RESEARCH

Knight Frank

Q3 2019

OFFICE MARKET REPORT

Moscow

HIGHLIGHTS

The total new office delivery amounted to 220,000 sq m in Q1-Q3 2019, which is 75% more than the annual result of 2018.

As of Q3 2019, the vacancy rate amounted to 10.8% for Class A offices and 7.6% for Class B offices.

The growth in the average asking rent rates continued and amounted to 1.5% (25,594 rubles per sq m per year) since the beginning of the year for Class A offices and to 10.8% (16,469 rubles per sq m per year) for Class B offices.

Konstantin Losiukov
Director Office Department
Knight Frank

"The Moscow office market entered the new development cycle. The stagnation of new supply in the last few years cumulated the volume of projects which launch was postponed due to the demand declining caused by crisis. Rental growth coupled with low vacancy rates in some business districts stimulated the launching of new office projects the volume of which increased significantly already. The completions volume expect to stay at the current high level next year".

OFFICE MARKET REPORT MOSCOW

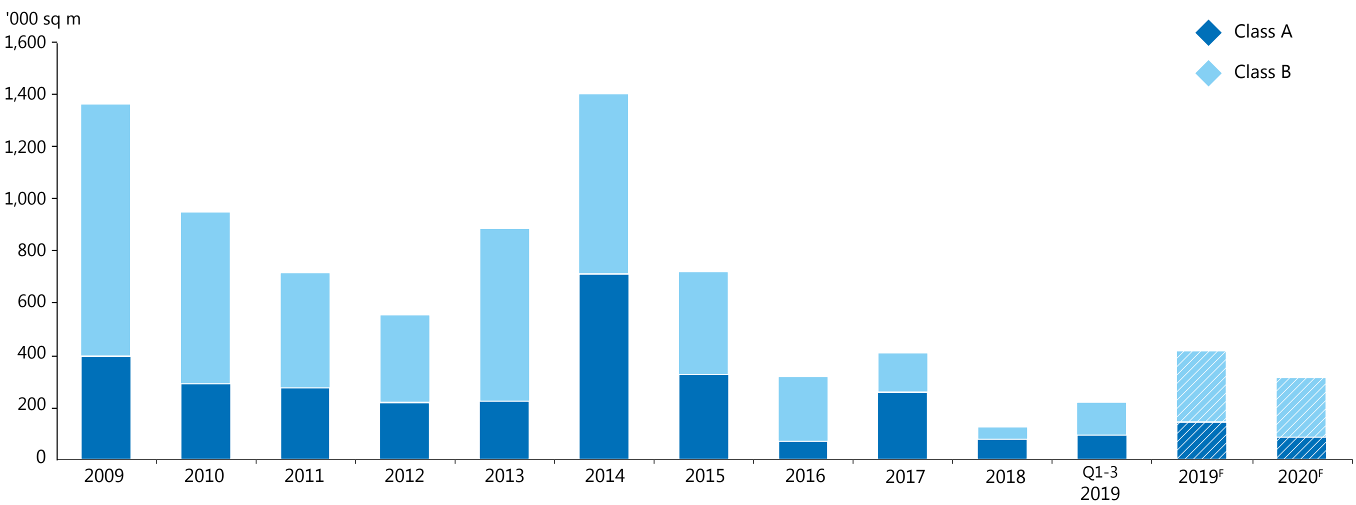
Key indicators. Dynamics*

		Q3 2019	Q3 2018
Total stock, '000 sq m		16,611	16,361
	Class A	4,369	4,244
	Class B	12,243	12,117
New supply in Q1-Q3, '000 sq m		220	95
	Class A	94	47
	Class B	126	48
Net absorption in Q1-Q3, '000 sq m		491	396
Vacancy rate, %	Class A	10.8	13.5
	Class B	7.6	9.9
Average weighted asking rental rate**, RUB/sq m/year	Class A	25,594	25,104
	Class B	16,469	14,264
OPEX rate range**, RUB/sq m/year	Class A	6,800	6,800
		4,580	4,580

* Compared to Q3 2018
** Excluding operational expenses, utility bills and VAT (20%). OPEX rate does not consider change related to property tax rate increase

