RESEARCH

Knight Frank

Q1 2017

OFFICE MARKET REPORT

Moscow

HIGHLIGHTS

- The delivery volume of office space hit new historical lows at 21 thousand sq m, absolutely non-relevant for the first quarter of the year.
- The Class A vacancy rate was quite steady at 20.2% since the end of 2016. Class B offices saw greater demand, and the vacancy rate sank by 1.5 p. p. to the level of 14%.
- Downtrend of Class B rental rates was identified. For the first time in a long time, the average rate showed plus adjustment of 0.4% and amounted to 13,430 rub./sq m/year. Class A rents resumed their downward slide by 4% by the quarter to 23,302 rub./sq m/year.

OFFICE MARKET REPORT MOSCOW

Konstantin Losiukov
Director, Office Department,
Knight Frank

"The results of Q1 2017 clearly demonstrate that we are now standing on the verge of fundamental changes. They were not witnessed by the market for more than two years – since December 2014. A slight increase in rental rates in the most in-demand Class B offices was encouraged by moderate but stable demand, shaped by the activity of state-owned Russian companies, the slowdown of new construction and, as a result, the reduction of new construction volumes to record levels. This is a sign that the market is finding a way out of the crisis. If the demand lasts, the interests of landlords will be strengthened and a certain increase in rates can become a trend that determines the relationship between tenants and landlords for the next 2–3 years".

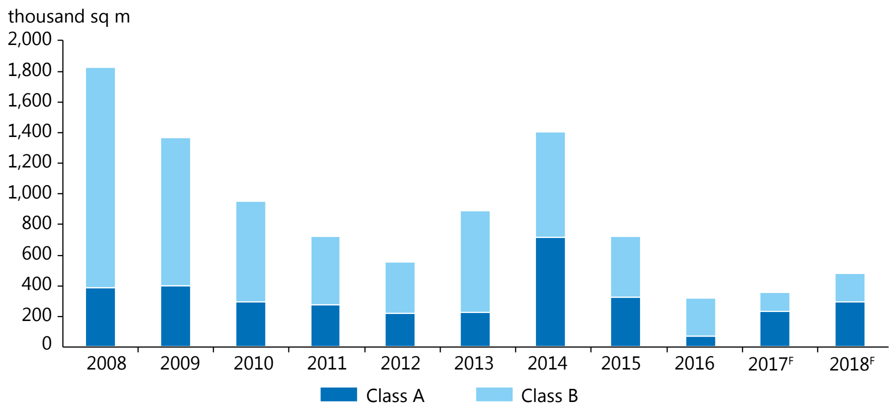
Key indicators. Dynamics*

	Class A	Class B
Total stock, thousand sq m	15,876	
including, thousand sq m	3,905	11,971
New delivery volume in Q1 2017, thousand sq m	21	
including, thousand sq m	14	7
Vacancy rate, %	20.2 (-0.5 p. p.)*	14 (-1.4 p. p.)*
Average weighed asking rental rate**, RUR/sq m/year	23,302 (-4.0%)*	13,430 (0.4%)*
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

