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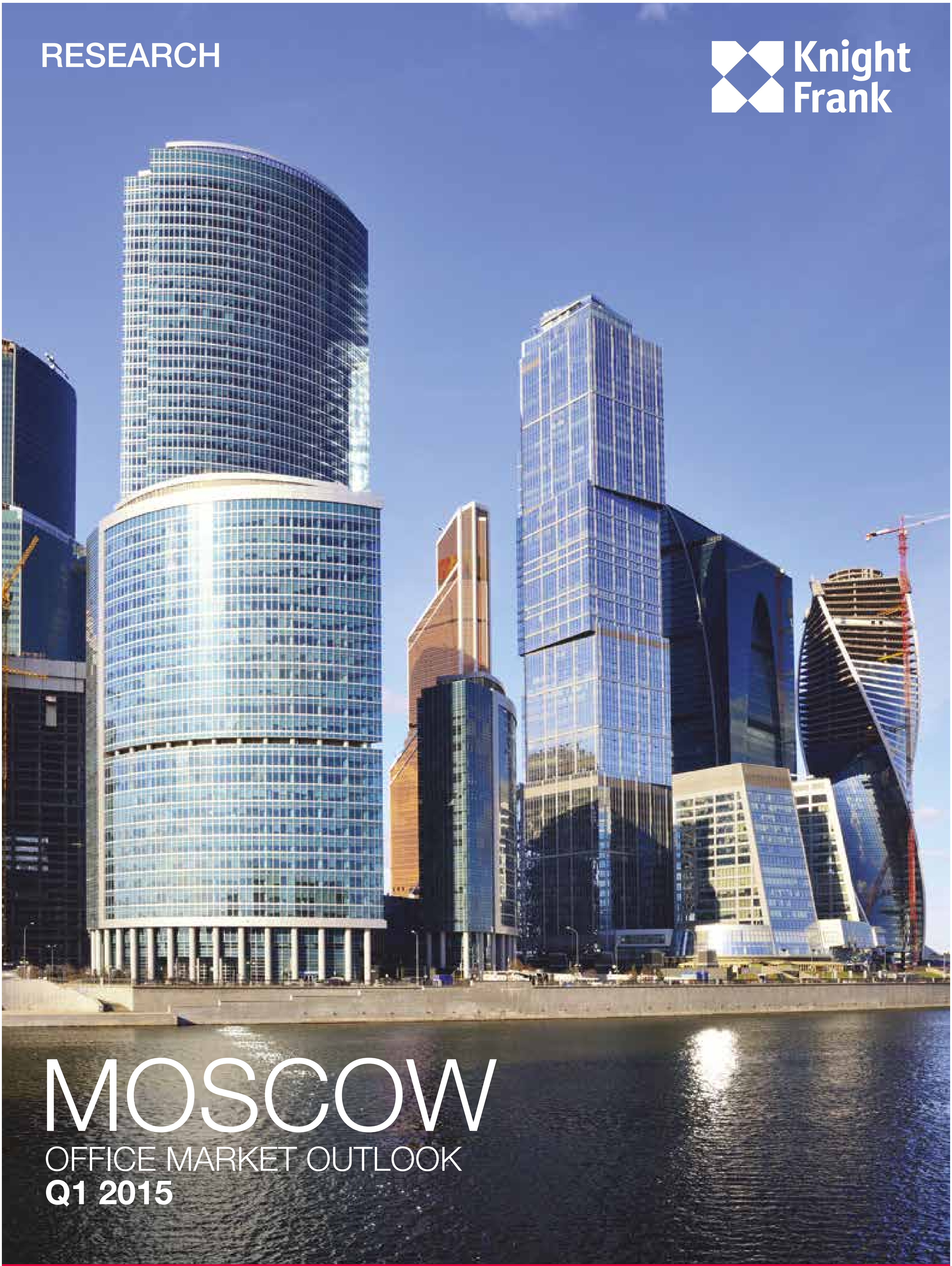


MOSCOW
OFFICE MARKET OUTLOOK
Q1 2015

OCCUPIER TRENDS | INVESTMENT TRENDS | MARKET OUTLOOK

KEY FINDINGS

GDP in Russia is expected to fall by at least 3% in 2015, as a recession looks set to hit the country