Source: Knight Frank Research, 2019

Class A and B new supply dynamics



Source: Knight Frank Research, 2019

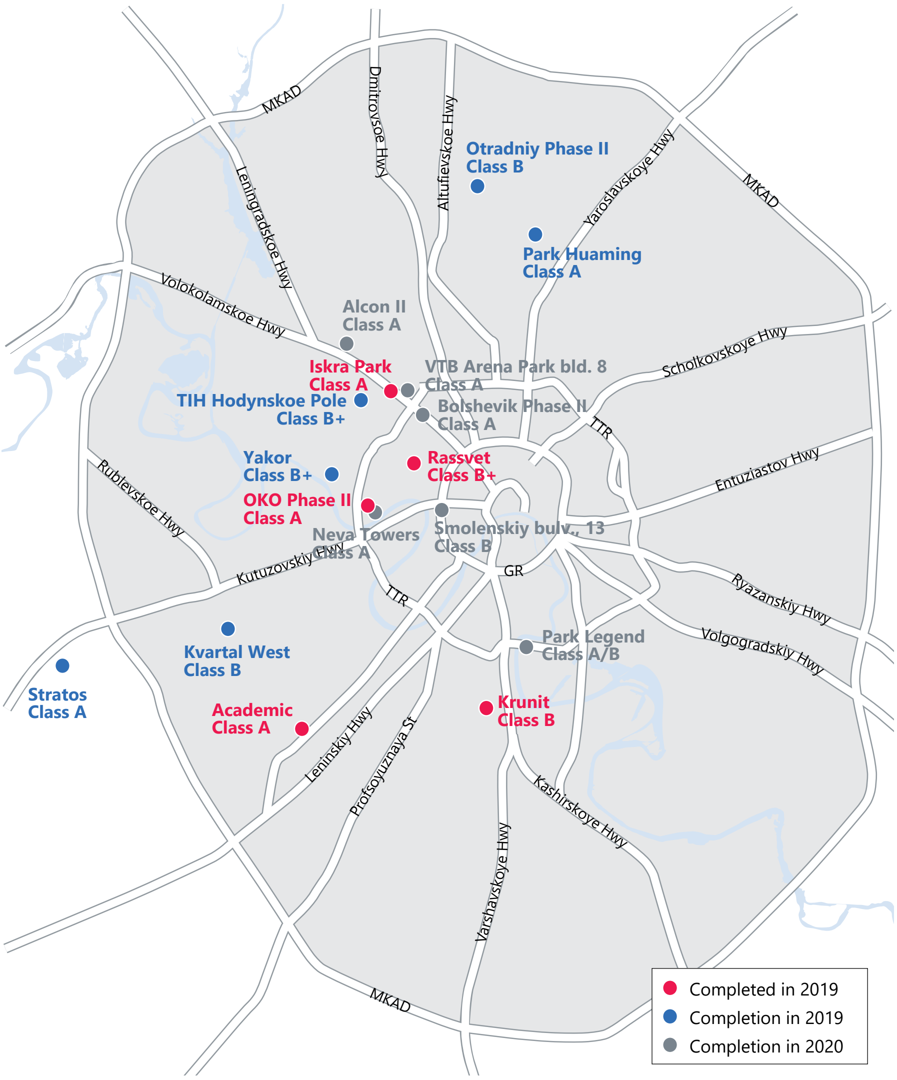
Supply

In Q3 2019, the total office stock in the Moscow market amounted to 16.6m sq m, 26% of which account for Class A and 74% - for Class B.

The volume of new office delivery proved to be significantly more not only than the figure for Q1-Q3 2018, but also than the total annual figure for 2018. Thus, 220,000 sq m of office spaces entered the market in Q1-Q3 2019, which is 75% more than the total 2018 result. Also, the largest share of this volume accounted for Q3 (107,000 sq m). The largest Class A property was Academic at Vernadskiy Ave (24,600 sq m of office space). The largest one Class B project was Vereyskaya Plaza IV, total office area amounting to 40,000 sq m. Apart from that, other major properties worth mentioning are Noviy Balchug at Sadovnicheskaya St. and OKO Phase II in MIBC Moscow City.