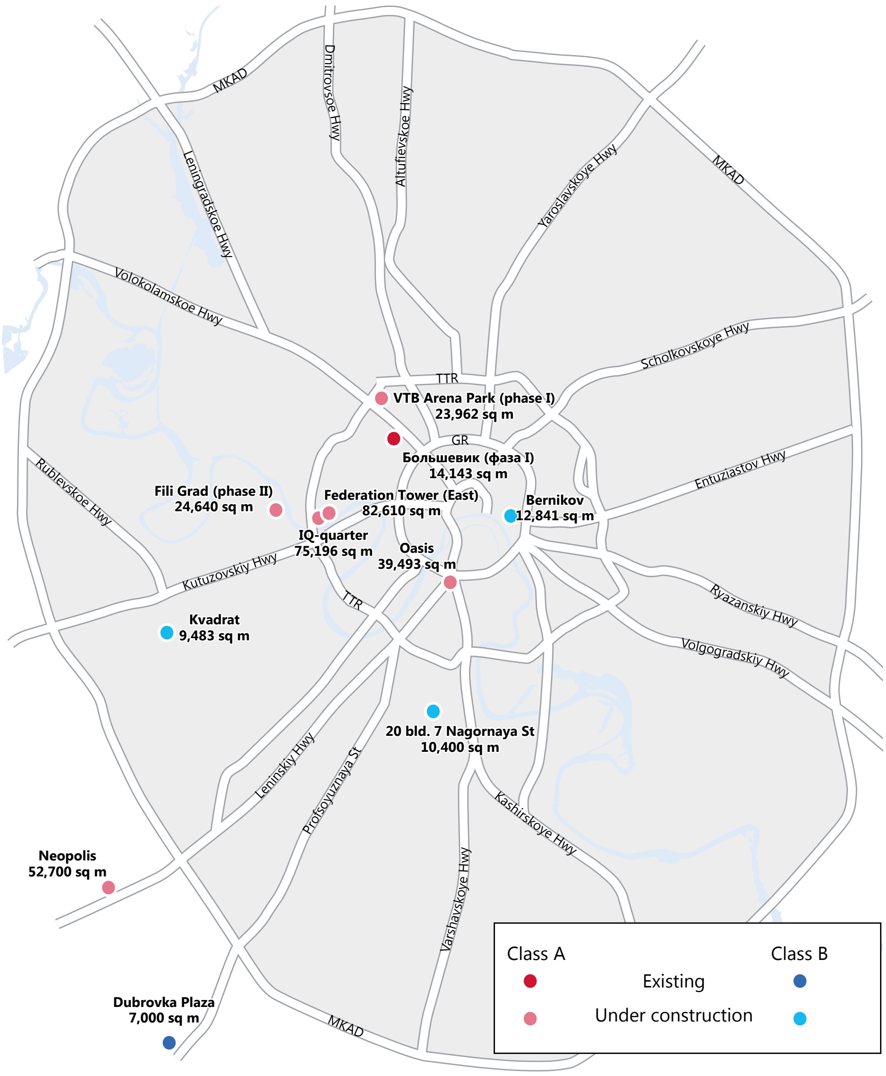
Source: Knight Frank Research, 2017

Class A and B new delivery volume dynamics



Source: Knight Frank Research, 2017

Map of projects scheduled for delivery in 2017



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

Source: Knight Frank Research, 2017

Supply

The overall supply of quality office space in Moscow totalled 15.9 million sq m in Q1 2017. 25% of them belonged to Class A offices and 75% to Class B.

New anti-record delivery was updated the last quarter: only 21,143 sq m were introduced for the first 3 months. Nevertheless, at around 350 thousand sq m have been declared for commissioning, which even exceeds altogether the delivery level of office centres in 2016.

