RESEARCH

Knight Frank

H1 2013 OFFICE MARKET REPORT

Moscow

HIGHLIGHTS

- The new construction volume of high-quality office space is on the rise: 96.3 thousand sq m of Class A office space and 244.7 thousand sq m of Class B were delivered in the first half of 2013.
- One-fifth of A and B Class office space, delivered in the first half of 2013, is located within the Garden Ring.
- About 300 thousand sq m of Class A and B office space was leased and purchased during the first 6 months of 2013.
- A decline in average size of transaction has been noted on the office real estate market of Moscow.
- Asking lease rates for office space remain at a stable level in the range of 650 - 1200 $/sq m/year (triple net) for Class A and 350 - 650 $/sq m/year (triple net) for Class B.

OFFICE MARKET REPORT

Konstantin Losiukov,
Head of Corporate Client Group, Office Department
Knight Frank

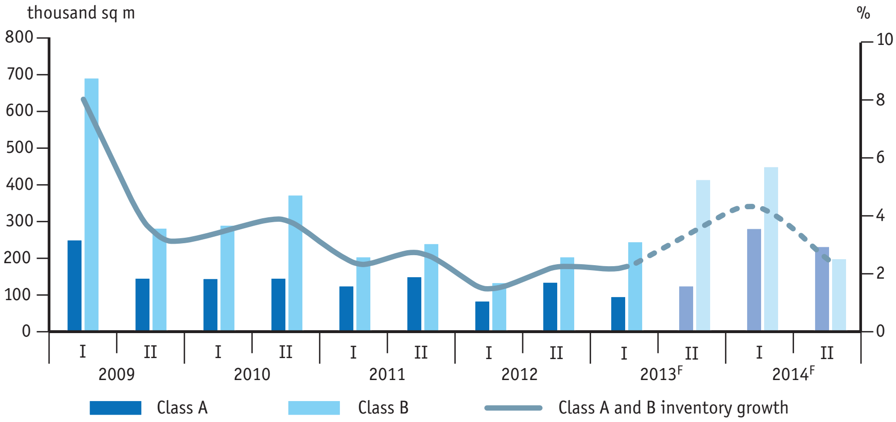
"For over a year already, we have been observing quality changes on the market of office real estate. The competition for tenants is growing stronger: the quality of properties is improving; more attention is paid not only to the creation of high-quality buildings, but also to the development of surrounding area and infrastructure. In turn, the tenants are becoming more demanding. They begin their search for a new office much earlier: 2 - 3 years before the end of current lease. On the demand side, the results of the first six months of 2013 were slightly lower than for the same period last year, due primarily to the wariness of tenants caused by the uncertain situation in the global economy of both Russia and the West. However, in the second half of the year, we are expecting a seasonal growth in tenant activity, and thus the annual take-up will be comparable with that of last year".

Key indicators. Dynamics*

Key indicators	Class A	Class B
Total stock, thousand sq m	12,789	
including, sq m	2,555	10,234
Delivered in H1 2013, thousand sq m	341	
including, thousand sq m	96.3	244.7
Vacancy rate, %	14.7	12.8
	+2.1 p.p.	-1.7 p.p.
Average weighted asking rental rate**, $/sq m/year	830	490
	-0.5%	+1.4%
Rental rates range**, $/sq m/year	650 - 1,200 (1,000 - 1,300***)	350 - 650
Operational expenses, $/sq m/year	110 - 210	80 - 120

* Comparing to Q4 2012
** Excluding Operational Expenses and VAT (18%)
*** Range of asking rents for premium space
Source: Knight Frank Research, 2013

Expected new delivery volume recovery will continue in 2014



Source: Knight Frank Research, 2013

Supply

The total supply of office space in Classes A and B in Moscow in the first half of 2013 amounted to nearly 12.8 million sq m, of which 20% belong to Class A.