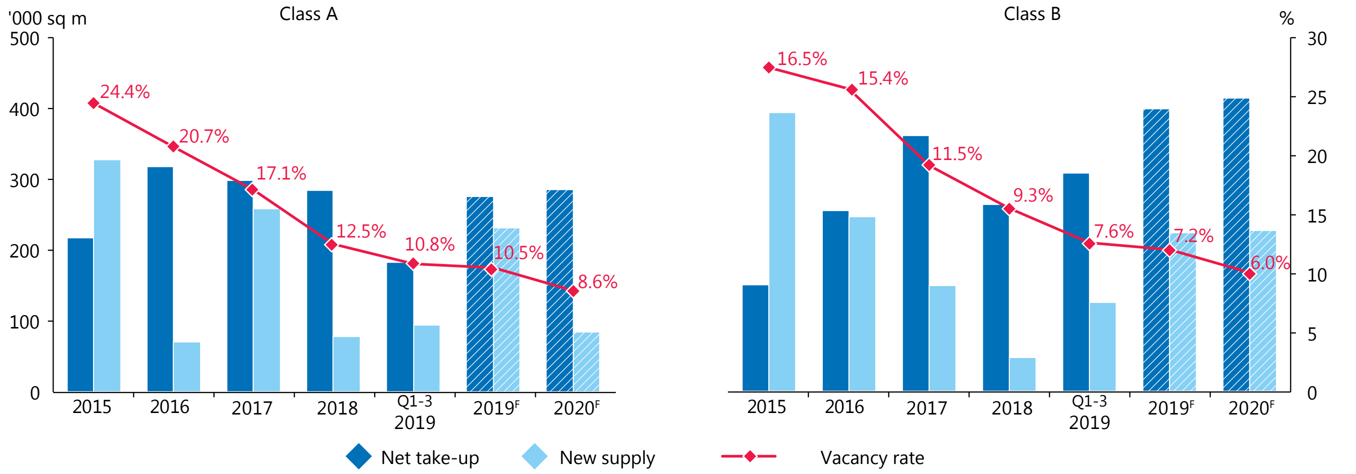
The growth in new office deliveries did not boost the vacancy rate greatly. First of all, almost all of the newly delivered properties in Q3 2019 were partially pre-leased when entering the market. Secondly, the growing office net absorption balanced the new deliveries. These factors combined allowed the vacancy to decline further in both high-quality sectors of the office market. Therefore, the Class A vacancy rate properties amounted to 10.8% or 473,000 sq m in Q3 2019, with a 1.6 ppt drop since the beginning of the year. Basically, the same kind of downward movement was recorded in Class B office market, i.e. a 1.7 ppt drop with the vacancy rate amounting to 7.6% or 928,000 sq m. Considering the large amount of expected new office deliveries by the end of 2019, a reserved

Properties delivered in Q1-Q3 2019 * and scheduled for delivery throughout 2019, 2020



