RESEARCH

MOSCOW

OFFICE MARKET OUTLOOK

Q1 2016

OCCUPIER TRENDS | INVESTMENT TRENDS | MARKET OUTLOOK

KEY FINDINGS

Russia's economy contracted by 3.8% in 2015 as oil prices collapsed and sanctions were imposed by the West. The economy is expected to make a slow recovery with GDP returning to positive territory in 2017.

Class A and B rents reached a ten year low of US$474/sq m and US$285/sq m per annum respectively and have begun to show signs of bottoming out.

A total of 721,000 sq m of office space was delivered to the market, representing a halving from the previous year and indicative of both high construction costs and low availability of development finance.

Macroeconomic difficulties and geo-political conflicts caused Russian office investment volumes to decline to US$2.7 billion in 2015.

Office yields are expected to face further upward pressure throughout 2016, as investment activity is constrained by expensive and limited financing. Local investors will remain the dominant market players.

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

Source: Knight Frank Research

OCCUPIER MARKET

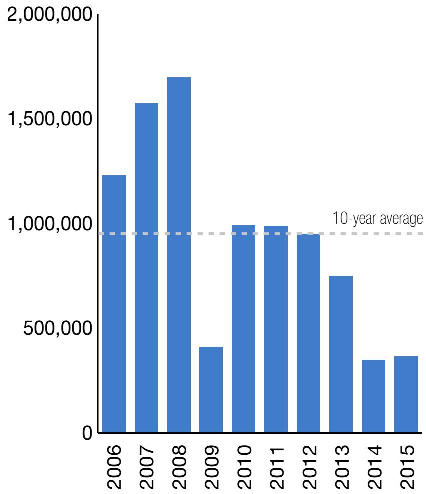
Weak macroeconomic conditions have contributed to contraction and rationalisation in the occupier market as well as renegotiation of lease terms.

The rationalisation and contraction of tenants was a key theme in Moscow's office landscape throughout 2015. This was on the back of falling commodity prices and the devaluation of the Russian ruble. Despite the weak macroeconomic factors, take-up of office space in 2015 amounted to 367,000 sq m and was comparable to the levels achieved in 2014. The main reason for this continued level of take-up was the renegotiation of lease terms accounting for around 60 per cent of the leasing volume, with tenants taking advantage of the favourable lease terms offered by landlords.

Commercial lease terms have been impacted by the devaluation of the ruble and currency exchange fluctuations. The average asking rents in US$ have fallen for Class A and Class B by approximately 17% and 12% respectively over the year, with the larger drop in Class A coinciding with a higher vacancy rate. However rents denominated in rubles have been less volatile with Class A and B rents comparable to the ten year average. These soft market conditions have subsequently encouraged occupiers to explore alternative leasing arrangements, with some evidence of migration to central areas where rental rates have now become more affordable.

Tighter lending conditions and limited access to development finance is stalling the volume of new supply entering the market. A total of 721,000 sq m of new supply brought to market in 2015, representing a halving from the previous year. Several projects in the development pipeline have been deferred or completely abandoned. This will continue to assist in tempering vacancy levels, which currently sit at 24.4% for Class A and 16.5% for Class B office stock.

FIGURE 2
Office take-up
sq m



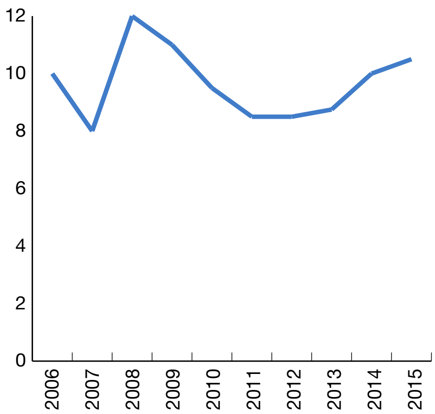
Source: Knight Frank Research

Key office leasing transactions in 2015

Quarter	Building	Occupier	Building Class	Size (sq m)
Q3	Orbita (phase II)	Moscow Region Government	B	31,860
Q3	Algoritm	Yamal LNG	B	20,400
Q3	Krylatsky Hills	Adidas	A	20,045
Q4	Simonov Plaza	Svyaznoy	B	13,000
Q4	Pushkin House	Avtodor	A	12,192
Q1	Comcity (phase Alpha)	Asteros	A	10,335
Q2	Arcus III	BASF	A	10,200
Q2	Alcon	Mars	A	8,635