In Q2 2013, thanks to the efforts of the Moscow Research Forum, a classification of office buildings, which had been created in 2003 and developed in 2006, has been updated. The requirements for Class A office buildings have become stricter and the buildings that do not meet the new criteria were reclassified as B. Thus, the total supply stock of high-quality office space, corresponding to Class A, has declined in the first half of 2013 and amounts to 2.55 million sq m.

Presently, we observe the expected recovery in new construction volumes on the market of high-quality office real estate. During the first six months, 96.3 thousand sq m of office space have been delivered in Class A category and 244.7 thousand sq m – in Class B. The new construction volume exceeded last year's figure for the same period by 36%, and we expect more than 500 thousand sq m of high-quality office space to be built and delivered in the second year-half.

During the first half of 2013, we could still observe reinforcement of business life decentralization in the capital: the largest volume of delivered of-

* Moscow Research Forum is functioning since 2003, and presently unifies analytical divisions of five leading international consulting companies: CBRE, Colliers International, Cushman & Wakefield, Jones Lang LaSalle, and Knight Frank.

fice space was in the area between the Third Ring Road and the Moscow Ring Road (77%). Inside the Garden Ring, 17% of office space in Classes A and B were delivered. Because of restrictions on the construction of new properties in the city center, this figure appears quite high. However, the construction of last objects, which were authorized prior to the implementation of a new urban policy aimed at decentralization of business life in the capital, is being completed at the moment.

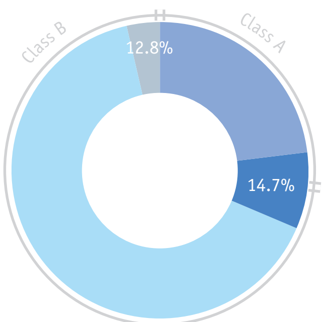
Demand

About 300 thousand sq m of Class A and B office space was leased and purchased in the first 6 months of 2013. The take-up volume capacity has dropped by 25% compared to the first half of 2012. However, we expect that in the second half of the year the activity of tenants will, as usually, increase, and the annual take-up volume will be comparable to the figure of 2012. Achievement of this result is largely made possible by a number of large transactions, which are presently at the stage of negotiation, and should be completed in the second half of 2013.

Although a large number of transactions can be observed on the office real estate market, the average deal size dropped to about 1.2 thousand sq m in this year-half against 2 thousand sq m in the first half of 2012. This is primarily a result of the companies' wish to optimize office space to reduce lease costs.

In the first half of 2013, the vacancy rate was 14.7% for Class A office buildings and 12.8% for Class B. The vacancy in Class A office centers has slightly grown: in comparison with Q4 2012, this figure grew by 2.1 percentage points. Such dynamics is explained by some reduction in demand associated with the general uncertainty of both Russian and global economies. It should