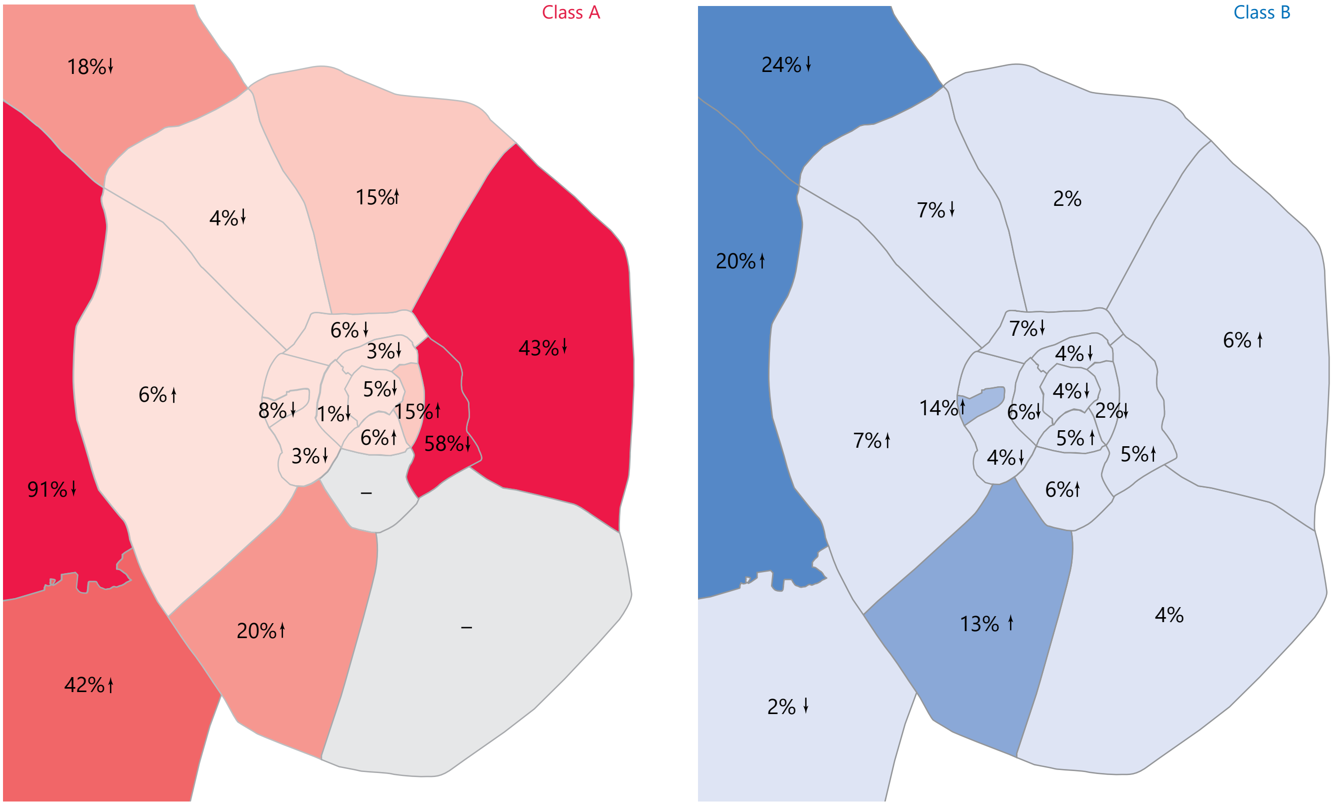
Source: Knight Frank Research, 2019

Net absorption, new supply and vacancy rate dynamics



Source: Knight Frank Research, 2019

Moscow submarket data. Vacancy rate



Source: Knight Frank Research, 2019

decline of vacancy rate is likely to take place in both classes. Nevertheless, the figures are most likely to be similar to the current ones by the end of the year.

The deficit in the downtown of Moscow continues to intensify. This leads to the appearance of pockets of demand in non-central locations of the city. For instance, the vacancy rate dropped from 13.0% at the beginning of the year to 4.9% in Q3 2019 for Class A offices within the Boulevard Ring. A similar dynamic was recorded for Class B, with the decline amounting to 4.9 ppt (3.0%). A similar situation is reported for the zone within the Boulevard Ring – the Garden Ring. And, although the decline has proven to be not so dramatic here, the vacancy rate for both classes is significantly lower than the average market figures. Thus, it went down by 1.0 ppt in Class A in this location since the beginning of the year and amounted to 5.6% and it declined by 0.8 ppt to 4.1% in Class B offices.

The decreasing availability of offices in the most sought-after business districts accelerates the shift of demand toward the zone within the Garden Ring – the Third Transportation Ring. The vacancy rate for

Academic, Vernadskogo pr-t, 41

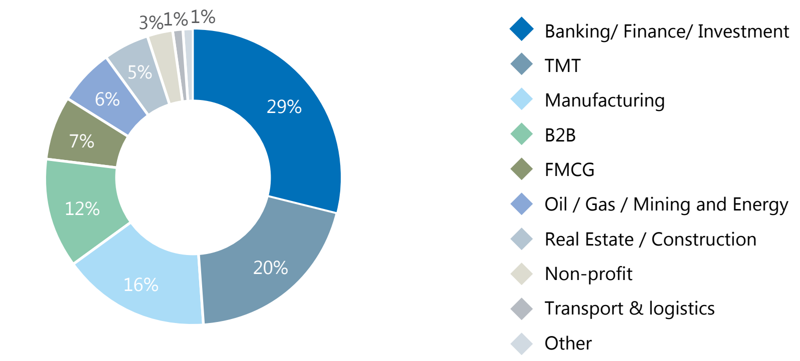
Class A offices declined significantly, i.e. by 3.8 ppt to 5.4% in this location by the quarter. Despite the expected growth in the new office deliveries, it will not contribute to a substantial rise in the vacancy rate. The new delivery has been stagnating for too long, with the developers having been waiting for a growth in the net absorption and keeping their properties at an advanced stage of construction. This holdback turned out to have lasted so long that it caused a deficit of high-quality office premises in certain locations of the city. Therefore, as soon as new properties appear in these locations, they will be leased to the tenants even ahead of the delivery. This trend is a sign of a gradual recovery of the pre-lease and pre-sales markets, as major users are currently considering the properties that are scheduled for delivery not earlier than 2-2.5 years.

Demand

The volume of net absorption in Q1-Q3 2019 exceeded last year's figure by 24% and amounted to 491,000 sq m. Meanwhile, such a growth was mainly due to the increase in the figure for Class B while that of Class A remained basically unchanged.

