RESEARCH

# 2012 OFFICE MARKET REPORT

Moscow

Knight Frank

## HIGHLIGHTS

- The volume of new high-quality office buildings construction for the year has dropped to the lowest figure of the last nine years. The growth of new stock amounted to just over 550 thousand sq m, which is about 21% lower than in 2011. In 2013, we expect a change in the downward trend and almost a double growth in the volume of new construction.
- Decentralization of business life in Moscow continues: 80% of new delivery is located outside the Garden Ring. On the other hand, the demand for high-quality offices in the city centre is still high.
- Demand for Class A and B office space remains at the level of 2011. At the end of 2012, the take-up volume exceeded 900 thousand sq m, with a fifth part of this volume being office space purchased by end users.
- Since the beginning of the year, the vacancy rate has not changed for Class A–12.6%, and dropped from 17.2% to 14.5% for Class B properties.
- The lease rates remain stable for already a year in the range of 700–1,200 $/sq m/year for Class A and 350–650 $/sq m/year for Class B office centres.

# OFFICE MARKET REPORT

**Nikola Obajdin,**
Director,
Office Department

*«The stability of key indicators was the main trend of the office real estate market of Moscow in 2012. For instance, average lease rates, while generally remaining at the level of mid-2011, have demonstrated a slight growth only in the segment of premium office properties. The rate of new space delivery on the office real estate market remained low, as the demand remained stable. However, due to a large share of high-quality office tenants, wishing to move to newer objects, and due to a limited introduction of Class A properties, the vacancy rate has not changed.*

*Implementation of a number of urban initiatives of Moscow authorities continued in 2012. The city development is becoming more balanced: new construction in the historic centre is being limited, the investment contracts are being revised, and the projects concerning reorganization of industrial zones are being developed.*

*Despite the fact that some uncertainty is still present on the market, the construction activity is at a high level, and we expect an increase in the delivery of new office space in 2013».*

**Key indicators. Dynamics***

| Indicators | Class A | Class B+ | Class B- |
|---|---|---|---|
| Total stock, thousand sq m | 12,468 | | |
| including, sq m | 2,558<br>(+8.6%) | 6,739<br>(+4.9%) | 3,171<br>(+0.9%) |
| Delivered in 2012, thousand sq m | 556 | | |
| including, thousand sq m | 218.5 | 323 | 14.5 |
| Vacancy rate, % | 12.6<br>(+0.1 p.p.*) = | 14.5<br>(-2.7 p.p.*) ▼ | |
| Average weighted rental rate*, $/sq m/year | 834<br>(+0.5%) ▲ | 483<br>(+0.6%) ▲ | |
| Rental rates range**, $/sq m/year | 650–1,200<br>(1,000–1,300***) | 350–650 | 260–400 |
| Operational expenses, $/sq m/year | 110–210 | 80–120 | 50–95 |

* comparing to the end of 2012
** excluding Operational Expenses and VAT (18%)
*** range of asking rents for premium space
Source: Knight Frank Research, 2013

## Supply

The total stock of high quality office space in Moscow at the end of 2012 exceeded 12.5 million sq m with 2.6 million sq m in Class A and 9.9 million sq m in Class B. The same year 218.5 thousand sq m of Class A and 337 thousand sq m of Class B office space was introduced, that is lower than in 2011 by 21% (566 thousand sq m against 720 thousand sq m).

