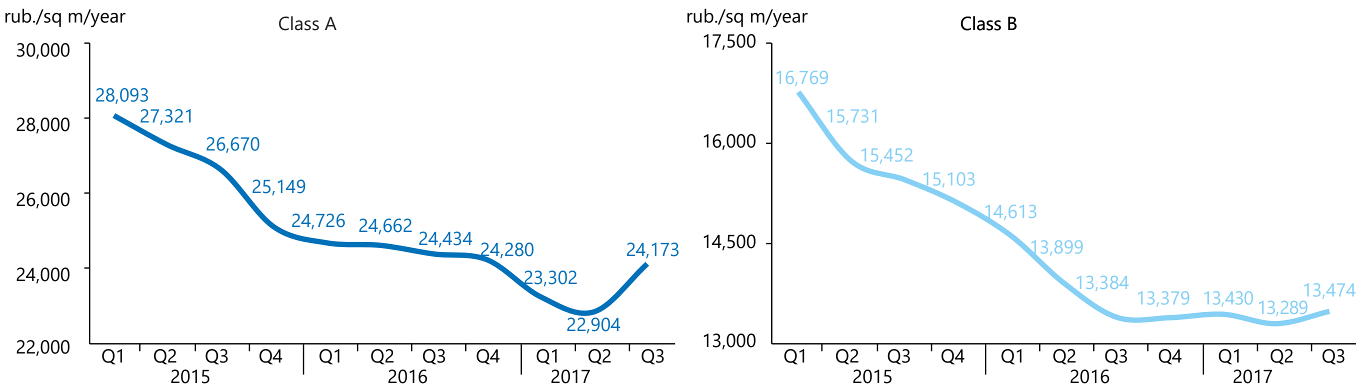
Moscow submarket data. Average weighed rental rate



Source: Knight Frank Research, 2017

Average asking rental rates dynamics for Class A and B offices denominated in RUB





Source: Knight Frank Research, 2017

up to 19.1% in Class A offices and up to 13.5% in offices of Class B.

The state authorities do not forecast the strengthening of the Russian currency in the next 2–3 years. The average annual dollar exchange rate may rise to 64 rubles in 2018 (in 2017 – 59.4 rubles) according to the forecasts of the Ministry of Economic Development of Russia. By 2020, the Russian currency is expected to depreciate to 68 rubles per dollar. Thus, the probability of reapplying the nomination of rental rates in dollars in the next 3 years is next to none. Those office buildings, where landlords still nominate the rental rate in dollars, will stick to their leasing policy. However, there unlikely be new properties with dollar rental rates, as the strengthening of the dollar against the ruble does not contribute to the nomination of rental rates in dollars.

We expect that Class A and B average rental rates will be kept at the 2016 level until the end of 2017 – 24,000 rub./sq m/year and 13,500 rub./sq m/year, correspondingly. In our 2018 projections, there will be a decrease in volatility and stabilization of Class A rental rates with a small growth in the range of 2–3%. Class B offices will face the increase of the average asking rental rates at the level of 4–5% in 2018.

Moscow submarket data. Key indicators

Submarket		Lease Area, thousand sq m	Class A						Class B					
			Average rental rates*				Vacancy rate, %		Average rental rates*				Vacancy rate, %	
			USD/sq m/year		RUR/sq m/year				USD/sq m/year		RUR/sq m/year			
Boulevard Ring	Central business district	712	680		37,386		22.3		480		25,450		7.9	
Garden Ring	South	985	467	477	25,701	26,244	17.8	16.6	411	383	21,776	20,294	8.7	9.8
	West	546	690		37,941		29.1		–		22,745		11.8	
	North	660	–		22,427		9.9		383		20,286		6.0	
	East	401	–		24,423		11.6		294		15,599		11.1	
Third Transport Ring	South	1,263	–	527	–	28,992	–	15.0	–	300	14,072	15,891	7.8	10.6
	West	785	–		24,406		12.2		–		17,635		33.4	
	North	928	532		29,249		15.7		364		19,284		8.2	
	East	1,114	–		20,924		70.1		302		15,988		6.5	
	MIBC Moscow-City	913	536		29,506		14.9		–		–		–	
TTR–MKAD	North	1003	–	342	19,153	18,783	1.5	20.7	–	237	12,316	12,796	10.9	14.7
	Northwest	734	463		25,460		11.5		–		15,048		27.6	
	South	1,988	339		18,660		15.9		237		12,873		13.7	
	West	1,412	–		–		–		–		11,551		15.9	
	Southwest	583	–		18,493		27.3		–		14,541		17.5	
	Preobrazhenskiy	992	–		13,380		63.4		–		10,822		9.2	
MKAD	Khimki	266	–	–	11,335	11,150	24.4	29.9	–	–	6,552	8,208	27.1	22.8
	West	388	–		12,875		63.4		–		9,137		24.3	
	New Moscow	278	–		9,683		25.9		–		6,354		11.6	
Total		**15,950**	**440**		**24,173**		**18.4**		**254**		**13,474**		**13.3**	

Source: Knight Frank Research, 2017

RESEARCH
Olga Shirokova
Director, Russia & CIS
Olga.Shirokova@ru.knightfrank.com

OFFICES
Konstantin Losiukov
Director
konstantin.losiukov@ru.knightfrank.com

+7 (495) 981 0000