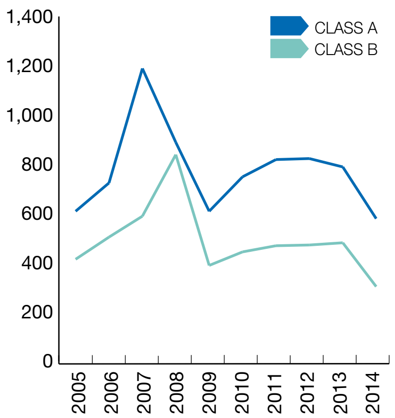
The depreciation of the Russian ruble in 2014 caused average Class A and B rents to fall to US$590 and US$314 per sq m per annum respectively – the lowest levels in the last ten years

In 2014, new supply reached its highest level since 2008 at 1.4 million sq m

Macroeconomic difficulties and geopolitical conflicts in Russia caused office investment volumes to decline to US$2.2 billion

Office yields will continue to be subject to upward pressure in 2015, potentially exceeding the peak of 12% reached during the global financial crisis

FIGURE 1
Average asking office rents
US$ per sq m per annum



Source: Knight Frank Research

OCCUPIER MARKET

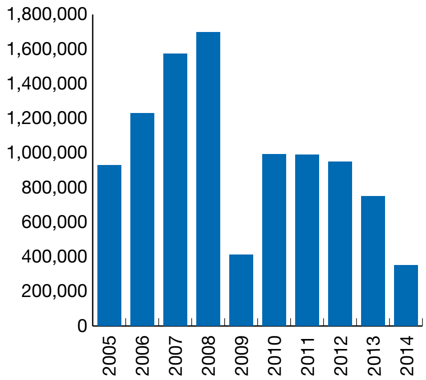
Ongoing economic difficulties in Russia, combined with a weakening ruble, diminished occupier demand in Moscow in 2014 and put office rents under downward pressure.

The reluctance of occupiers to lease office space in Russia is evident, with 2014 net take-up for Moscow halving to 350,000 sq m in twelve months, below levels achieved during the 2009 recession. As demand concentrated on smaller units, landlords responded by splitting up large areas of vacant space into smaller areas to let, resulting in the average deal size declining by 14% on 2013 to 1,211 sq m. Few large deals over 10,000 sq m took place in 2014, the largest being Systematika's leasing of 17,370 sq m in the new build Comcity building in Q1.

Average asking rents in Moscow suffered significantly in 2014, with Class A rents falling to US$590 per sq m per annum, 26% down on 2013, and Class B rents falling 36% to US$314 per sq m per annum. Q4 saw the steepest fall owing to a volatile Russian ruble, which went to an all-time low against the dollar of US$68 in December 2014, before re-gaining some strength in January 2015 and again falling in early February. Until the currency finds some form of stability, landlords are offering short-term ruble only tenancy agreements, or adopting fixed exchange rates to prevent loss by converting to US dollar (or euro).

Regardless of falling rents and leasing activity, construction completions increased in 2014 reaching 1.4 million sq m, the highest figure since 2008. The Class A and B stock in Moscow now exceeds 14.8 million sq m. High supply and falling occupier demand caused 2014 vacancy rates to increase greatly by 670 basis points in twelve months to 19.5%, repeating the sharp increase in vacancy rates seen in 2009. Although similar volumes of Class A and B stock were delivered in 2014, the latter appeared easier to lease with higher take-up figures and a lower vacancy rate of 15.3%, compared to 29.8% for Class A. Falling rents and surplus stock has put occupiers in a stronger position going into 2015. They have a choice of new stock to lease in buildings such as the 115,000 sq m President Plaza building and 108,000 sq m Comcity building, completed in Q2 and Q3 respectively, both of which are partially vacant.

FIGURE 2
Net office take-up
sq m



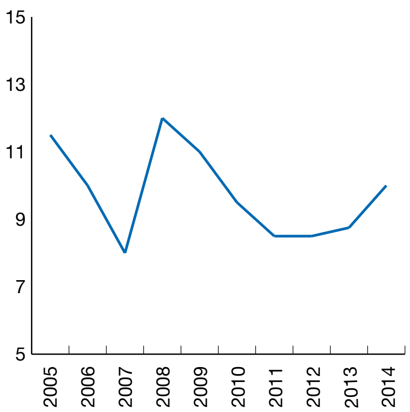
Source: Knight Frank Research

Key office leasing transactions in 2014

Quarter	Building	Occupier	Building Class	Size (sq m)
Q1	Comcity - Phase Alfa	Systematika	A	17,370
Q1	ALCON Business Complex	PepsiCo	A	13,009
Q3	ZVI	Ren TV	B+	10,375
Q4	Diamond Hall	TNT-Teleset	A	7,117
Q3	South Port	Soglasie	B+	7,033
Q4	Yakovoapostolskiy	Locomotive Technologies	B+	6,646