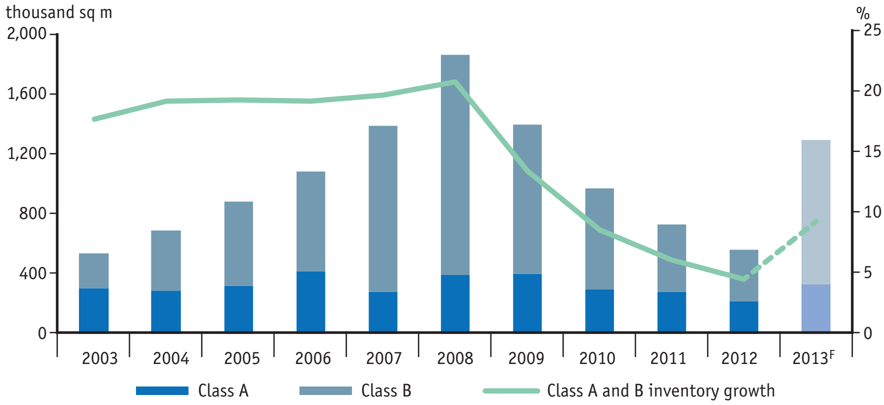
The new high quality office space construction volume in Moscow has been gradually declining over the past four years and in 2012 reached a record low since 2004. However, according to our estimates, in 2013, the situation will change with the volume of new supply growing to almost a double of 2012 figure.

It should be noted, that the provision of office space per capita is still low when compared to the relatively developed markets of the world capitals. However, despite the record low volume of new construction in 2012, Moscow office real estate market continues to develop much more rapidly than the markets of most European cities.

In 2012, decentralization of business life in Moscow has increased: more than 80% of new delivery was built outside the Garden Ring. Although some infill development is taking place in the city centre, the number of such projects is low, and we estimate further reduction in the amount of new construction within the Garden Ring down to 10% of the annual construction volume.

Establishment of decentralized business districts continues on the office market

**The volume of high quality office space delivery in 2012 dropped to its minimal value since 2004**




Source: Knight Frank Research, 2013

Evolution Tower
MIBC Moscow City

of Moscow, where construction of a number of landmark projects has been announced. The Leningrad direction area is becoming one of such districts, where in 2012 Class A office complexes (Alcon with office area of 66.7 thousand sq m and Skylight with office area of 61.2 thousand sq m) were built and four projects are in various stages of construction.

Several business parks will also be introduced in the coming few years. Office properties of this type imply location outside of the city, and are being developed near Moscow Ring Road in the Northwestern and Southwestern directions. Among the biggest and most anticipated properties worth mentioning are the K2, Dudkino, Telecom City and Orbita (phase II).

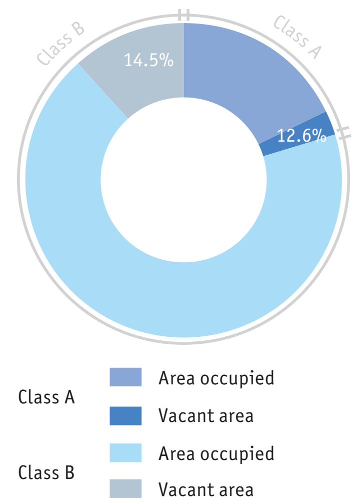
MIBC "Moscow-City" is also being actively developed; here, over 300 thousand sq m of office space will be delivered in 2–3 years time.

## Demand

The demand for high quality office space in Moscow remains almost unchanged since 2011. A relatively high take-up in Q1 dropped in Q3 due to some slowdown over the summer months, though then habitually recovering in Q4 to the point of almost doubly exceeding Q3 values.

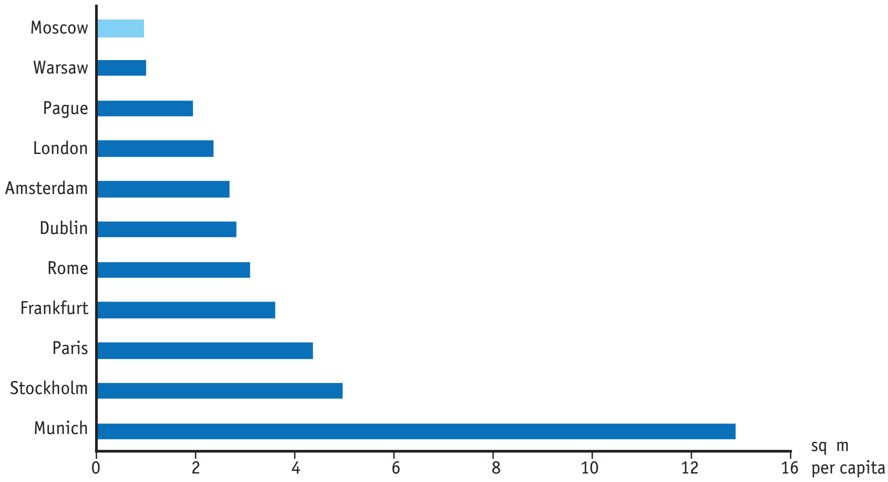
At the end of 2012, the office space take-up volume in Classes A and B amounted to roughly