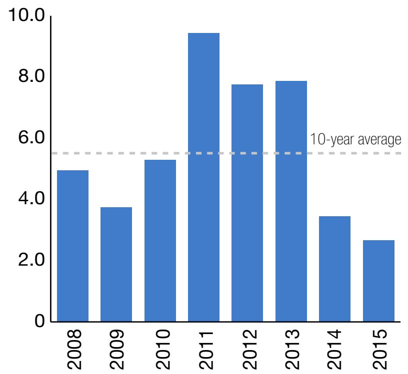
Source: Knight Frank Research

FIGURE 3
Prime office yields
%



Source: Knight Frank Research

FIGURE 4
Russia office investment volumes
US$ billion



Source: Knight Frank Research

INVESTMENT MARKET

Last year was another tough year for the Russian real estate market, as annual office investment volumes reduced by 30% on 2014 to US$2.7 billion. The market moved in line with the macroeconomic environment as the reduced availability of financing constrained investment activity. The investment market is continuing to be impacted by this as the majority of buyers are risk averse and unwilling to invest in assets in a declining market.

Prime yields have reacted to the current market situation as evidenced by a further 50 bps softening of yields, to end 2015 at 10.5%. More expensive and reduced availability of debt financing is likely to lead to further pressures throughout 2016. Local players have been most active, dominating the market as they are more familiar with market conditions. Foreign investors in turn have reduced their exposure to Russia's real estate. That said, as foreign investors generally have a lower cost of debt financing, those with risk appetite have capitalised on market conditions and expanded their real estate portfolios.

One of the largest transactions in 2015 was Hines and PPF's acquisition of Moscow's Metropolis Office Buildings I and III for US$430 million. The buildings are understood to be fully occupied and leased to blue chip tenants, demonstrating demand for secure and attractive assets.

The ongoing weak macroeconomic environment will continue to hamper investment activity in Moscow. An increase in investors using equity as collateral is likely to be witnessed in the market.

Key office investment transactions in 2015

Quarter	Building	Vendor	Purchaser	Price (US$)
Q1-Q3	Metropolis (office buildings 1 and 3)	Capital Partners	Hines + PPF	430m
Q4	Oruzheyniy	N/A	Megafon	282m
Q3	Zarechye	ICT Holding	O1 Properties	100m
Q2	Mercedes Benz Plaza	ASKK Holding	Regional Group	90m
Q2	Bakhrushin House	Sponda	Horizon Properties	32.5m

Source: Knight Frank Research

Evolution Tower completed in late 2014

KNIGHT FRANK VIEW

Russia's economy is facing significant headwinds and will continue to in the short to medium term. Current economic conditions have highlighted structured challenges across many parts of the economy weighing on business sentiment, which could undermine future growth prospects.

From an occupier perspective, Moscow will remain a tenant's market in 2016. However, rents are showing signs of bottoming out, which will come as welcome news to landlords. There will be a diminishing supply pipeline as the feasibility of commercial projects continues to be undermined due to the high construction costs and the low availability of financing.

Russia's investment market is expected to remain relatively muted in the short term. Limited and expensive financing will provide ongoing difficulties for local players while many foreign investors will reconsider their investment strategies and put plans on hold or cancel altogether. The demand cycle is now passing through the trough, although yields may potentially be subject to further upward pressure before beginning to stabilise in the latter part of the year.

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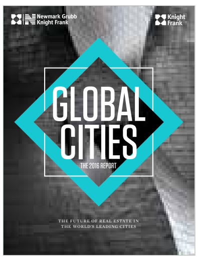

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