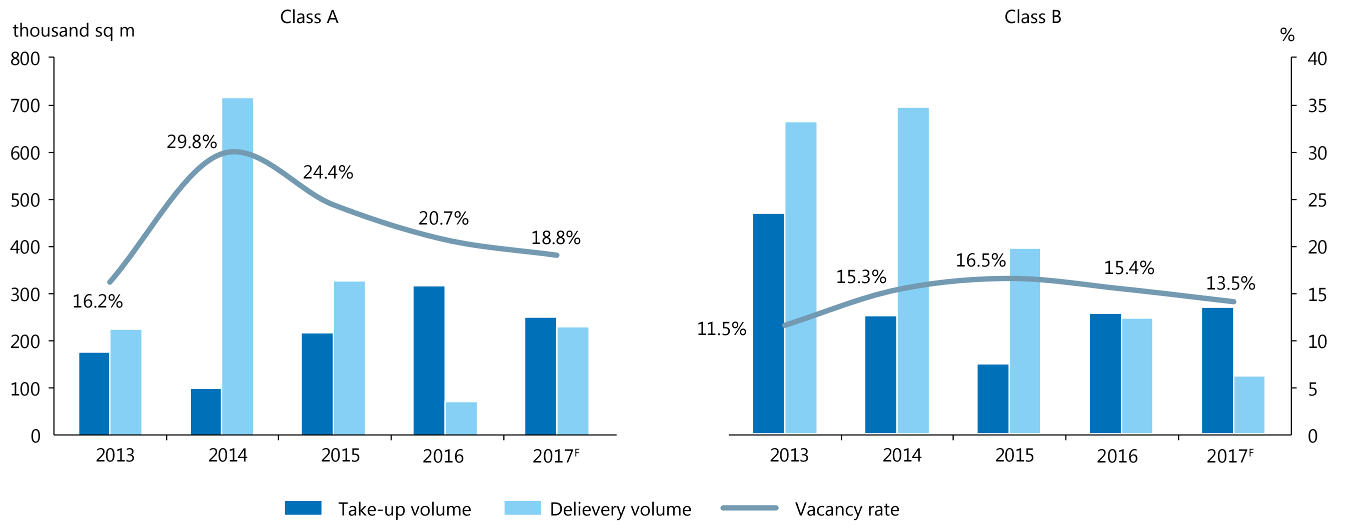
Two major Moscow developers – KR Properties and O1 Properties – simultaneously announced their plans to resume construction of their office projects and started an active stage of their implementation: the delivery of Bolshevik and Rassvet business centres is scheduled for 2018–2019.

The Class A vacancy rate went on declining originating from the mid-2015 and reaching 20.2% in the first quarter of 2017. This drop was caused by the decrease new construction volume and the presence of a small but stable demand for office space.

The Class B vacancy rate also remained in a last year's downtrend at 14% for Q1 2017.

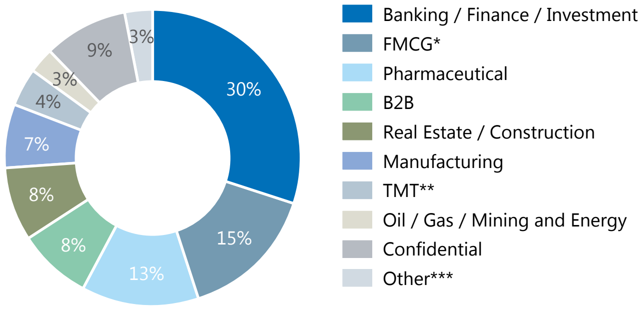
Further reduction of the vacancy rate both in Class A and B offices is projected in 2017.

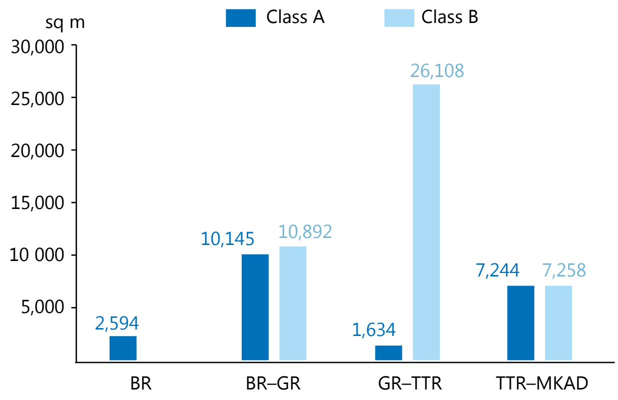
The net take-up and vacancy rate dynamics



Source: Knight Frank Research, 2017

Distribution of leased office space depending on the company profile and location of the office building