**Distribution of total supply of high quality office space in Moscow**



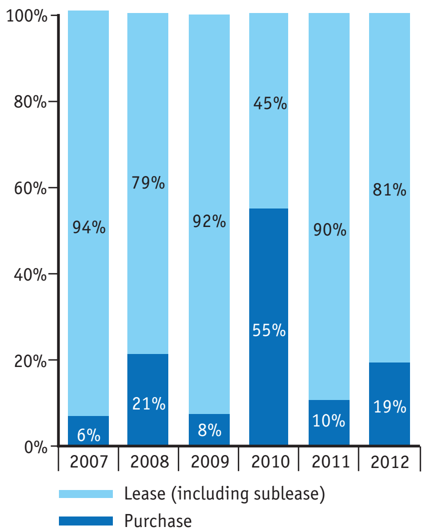

Source: Knight Frank Research, 2013

**High quality office space provision in Moscow remains low when compared with the markets of European cities**




Source: Knight Frank Research, 2013

**In 2012, the percentage of space purchased by the end-users, has increased by almost three times within the total take-up volume**



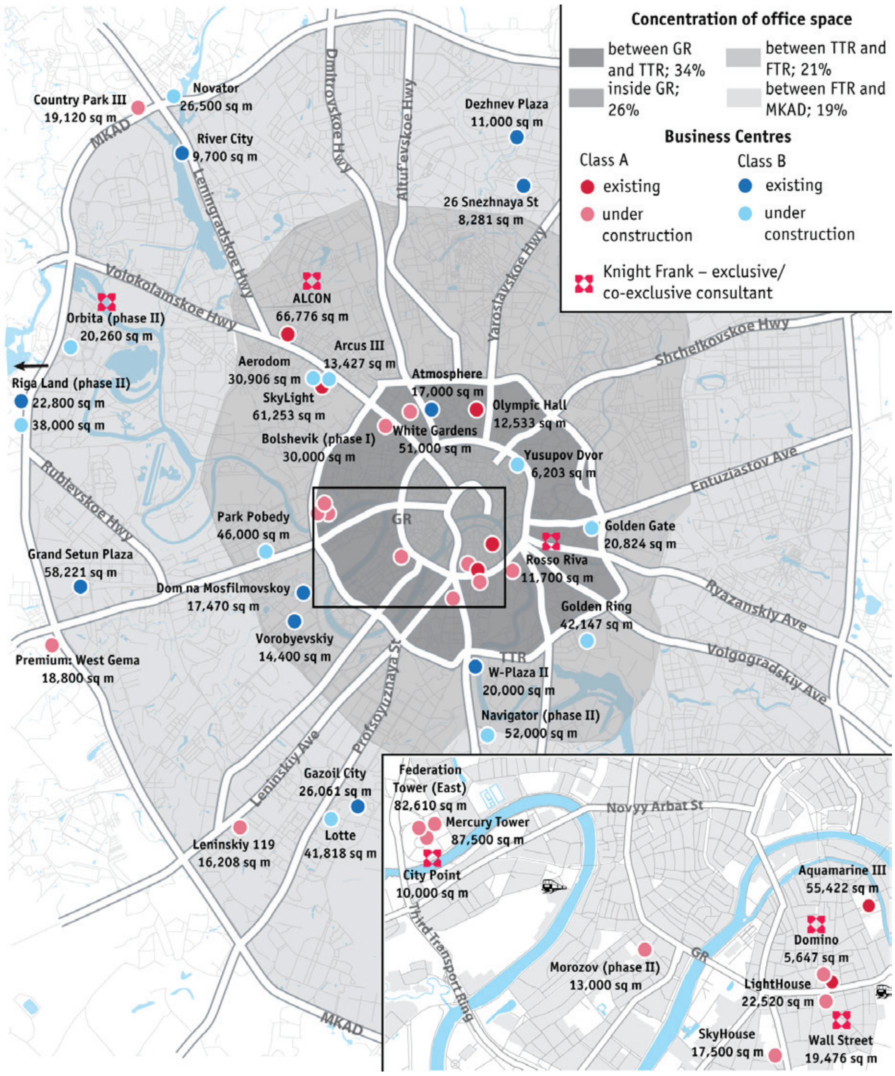

Source: Knight Frank Research, 2013

950 thousand sq m, which is comparable to 2011 figures, reflecting the general trend of stability characteristic of today's market.

In 2012, the largest share, amounting to almost a quarter of total office space demand within the take-up structure, belonged to financial sector companies. Financial organizations traditionally consume a large share of high quality office space – since 2007, it had not dropped below 15%. It is worth noting that in 2012, the banking sector companies also conducted several major acquisitions of office space. Industrial companies in 2012 increased their share by almost three times – up to 19%, whereas oil and gas production companies' share dropped by almost a third. Traditionally, with the exception of 2010, there is a strong demand from the IT and telecom industry, whose share in 2012 amounted to 20% of the take-up volume.