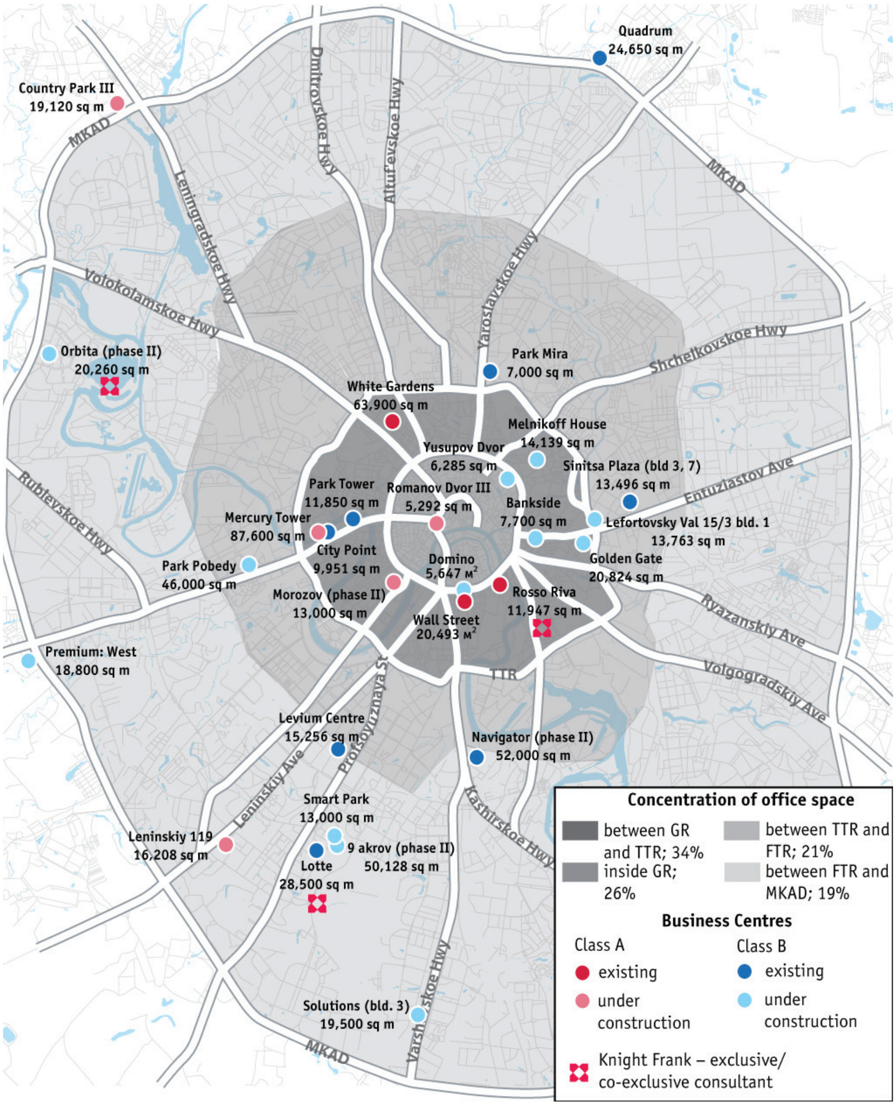
Distribution of total supply of high quality office space in Moscow



Class A		Class A area occupied
		Class A area vacant
Class B		Class B area occupied
		Class B area vacant

Source: Knight Frank Research, 2013

Key projects delivered* in the H1 2013 and planned by the end of 2013



* Office projects that passed the State Commission in H1 2013. Office building classes according to Moscow Research Forum

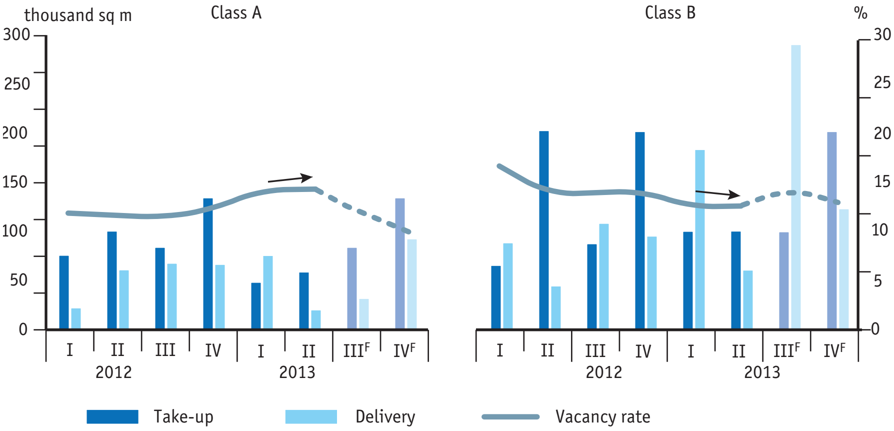
Source: Knight Frank Research, 2013

Alcon
72 Leningradskiy Ave

also be noted, that despite the recovery in the new construction volume, the share of preliminary agreements has changed only slightly. Thus, due to the delivery of even a few large projects, the vacancy rate has grown.