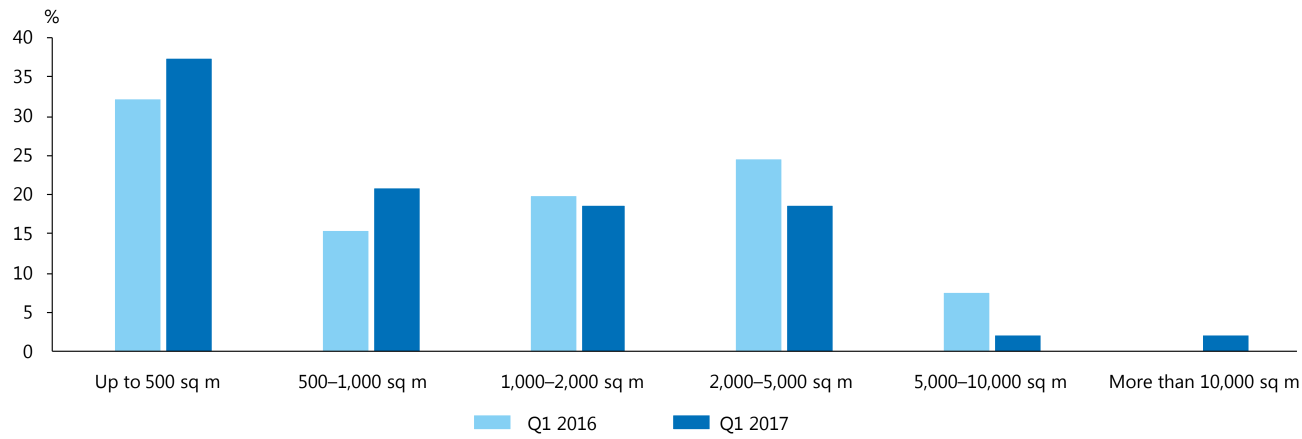




* Fast moving consumer goods
** Technology, media and telecommunications
*** Non-profit / Transport&Logistic

Source: Knight Frank Research, 2017

Distribution of leased office units by size



Source: Knight Frank Research, 2017

Demand

86.2 sq m were taken-up for the first quarter, half the volume of the same period last year (27.4 thousand sq m in Class A offices and 58.8 thousand sq m in Class B). Interestingly, the high take-up index of 2016 was primarily due to the closure of two major transactions, which accounted for almost 80% of the total volume. The demand for offices was more even in Q1 2017.

Q1 was marked by a significant demand for office space in business centers inside the Garden Ring. However, this cannot become the new trend. Tenants have to look for offices between the Garden Ring and the Moscow Ring Road (64% of the total transaction volume) due to the decreasing number of parking spaces, their increasing cost, rumors of entry fee to the city center.

Banks and financial institutions completed the major number of transactions (30%) both in Q1 2016 and Q1 2017. 28% of transactions were closed by FMCG, pharmaceutical and health companies.

The demand for office units of up to 1,000 sq m increased substantially from the same period last year. Thus, a year ago the transactions with such units reached 50%, now it has run up to 60%.

The demand for small office units was trending upward as the average size of the transaction totaled 1,180 sq m in Q1.

Renewal transactions of the current lease agreements are still dominant accounting for 60% of the total transaction amount. Notably, the ratio of new leases and renewals is 80/20. This means that major tenants prefer to negotiate renewals with the landlords, and the demand for new office space is shaped by companies requiring small office units.

Key lease and purchase transactions closed in Q1 2017

Company	Area, sq m	Office building	Class	Address	Transaction type
BBDO	11,030	Novospasskiy Dvor	B+	7, Derbenevskaya Emb	Lease
Russian Agricultural Bank	9,200	Incom City	B+	7, bld 1, 1st Krasnogvardeyskiy Passage	Sale
LOCKO-Bank	4,467	Skylight	A	39, Leningradskiy Ave	Sale
Samsung R&D Institute Rus	4,375	Dvintsev	A	12, bld 1, Dvintsev St	Lease
Panasonic*	**3,122**	**Shabolovka 31**	**B+**	**31, Shabolovka St**	**Lease**
Toyota Bank	3,030	Silver City	A	29, Serebryanicheskaya Emb	Lease
Regus	2,594	Vozdvizhenka Centre	A	10, Vozdvizhenka St	Lease
Ingrad Realty	2,523	Hermitage Plaza	A	2, bld 13/4, Krasnoproletarskaya St	Lease
X5 (Perekrestok)	2,400	RTS	B+	26/27, Sredniy Kalitnikovskaya Passage	Lease
Komatsu*	**2,125**	**Diapazon**	**B+**	**10, 1st Volokolamskiy Passage**	**Lease**
Herbalife	2,079	Citydel	A	9, Zemlyanoiy Val St	Lease