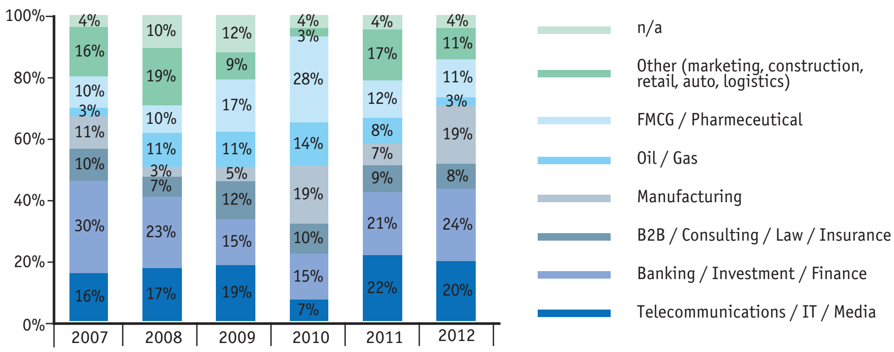
Throughout the year, a downward trend of the vacancy rate has been observed, caused by a strong demand and extremely low volume of delivery. However, the vacancy rate in Class A category remained almost unchanged at 12.6%, primarily due to the migration of tenants between Class A properties. Class B share fell to 14.5%, almost reaching the level of 2008. It is important to note that in 2013, the market is expected to increase delivery volume, and, bearing in mind current level of demand, it is hard to expect further decline in vacancy rates.

**Office properties delivered in 2012 and due to be completed in 2013**



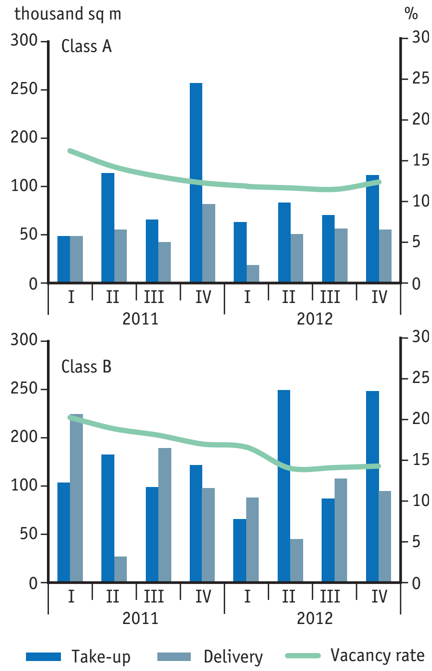

* Office projects that passed the State Commission in 2012. Office building classes according to Moscow Research Forum.
Source: Knight Frank Research, 2013

**The share of IT, telecommunication and media companies as well as B2B sector, accounts for nearly a half of total take-up based on the results of 2011-2012**




Source: Knight Frank Research, 2013

**During 2012, the amount of office space take-up exceeded that of its delivery, as a result, vacancy rates slightly decreased**




Source: Knight Frank Research, 2013

## Commercial terms

The weighted average rental rates for high quality office space amounted to 834 $/sq m/year for Class A and 483 $/sq m/year for Class B properties.