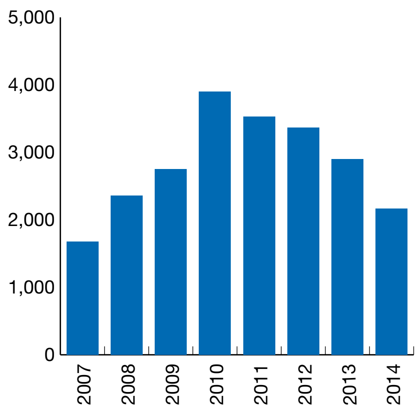
Source: Knight Frank Research

FIGURE 3
Prime office yields
%



Source: Knight Frank Research

FIGURE 4
Moscow office investment volumes
US$ million



Source: Knight Frank Research


The Imperia Tower building purchased by Solvers Group for US$360m in Q2 2014

INVESTMENT MARKET

Ongoing geopolitical conflicts, such as the Russia-Ukraine crisis, caused investment sentiment in Moscow to decline throughout 2014, as many investors cancelled, delayed or put investment plans on hold. Office investment suffered as a result, falling 25% on 2013 to reach US$2.2 billion. However, although volumes fell, offices performed better than other commercial sectors, some of which declined by as much as 90% in the same period.

Russia's key interest rate, which increased by 650 basis points in December 2014 to reach an all-time high of 17%, also contributed to this fall and left many purchasers unable to complete their transactions. If completed as originally scheduled, 2014 office volumes could have been closer to US$3.5 billion – an increase on 2013. The key interest rate has since been cut to 15% in January 2015 and then 14% in mid-March, but still remains at a historically high level. With a high degree of uncertainty surrounding Russia's monetary policy, some pending investment deals are expected to close within the first half of 2015.

For the first time since 2009, prime office yields reached double-digits and stood at 10% at the end of 2014, after rising 125 basis points in twelve months. Although yields look attractive, investment opportunities in Moscow's current economic climate are deemed too risky for many buyers. During the first half of 2014, Russian investors remained dominant, taking a 78% share of office investment volumes; however, the second half of the year, unsurprisingly, saw domestic interest reduce as investors began facing funding issues. Debt financing options were severely reduced in this period and what was available was too costly – problems which have continued into 2015.

Key office investment transactions in 2014

Quarter	Building	Vendor	Purchaser	Price (US$)
Q2	Imperia Tower	MCG	Solvers Group	360,000,000
Q4	Hermitage Plaza	Forum Properties	Eastern Property Holdings	195,000,000
Q3	Severnoe Siyanie	Bolshoy Gorod	Eastern Property Holdings	152,800,000
Q3	Berlin and Geneva House	Private Investment Group	Eastern Property Holdings	148,500,000
Q1	Nevis	O1 Properties	Capital Group	60,000,000

Source: Knight Frank Research

KNIGHT FRANK VIEW

A range of economic and political uncertainties will continue to cause strains in Moscow. With GDP for 2015 forecast to fall by at least 3% in Russia, a recession seems inevitable.

Office rents are expected to fall further throughout 2015, as occupier demand is set to remain restricted, but effects could be partly counteracted if the ruble begins to strengthen. New supply will also decrease, with 1 million sq m of construction projects due to complete in 2015. However, in practice, completions are expected to be much lower, because a large number of developers are purposely delaying construction progress since leasing space has become increasingly difficult.

Moscow's investment market is unlikely to recover in 2015. Limited funding options for Russian investors are likely to make many deals unworkable, thus reducing domestic market share. Office volumes will suffer and are projected to halve to circa US$1.2 billion; however, further reduction of Russia's key interest rate may improve domestic sentiment. Foreign investors with a high-risk appetite are expected to account for the bulk of office volumes this year, as they seek to achieve double-digit yields. Prime office yields are likely to face further upward pressure, potentially exceeding the peak of 12% reached during the global financial crisis.

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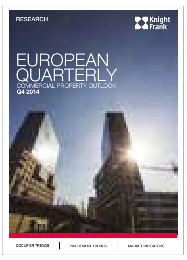

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