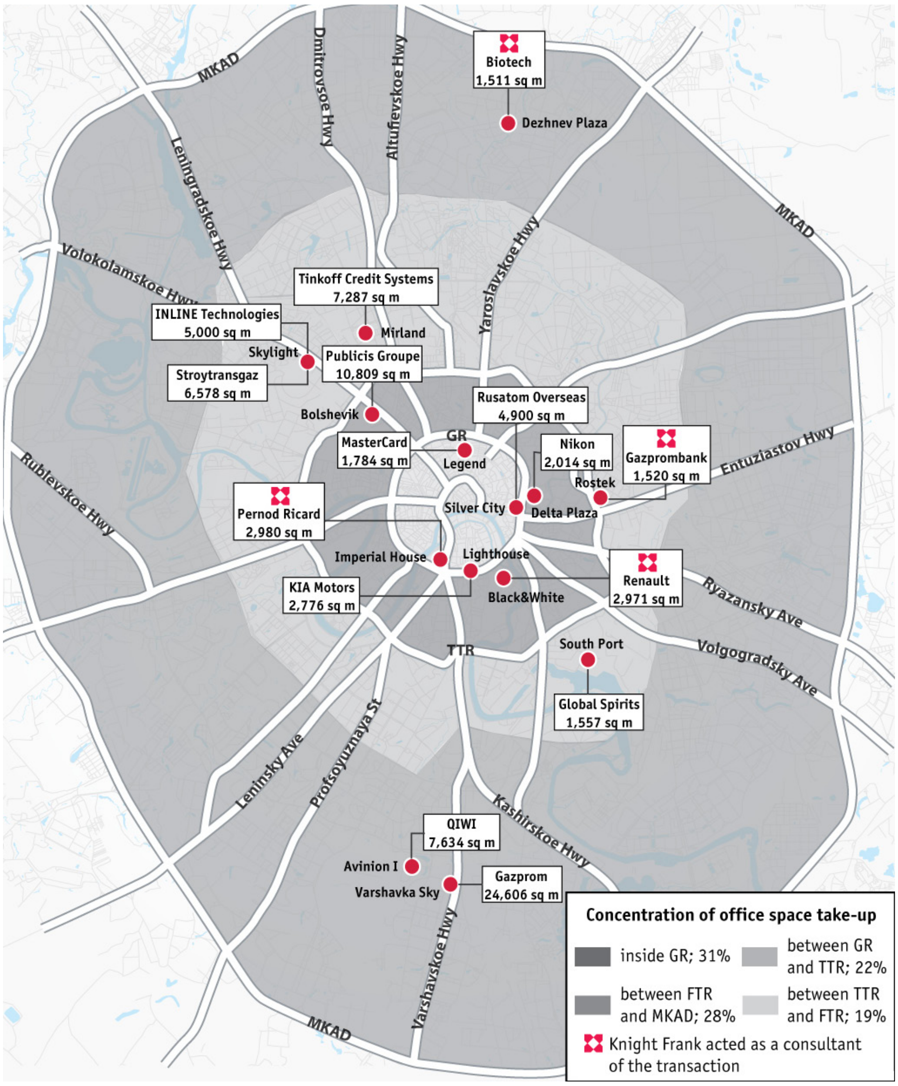
Compared to the end of 2012, the vacancy rate in Class B office properties dropped by 1.7 percentage points. Such dynamics is explained by the desire of some companies to move from lower-quality offices to Class B business centers, which leads to the take-up volume growth in this class. Class B facilities attract tenants with more flexible lease terms, an option to lease fitted-out office blocks, and by offering a larger range of choices than in Class A. Furthermore, considering the not quite stable economic situation, some private investors wish to diversify their assets, and are considering the opportunity to purchase small office space for the purpose of leasing it out. They also generate demand for units in Class B, as the purchase of small-sized premises in the business centers of Class A is practically impossible.