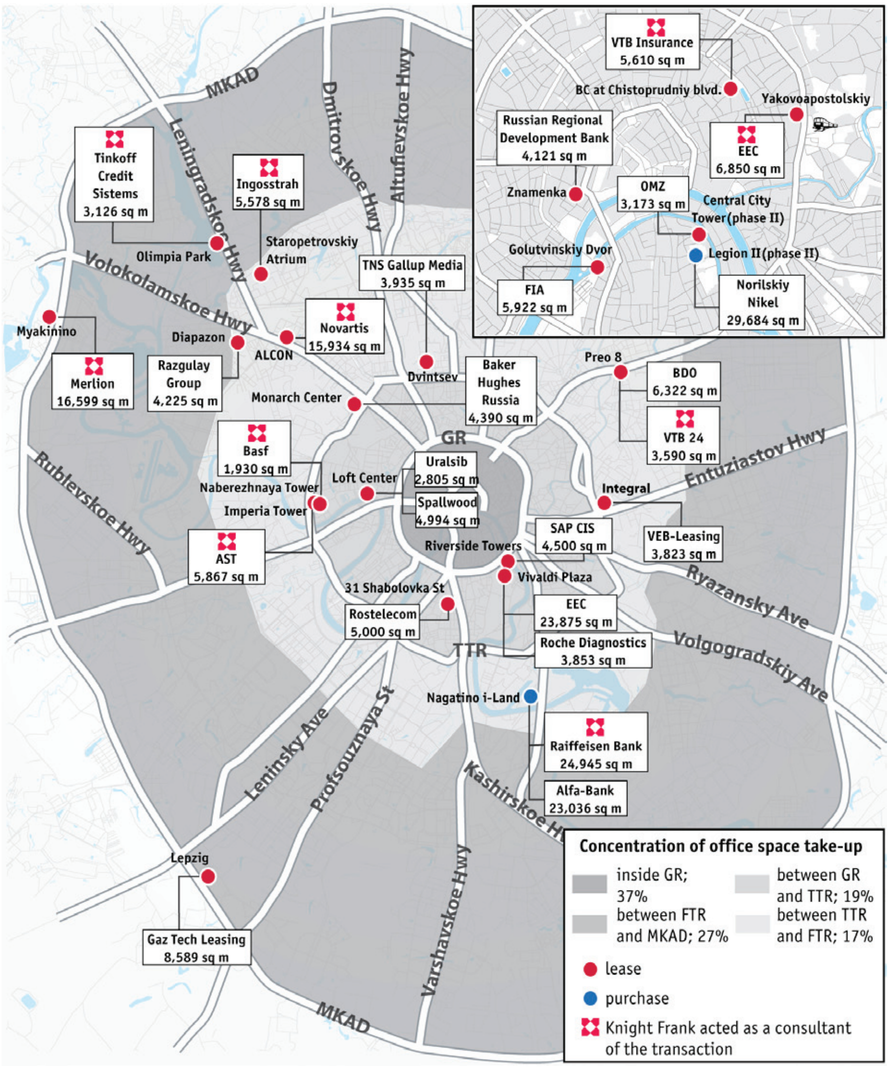
Having been stable since the middle of 2011, the lease rates showed a minor correction to increase only by the end of 2012.

We still observe a strong differentiation of rental rates, depending on location, quality of the property and its level of occupancy, common for the office real estate market of Moscow. Initiative of the city authorities to limit construction within the Third Transportation Ring, and the resulting shortage of quality office space in the city centre, suggest that the lease rates for objects with a premium location may slightly increase.

