RESEARCH

Knight Frank

2014

OFFICE MARKET REPORT

Moscow

HIGHLIGHTS

New delivery volume of Class A and B offices in 2014 has exceeded that of the previous year by 36%, amounting to 1.4 million sq m.

Vacancy rate in Class A offices has reached the level of 29.6% and 15.3% in Class B by the end of the year.

Total take-up volume in 2014 amounted to 350 thousand sq m.

OFFICE MARKET REPORT MOSCOW

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"The past 2014 was one of the most challenging years for commercial real estate market in general and for office real estate market in particular. H2 was marked by a high degree of uncertainty caused by both internal and external factors. The anticipated growth of new supply volume during the course of the year has contributed to the increase in vacancy rates, while currency fluctuations and limitations caused by sanctions have forced some companies to review their development plans in Russia: some have declared significant staff cuts; others have announced plans to leave the Russian market. However, despite the high risks present on the office real estate market of Moscow, these changes offer new opportunities, which can be very attractive to potential tenants".

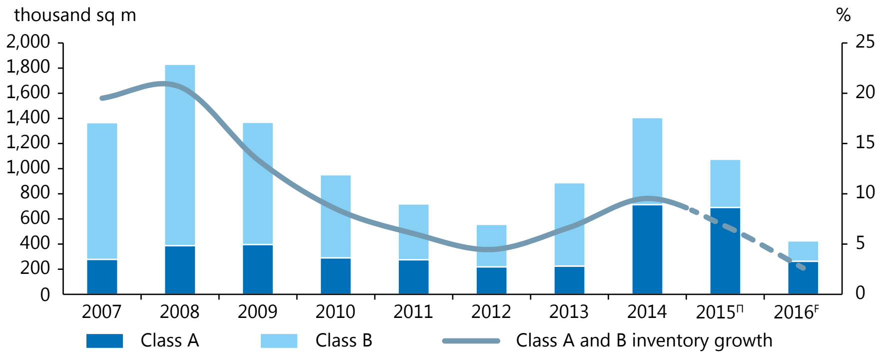
Key indicators. Dynamics*

		Class A	Class B
Total stock, thousand sq m		14,762	
including, thousand sq m		3,416	11,346
Delivered in 2014, thousand sq m		1,406	
including, thousand sq m		713	693
Vacancy rate, %		29.6 (+13.4 p. p.)*	15.3 (+3.8 p. p.)*
Average asking rental rate**	$/sq m/year	590 (-26%)*	314 (-36%)
	rub./ sq m/year	30,144	17,150
Rental rates range**	$/sq m/year	400–850	300–700
	rub./sq m/year	22,000–35,000	12,000–20,000
Average OPEX rate, rub./sq m/year		4,000–6,700	2,500–4,500

* Compared to Q4 2013
** Excluding Operational Expenses and VAT (18%)