In H1 2013 vacancy rate dynamics of Class A and B office premises have changed diversely



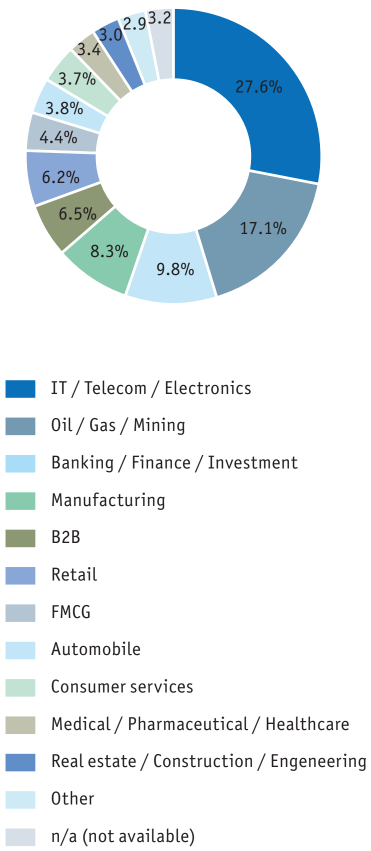
Source: Knight Frank Research, 2013

Key deals in H1 2013



Source: Knight Frank Research, 2013

Almost half of the office space, which was leased and purchased in the first six months of 2013 fell on IT, telecommunications companies and the mining sector



Source: Knight Frank Research, 2013

Embankment Tower
10 Presnenskaya Emb

In H1 2013, representatives of the IT and telecommunications industry were the most active on the market of buying and leasing office space. Their share accounted for almost 30% of the total take-up volume Classes A and B office space. The share of these companies does not fall below 20% over the past two years. The mining sector companies also demonstrated high activity, as their share of the market last year was not more than 5%. In the first six months, almost 20% of office space was leased and purchased by the companies operating in the field of oil and gas of mining and delivery. This growth has largely occurred due to a major deal: a lease contract by the OJSC Gazprom for 24,600 sq m of office space in BC Varshavka Sky. The share of financial institutions that traditionally take-up a significant part of high-quality office space, has gone down by almost a half compared with the end of 2012: in the first half of the year, their share was approximately 10%. We also observed a drop in demand from the B2B sector, production companies and FMCG. The share of these companies did not exceed 10% of the total take-up.

Speaking about the territorial distribution of demand, it is worth noting that half of the total volume of transactions on lease and purchase of office space fell with objects located within the Third Ring Road. The office space located in the Central Business District is mostly popular with representatives of banking sector and B2B companies: prestigious location and infrastructure are important for these organizations. The largest amount of office space located between the Third Ring Road and the Moscow Ring Road was leased and purchased by IT and telecommunications companies, as well as companies operating in the oil and gas mining and distribution sector. It is exactly in this area that one has more opportunities to find large blocks of office space.

Commercial terms

Asking rental rates for office space remain stable and are in the range of 650 - 1,200 $/sq m/year (triple net) for Class A and 350 - 650 $/sq m/year (triple net) for Class B facilities. However, difference between asking rental rate and the rate at which the contracts are signed, is growing larger due to some slowdown in tenant activity associated with longer decision-making period.

In the first half of 2013, some adjustment to weighted averages of rental rates took place. This situation was partly caused by the reclassification of office buildings and the change in the calculation basis, as well as by the growing demand for office space in Class B. Average weighted asking rental rate for Class A office space amounted to 830 $/sq m/year (triple net) and 490 $/sq m/year for Class B.

Increased decentralization of business life has led to the situation when quite a lot of high-quality objects of Class A began to appear on the market in remote business areas with lease rates that can be more than doubly different when compared to equivalent office buildings located within the Garden Ring. In the future, delivery of such projects will somewhat adjust the weighted average in the downward direction. However, in the case of further development of decentralized office properties segment and simultaneous development of infrastructure, one can expect an increase in lease rates for such objects.

In the first half of 2013, the highest weighted average lease rates were noted in the Central business district (1,186 $/sq m/year), in the western part of the Garden Ring Road (1,184 $/sq m/year) and in the vicinity of metro station Belorusskaya (1,018 $/sq m/year). The asking lease rates in the areas adjacent to the Moscow Ring Road are the lowest, in the range of 216 - 520 $/sq m/year.