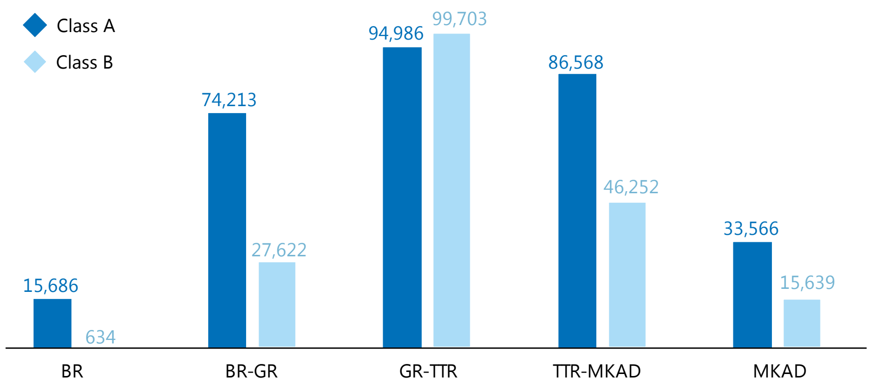
Office lease and office sales accounted for 79% of all transactions in Q1-Q3 2019 against 72% a year earlier. The incremental decentralization of demand for offices continues in accordance with the market trends. Thus, while 11% of lease and sales deals accounted for the zone within the Boulevard Ring in Q1-Q3 2018 along with 4% of prolongation and renewal of contracts, the figures amounted to 3% and 2% accordingly in Q1-Q3 2019. A similar situation was recorded for the zone within the Boulevard Ring – the Garden Ring, where the share of new lease and sales deals amounted to 16% in 2019 against 23% a year ago. In its turn, a noticeable growth was reported for the zones within the Garden Ring – TTR and within the TTR – MKAD. Thus, the share of new lease and sales transactions grew by 2 ppt and 16 ppt here accordingly, while the share of prolongations and renewals increased by 19 ppt and 4 ppt accordingly. At the same time, many office users still don't consider it the most convenient option to locate their offices outside MKAD. The share of deals here turned out to be less than that of 2018. Thus, the share of the new lease and sales sector amounted to 6% against 10%, the share of prolongations and renewals stood at 7% against 21% a year earlier. The territories from the Garden Ring to the Moscow Ring

Take-up structure by business sector



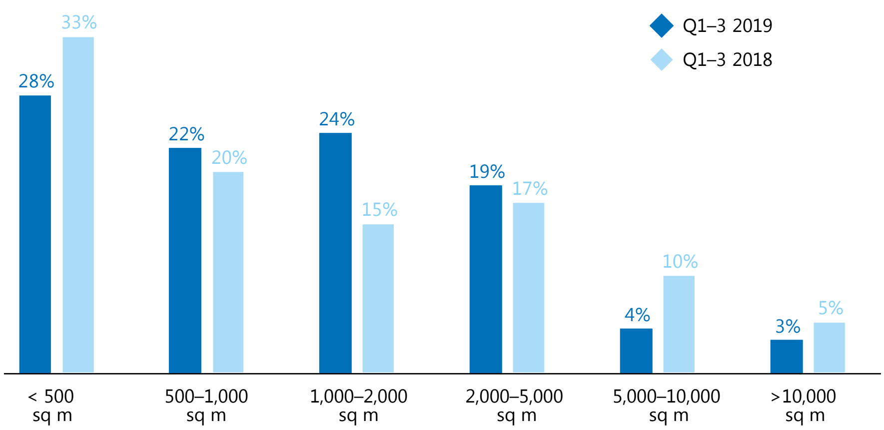
Source: Knight Frank Research, 2019

Distribution of leased space by location



Source: Knight Frank Research, 2019

Distribution of leased office units by size



Source: Knight Frank Research, 2019

Road are expected to consolidate their position as the most popular locations within office users next year.

The banks as well as the financial and investment companies continue leading the way in the structure of demand. Their share amounted to 29% in Q1-Q3 2019. Another major deal was signed with a company from this sector in Q3 2019, which contributed to this leadership significantly. It was the purchase of an office building on the premises of Nagatino i-Land Complex by Raiffeisen Bank. The property is to be built to custom requirements of the bank. The TMT sector companies came in second with their share amounting to 20% of all deals. The third place belongs to manufacturers with their share in the demand structure amounting to 16%.

As of Q1-Q3 2019, the bulk of transactions accounted for the confidently leading sector of office blocks under 500 sq m (28% against 33% a year earlier). The share of transactions with the spaces of 500 sq m to 1,000 sq m amounted to 22%, while that of the spaces of 2,000-5,000 sq m – to 19%. The increase amounted to 2 ppt YoY in both cases. The largest rise was recorded for the premises of 1,000 sq m to 2,000 sq m. i.e. 24% against 15% last year.