* Knight Frank acted as a consultant of the transaction
Source: Knight Frank Research, 2017

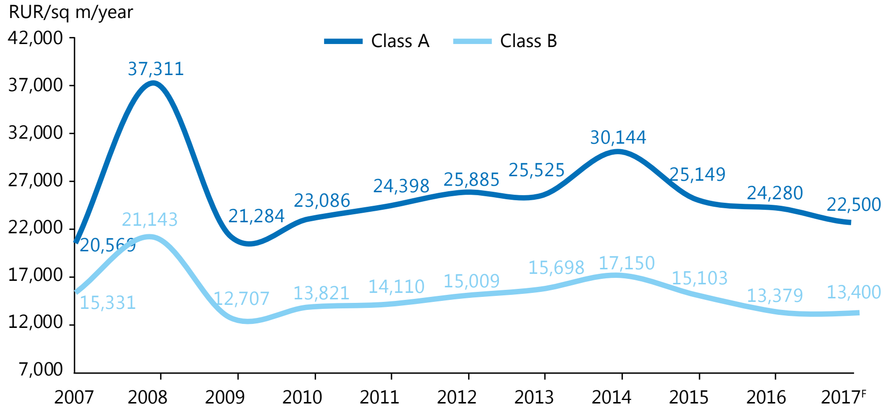
Commercial terms

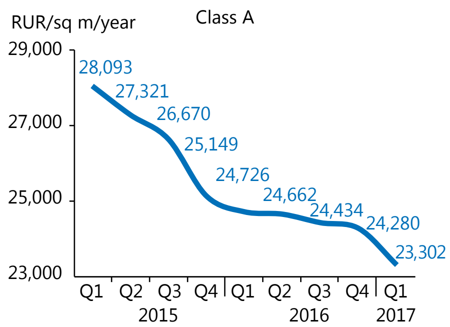
Landlords of Class B properties could celebrate the change of downward movement of rents for the first time in the last three years. The correction was positive by 0.4% – to the level of 13,430 RUR/sq m/year following the results of the first three months of the year.

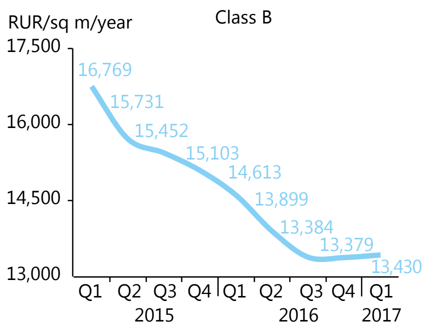
But, the decline of Class A rents is still in progress, falling by 4% against the end of 2016 to 23,302 RUR/sq m/year. This is largely due to too much supply in the territories of the Third Transport Ring-Moscow Ring Road (29.5% of the total supply volume) and outside the Moscow Ring Road (21.4%), as well as the bulk of vacant space in office centres in the territories of the Third Transport Ring-Moscow Ring Road (965 thousand sq m) and outside the Moscow Ring Road (984 thousand sq m).

Landlords have started to experience cautious optimism thanks to the stabilization of rental rates. Some of them became less flexible in negotiations regarding rental rates discussion at the beginning of 2017. The discount from the asking rental rate could reach 20–30% in the midst of 2015 crisis – early 2016, but now the discount

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







Source: Knight Frank Research, 2017

rate has fallen to 7–10%. However, it is too early to speak of the general market trend.