Forecast

Following the record low office space delivery volume in 2012, we expect the figures of 2013 to exceed those of last year by almost 35%. According to our forecast, by 2016 about 2.8 million sq m of high-quality office space will be delivered. Until the end of the year, a number of projects are planned for delivery, such as the Mercury tower in MIBC Moscow-City, the second stage of the business park Orbita and the business center Leninsky 119.

More than 90% of business centers, which are planned for delivery until 2016, are located outside the Garden Ring Road. One sixth (16%) of the projects under construction is located on the Moscow Ring Road, and within 10 km range from it.

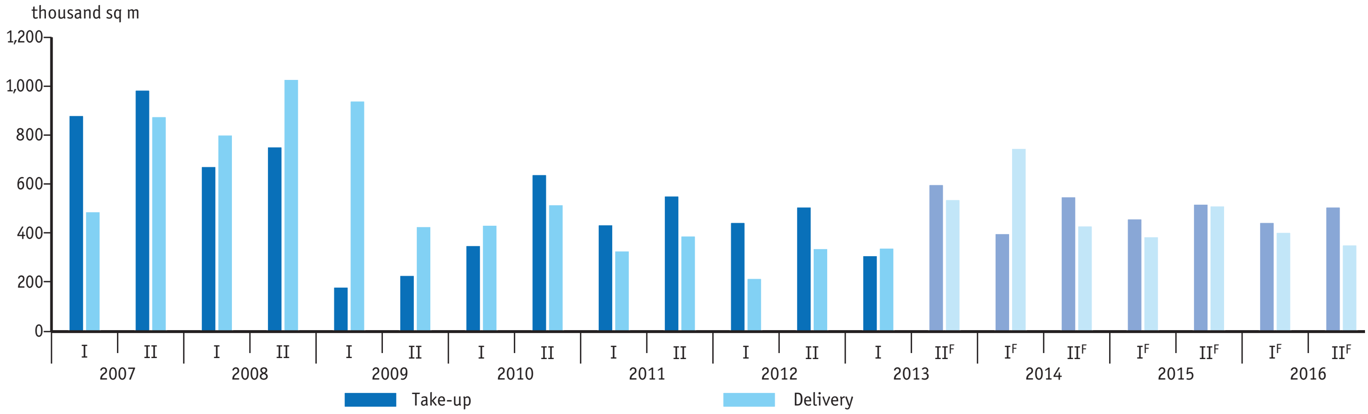
New business districts continue to appear on the office real estate map of Moscow while existing business areas continue to develop. About 160 thousand sq m of Class A and B+ offices, which can potentially house 16 to 26 thousand people are going to be built on the New Moscow territory until the end of 2016. The key objects planned for delivery on the attached territory include business parks Com City and G8. As part of the MIBC Moscow City, the construction of towers Evolution and OKO will be completed in 2014, as it will be for the project IQ-quarter in 2015. Development of the Leningrad area continues: high-quality office projects in the area of the Third Ring Road and near the Moscow Ring Road are planned for market delivery here. Among the most interesting projects, those worth special mention are the reconstruction of the Bolshevik factory, an office complex in place of the watch factory Slava, VTB Arena Park project, as well as a business center Mebe One Khimki Plaza.

At present, some uncertainty can be observed on the market. It is in part related to the recession in Eurozone, which will affect the economies of many countries in case of a negative scenario. However, if the negative impact on the economy of Russia will not occur, we expect steady demand at the level of 2012 in the coming years.

In the case of a balanced state of supply and demand, the lease rates for Class A and B offices will be stable. In case of the positive demand dynamics, an upward correction in lease rates in the range of 2 - 3% is possible.

Evolution Tower
3 Krasnopresnenskaya Emb

Incipient recovery in the volume of new construction of high-quality office properties will continue in the next 2 - 3 years



Source: Knight Frank Research, 2013

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