Kvartal West

Key lease and sale deals in Moscow office market, Q3 2019

Company	Area, sq m	Transaction type	Class	Office building
Raiffeisenbank	34,000	Sale	A	Nagatino i-Land
Yandex.Market	15,836	Lease	A	Lotte Plaza
WeWork	8,466	Lease	A	MFC Imperial Plaza
Huawei Technologies	7,789	Lease	A	Smolenskiy Passage II
MTS	4,565	Lease	B	Novoryazanskaya St., 8
Main Bureau of Medical and Social Expertise	3,672	Lease	B	Priorova St., 36
VTB	1,352	Lease	A	White Stone
AMADA	1,098	Lease	B	Volokolamskoe Hwy, 79 bldg. 1

Deals closed with Knight Frank

Source: Knight Frank Research, 2019

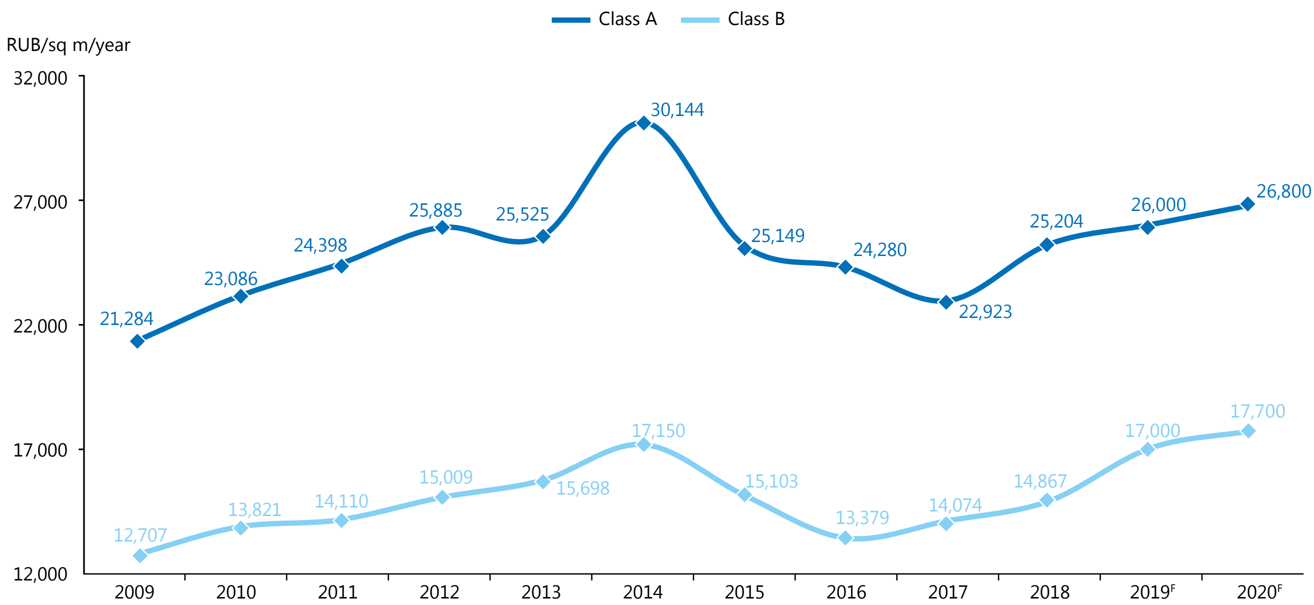
Commercial terms

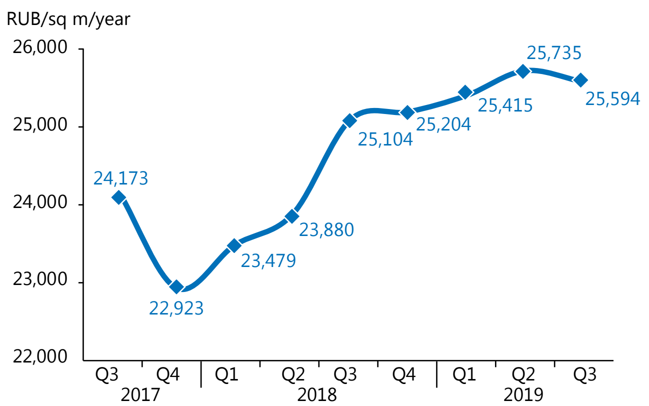
In Q3 2019, the average asking rent rate in Class A offices amounted to 25,594 RUB/sq m/year (excluding VAT and OPEX). Therefore, the growth amounted to 1.5% since the beginning of the year. A more rapid growth in the rent rates was recorded in Class B. Thus, the asking rent rate for Class B amounted to 16,469 RUB/sq m/year (excluding VAT and OPEX), which is a 10.8%-growth. Such a flashy growth that has been going on for three years straight now will undergo a slowdown in 2020, provided the new office deliveries are substantial. Nevertheless, the performance is expected to be positive.