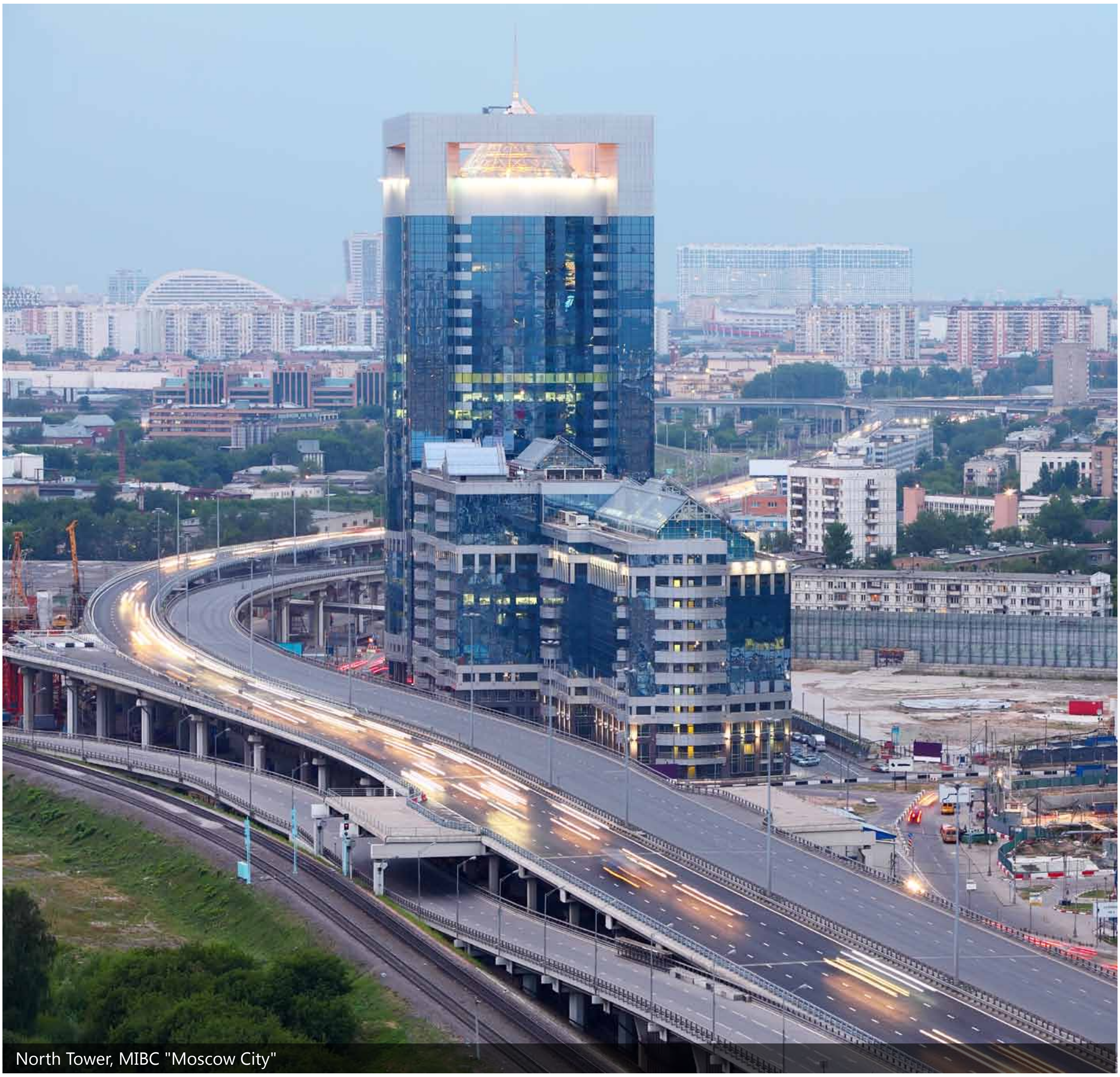
No changes occurred regarding the terms of lease agreements earlier this year: they are mostly 3–5 years with the right of early termination upon the expiry of the third year. The ruble has become the dominant currency on lease agreements.