At the end of 2012, the average indicated lease rate for Class A business centres in the Boulevard Ring area was 1260 $/sq m/year, which is higher than comparable rates on the markets of such cities as Paris (1091 $/sq m/year) and Geneva (1091 $/sq m/year). The average lease rate for Class A properties in the Garden Ring area is 842 $/sq m/year, while outside the Third Ring the rates do not exceed 700 $/sq m/year.

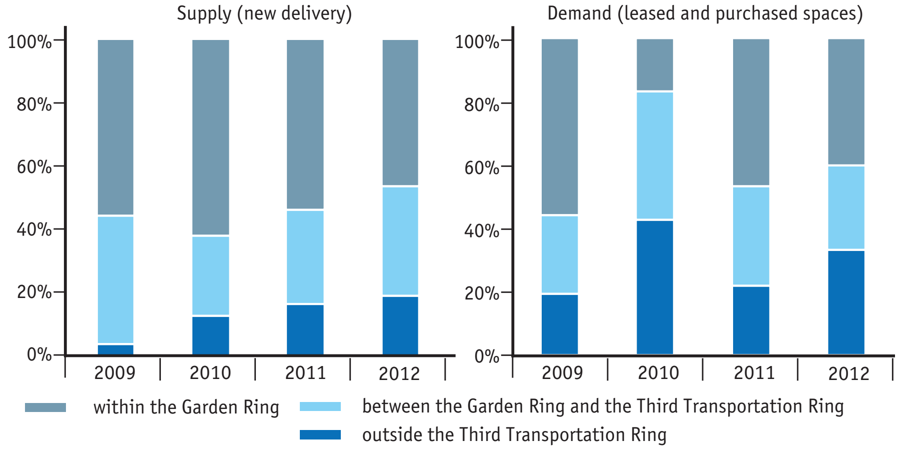
We should also mention the MIBC market "Moscow-City", where the average indicated lease rate is 915 $/sq m/year.

**Key deals in 2012**




Source: Knight Frank Research, 2013

**Office space in the city center is traditionally in high demand, while new construction is now only possible outside the Third Transportation Ring**




Source: Knight Frank Research, 2013

## Forecast

In coming years, we expect growth of construction activity on the office space market in Moscow. A significant amount of A and B+ Class office space with a total area of more than 1.2 million sq m is planned for delivery in 2013. Even considering the possibility of postponement of the delivery date, we expect the figure to exceed that of 2011 by at least 40%.

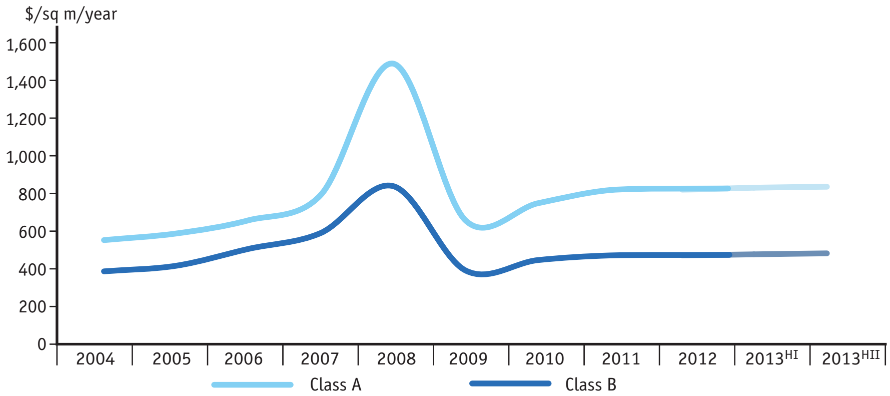
As part of the MIBC project "Moscow-City", a completion of three facilities: Mercury Tower, tower East (Federation complex) and a business centre City Point, is planned for 2013. Thus, the area of constructed office buildings will amount to almost 700 thousand sq m, which represents about 5.5% of the total supply on the office space market of Moscow.