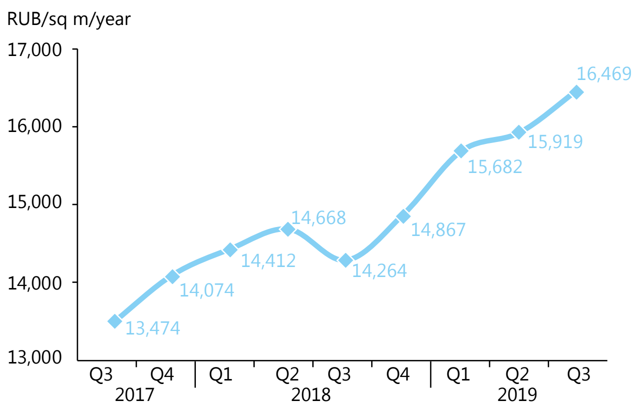
Among the business districts of the city, a noticeable increase in rent rates was reported in locations where the growing demand for office premises makes the owners be less flexible in negotiations and raise the rents for their properties. Thus, the asking rents grew from 28,177 RUB/sq m/year in the beginning of the year to 36,352 RUB/sq m/year at the end of Q3 2019 (excluding VAT and OPEX) for Class A offices in the zone within the Garden Ring – TTR. A similar growth was recorded for Class B offices within the same location. Therefore, the asking rental rates increased here from 16,494 RUB/sq m/year to 20,038 RUB/sq m/year over the first three quarters of 2019 (excluding VAT and OPEX). However, such a significant growth was caused rather by the accelerated shift of demand toward non-central locations. As the office markets become balanced in these zones, the growth, which already significantly exceeds the pace of the past years, will slow down.

The existing practices of the market remain unchanged. The average term of an office lease contract is still within five to seven years, with an early termination