Forecast

Despite the low Q1 delivery, this year shall add about 350 thousand sq m to the market, which in general exceeds the figure of 2016. However, there is still a high probability that the delivery dates of new business centres announced for this year will be postponed. Nevertheless, some developers owning the projects in readily marketable locations, have declared the construction renewals of projects frozen earlier. Though, it is too early to call it a new trend of 2017, since the vacancy rate is still too high: 788 thousand sq m in Class A offices and 1,676 thousand sq m in Class B.

We expect the stabilization of Class A rates in 2017. Despite the positive correction of Class B rents in Q1 2017, we do not assume their significant growth in 2017 for all of the market. Rental rates may even increase in some business districts most in demand, and landlords of less demanded business centres will be forced to further reduce rates and be more flexible in negotiations with potential tenants.

In general, provided that external economic and political stability is maintained, we do not expect any significant changes in the office market in 2017. Its participants go on taking wait-and-see attitude and will carefully catch the signals sent to them by the market. Any changes in the market can be identified either at the end of the year, an in 2018, which, among other things, may be due to the next elective cycle of the country approaching in 2018.



North Tower, MIBC "Moscow City"

Moscow submarket data. Key indicators

Submarket		Lease Area, thousand sq m	Class A: Average rental rates* USD/sq m/year		Class A: Average rental rates* RUR/sq m/year		Class A: Vacancy rate, %		Class B: Average rental rates* USD/sq m/year		Class B: Average rental rates* RUR/sq m/year		Class B: Vacancy rate, %	
Boulevard Ring	Central business district	712	712		39,186		21.3		459		24,309		9.3	
Garden Ring	South	950	431		23,715		16.4		525		27,814		10.4	
	West	286	–		34,125		16.5		–		24,322		14.7	
	North	660	–	464	24,042	25,546	17.3	15.9	394	403	20,877	21,379	6.3	12.5
	East	401	–		23,246		11.1		293		15,546		15.7	
	Khamovniki	260	690		37,969		13.7		–		24,385		15.7	
Third Transport Ring	Leninskiy	278	–		–		–		–		15,637		15.5	
	Tulskiy	985	–		–		–		–		13,468		9.7	
	Kievskiy	424	–		23,451		15.4		–		13,620		27.8	
	Presnenskiy	357	–		24,661		5.7		–		15,494		10.2	
	Prospekt Mira	162	-		–		–		–		19,038		54.4	
	Tverskoy-Novoslobodskiy	752	578	535	31,765	29,410	19.5	18.8	387	280	20,493	14,846	10.1	11.3
	Basmanniy	326	–		–		–		–		14,179		5.6	
	Taganskiy	175	–		–		–		362		19,185		10.2	
	Volgogradskiy	418	–		–		–		–		14,184		19.1	
	Lefortovo	195	–		–		–		–		12,927		9.6	
	MIBC Moscow-City	913	524		28,794		20.3		–		–		–	
TTR-MKAD	North	627	–		25,000		16.3		–		12,035		15.4	
	Northwest	692	460		25,290		11.3		–		15,047		20.9	
	South	1,152	–		–		–		–		10,465		13.6	
	West	565	–	355	–	19,508	–	21.9	296	242	15,664	12,823	13.4	14.7
	Southwest	626	–		11,643		32.8		–		14,016		16.1	
	East	453	–		–		–		–		9,000		7.6	
	Preobrazhenskiy	291	–		13,286		60.8		–		14,831		22.2	
MKAD	North	376	–		–		–		–		6,990		17.3	
	Northwest	308	–		10,808		44.6		–		6,724		26.1	
	South	260	–		–		–		–		9,789		37.9	
	West	1,789	307	231	16,871	12,711	16.5	30.8	–	–	10,402	8,990	18.0	18.4
	Southwest	215	–		11,643		37.9		–		8,003		12.6	
	East	248	–		–		–		–		3,237		0.8	
Total		**15,856**	**424**		**23,302**		**20.1**		**253**		**13,430**		**14.0**	

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

Source: Knight Frank Research, 2017

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