The office space demand is determined by the state of the economy in general and largely depends on such factors as the expansion of personnel of Russian companies, as well as market entrance and business development of the Western companies.

At present, the market is characterized by some degree of uncertainty, partly due to the Eurozone recession, which in case of a negative scenario development, will affect economies of many countries. However, in case of a moderate scenario, should the impact of the recession on the Russian economy in 2013 be minimal, we expect take-up volume to remain at the level of 2011–2012, at about 1 million sq m.

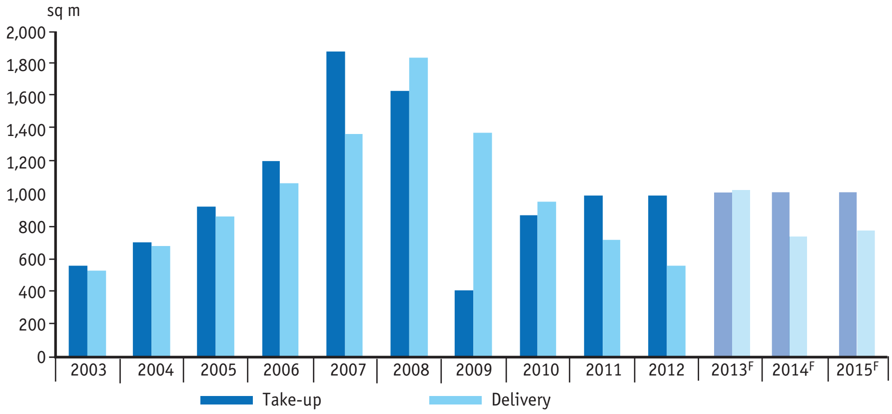
Thus, we expect the balance between supply and demand on the office market of Moscow to persist, with a possible increase in lease rates in the range of 2–3%.

**Increase in rental rates for office space has averaged to no more than 1% compared to 2011 figure**




Source: Knight Frank Research, 2013

**Developers plan to put into operation about 2.5 million sq m of Class A and B office space in the coming 3 years while demand is likely to remain at current level**




Source: Knight Frank Research, 2013

MEBE One Khimki Plaza

# GLOSSARY (THE KEY DEFINITIONS)

| Term | Definition |
|---|---|
| **Base Rental Rate** | The rental rate amount excluding operational expenses and VAT. |
| **Commissioning** | The object is commissioned after the state commission and the receipt of Operation Permit. |
| **Developer** | A company that conducts the construction of a real estate project, provides financing or attracts financial resources. Also the company provides further implementation of space developed (sale, lease). |
| **Free-rent period** | A time period that is free of rental payments. |
| **Lease Agreement** | An agreement, which is concluded between a tenant and a landlord and gives a right to the tenant to temporarily possess or use the property for the certain charge called a rental fee. |
| **Loss factor** | $(1 - \frac{useable \quad area}{rentable \quad area}) \times 100\%$ |
| **Multifunctional complex** | A property with three or more real estate components of different functions. |
| **OPEX (Operational Expenses)** | Money expenditures allocated for the operation and maintenance of the property. They usually include property taxes, insurance payments, management and maintenance costs of property, utilities. |
| **Pre-lease agreement** | A lease agreement that is concluded during the construction phase of the building. |
| **Rentable Area** | Area available for the exclusive use of the tenant, for which the tenant will pay rent. Includes common areas such as lobbies, restrooms and hallways. |
| **Rental Rate** | The amount of money paid by the tenant for leased office space. |
| **Sublease** | A lease in which the original tenant (lessee) sublets all or part of its premises to another tenant (subtenant) while still retaining a leasehold interest in the property. |
| **Take-up** | The amount of units occupied during a particular time period in a given market. |
| **Total Stock** | All occupied and vacant Class A, B+ and B- office space for a specific time period. |
| **Vacancy rate** | The percentage of total office stock that is vacant and available for occupancy at a particular time period within a given market. It is calculated by dividing vacant space by total stock. |

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