Class A and B average weighted asking rents dynamics

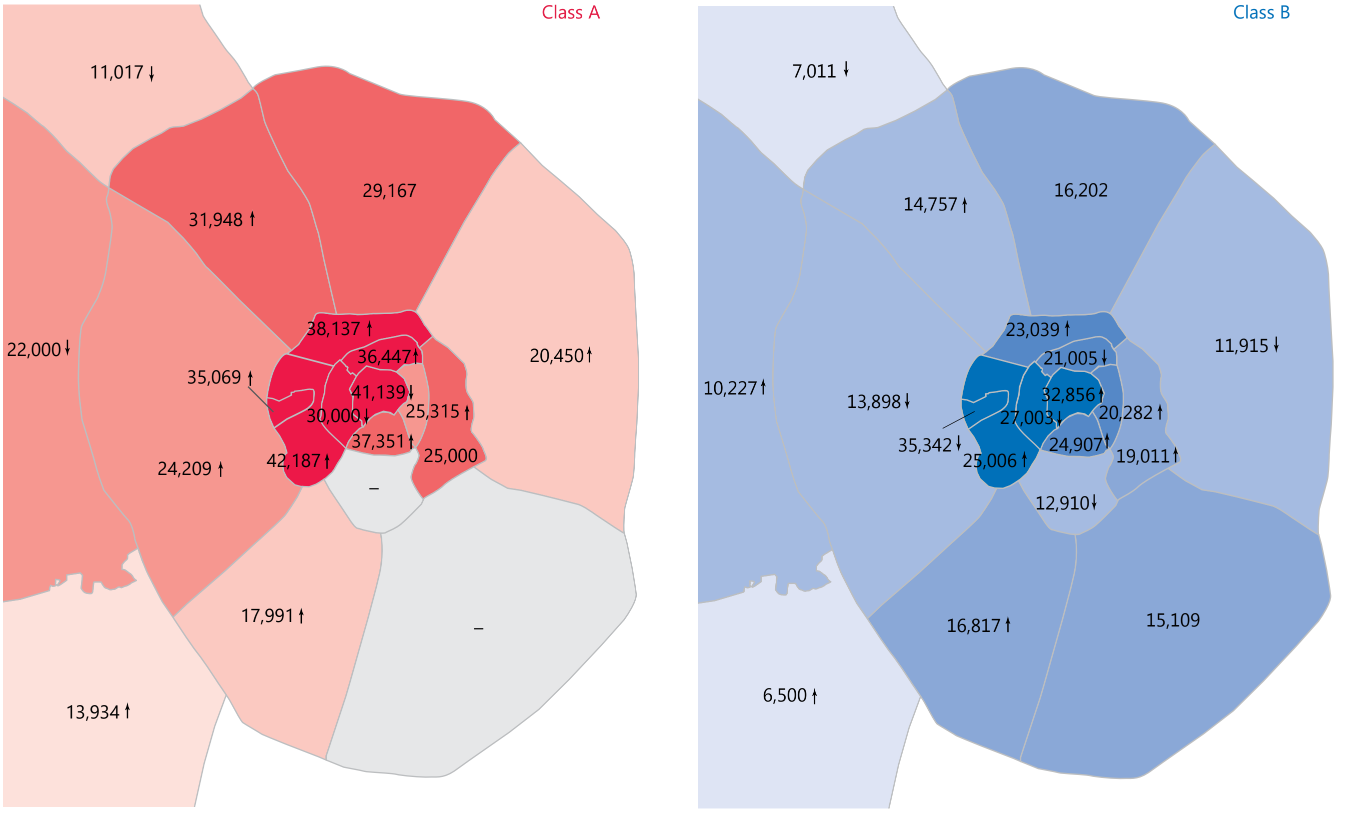






Source: Knight Frank Research, 2019

Moscow submarket data. Average weighed rent



Source: Knight Frank Research, 2019

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 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

The total delivery of office property is expected to amount to 312,000 sq m in 2020. Although this figure might increase by the end of this year as the trend of rescheduling deliveries is going on and some of the properties expected to be delivered by the end of 2019 are likely to be rescheduled for 2020.

A relatively small volume of the office premises scheduled to be delivered next year won't be able to balance large net absorption volumes; the vacancy rate is expected to decline further on. Thus, the vacancy rate for Class A office properties is expected to amount to 8.6% by the end of 2020, while the figure for Class B offices will stand at 6.0% over the same period. The decentralization of demand for offices will continue next year. Meanwhile, new transactions with pre-lease and pre-sales of office buildings are likely to be closed, as the situation of limited supply will remain the case for major office users.

Despite the rapid increase in rent rates during the period under consideration, especially in Class B offices, a slowdown in the pace of growth is expected. Most owners have already reconsidered their listed rent rates for offices. Should the growth of the rent rates go on with the same pace, it will cause an outflow in prospective tenants from certain locations. By the end of the coming year, the Class A rents are likely to amount to 26,800 RUB/sq m/year and for Class B – 17,700 RUB/sq m/year (excluding VAT and OPEX).

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 242,412 RUB/sq m for Class A offices, 131,176 RUB/sq m for Class B properties, and 254,504 RUB/sq m for mansions. The average weighted price for general purpose premises on the ground floors of residential complexes currently stands at 156,906 RUB/sq m.

Moscow submarkets. Average weighted sale price*.

	Class A	Class B	Mansion	Premises for free use
Boulevard Ring	–	375,000	293,781	449,467
Garden Ring	246,445	209,858	264,740	296,380
Third Transport Ring	262,989	139,991	227,237	226,340
TTR–MKAD	197,628	117,570	169,256	133,755
Out MKAD	193,230	96,805	-	94,535

* Excluding VAT (20%)

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, RUB/sq m/year*		Vacancy rate, %		Average rent, RUB/sq m/year*		Vacancy rate, %	
Boulevard Ring	Central business district	712	41,139		4.9		32,856		3.0	
Garden Ring	South	999	37,351	33,187	5.8	5.6	24,907	23,991	5.0	4.1
	West	546	30,000		0.2		27,003		5.6	
	North	667	36,447		3.4		21,005		4.0	
	East	407	25,315		14.8		20,282		2.4	
Third Transport Ring	South	1,280	-	36,352	-	5.4	12,910	18,024	6.2	5.5
	West	797	42,187		2.8		25,006		3.7	
	North	975	38,137		5.7		23,039		6.5	
	East	1,121	25,000		58.4		19,011		5.3	
	MIBC Moscow-City	1,173	35,069		8.4		35,342		14.2	
TTR-MKAD	North	1,014	29,167	23,212	15.3	11.5	16,202	13,816	1.6	6.3
	Northwest	801	31,948		4.5		14,757		6.8	
	South	1,997	24,209		6.0		13,898		7.1	
	West	1,421	-		-		15,109		3.9	
	Southwest	662	17,991		20.4		16,817		12.7	
	Preobrazhenskiy	993	20,450		43.1		11,915		6.5	
Out MKAD	Khimki	266	11,017	14,914	17.8	36.5	7,011	9,031	24.2	18.1
	West	435	22,000		90.8		10,227		20.4	
	New Moscow	345	13,934		41.5		6,500		2.2	
Total		**16,611**	**25,594**		**10.8**		**16,469**		**7.6**	

* Excluding OPEX and VAT (20%)

Source: Knight Frank Research, 2019

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