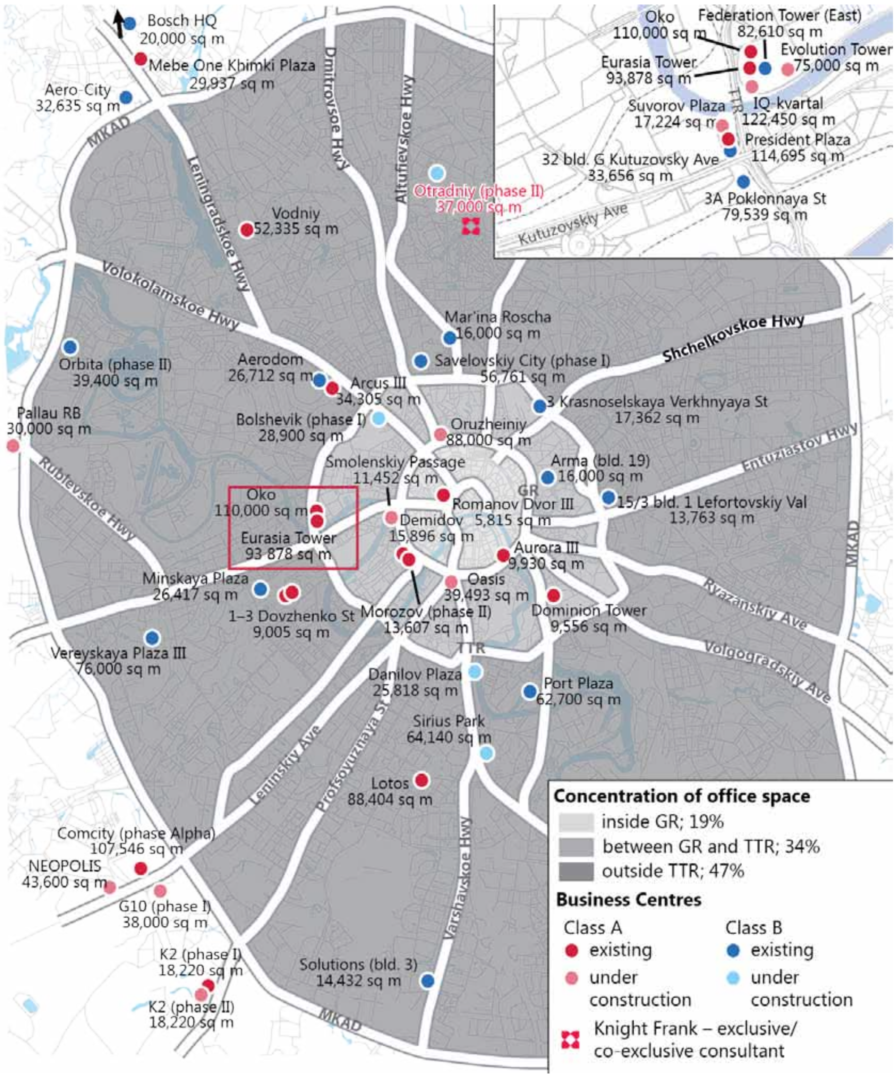
Source: Knight Frank Research, 2015

Delivery volume dynamics for Class A and B offices



Source: Knight Frank Research, 2015

Key office projects delivered in 2014* and due to be commissioned in 2015

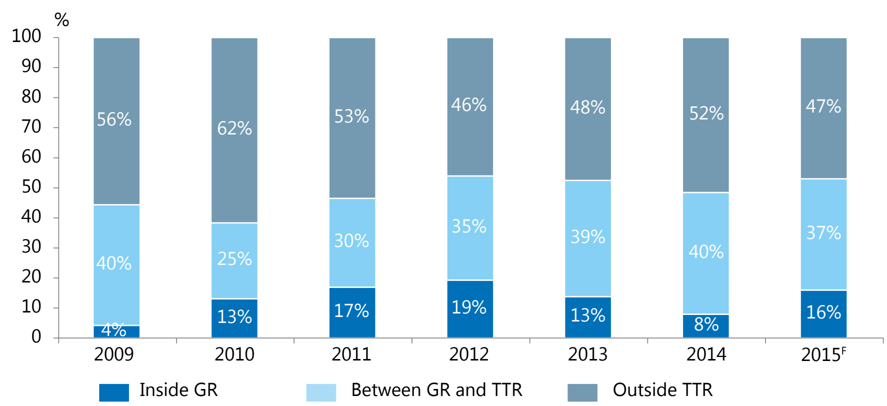


*Office properties that received the delivery act in 2014

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

Source: Knight Frank Research, 2015

Dynamics of delivered office space distribution in Classes A and B by location



Source: Knight Frank Research, 2015

Supply

By the end of 2014, the total supply of high-quality office space in Moscow amounted to 14.8 million sq m, of which 23% fell with Class A and 77% – with Class B offices.

The past 2014 was characterized by the anticipated growth in delivery volume of high-quality office space. 713 thousand sq m of Class A offices and 693 thousand sq m of Class B were delivered between January and December, which in total exceeds the same value for 2013 by 36%, setting the record since 2009. Such significant supply growth figures resulted from the recovery of development activity after the recession of 2008–2009: against the backdrop of growing market, having gained access to funding, developers have started new projects focusing on Class A facilities, due to the small difference in the construction costs.

The share of delivered office space in Class A and B within the Garden Ring in 2014 fell to its 5 years' lowest, with the largest amount of new space falling to the business districts of MIBC Moscow-City as well as to the South-Western and Leningradskoe directions.

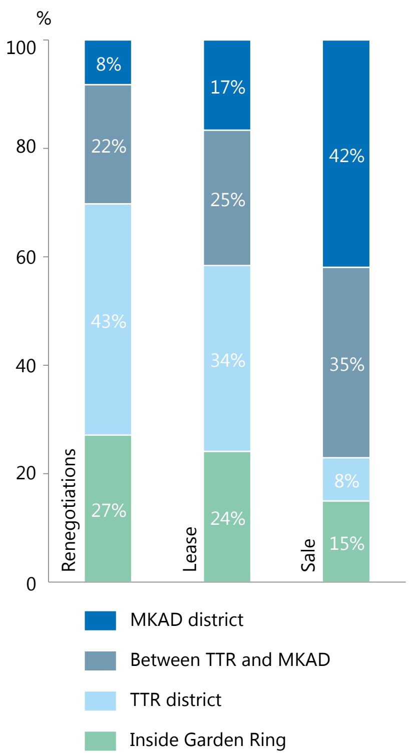
The vacancy rate in 2014 has reached its record value in Moscow office real estate market exceeding those of 2008–2009. By the end of the year, these rates amounted to 29.8% for Class A and 15.3% for Class B. Throughout the year, we observed a situation where large facilities were delivered whilst being completely vacant, or when office blocks were vacated due to the relocation of companies into buildings with comparatively lower lease rates. Another noteworthy market tendency is the delivery of a significant number of premises with high-quality finish offered for sublease.

Demand

Besides the strengthening of trends that emerged in 2013, the office real estate market in Moscow in 2014 was characterized by a number of events that had a significant impact on the type of tenants' requests as well as on the structure and volume of demand.

By the end of 2014, the net take-up has decreased by almost 70% and amounted to 350 thousand sq m. Market activity was determined by an increase in the number of renegotiation of commercial terms. A significant drop in lease rates has led to the

Distribution of deals by location



Source: Knight Frank Research, 2015

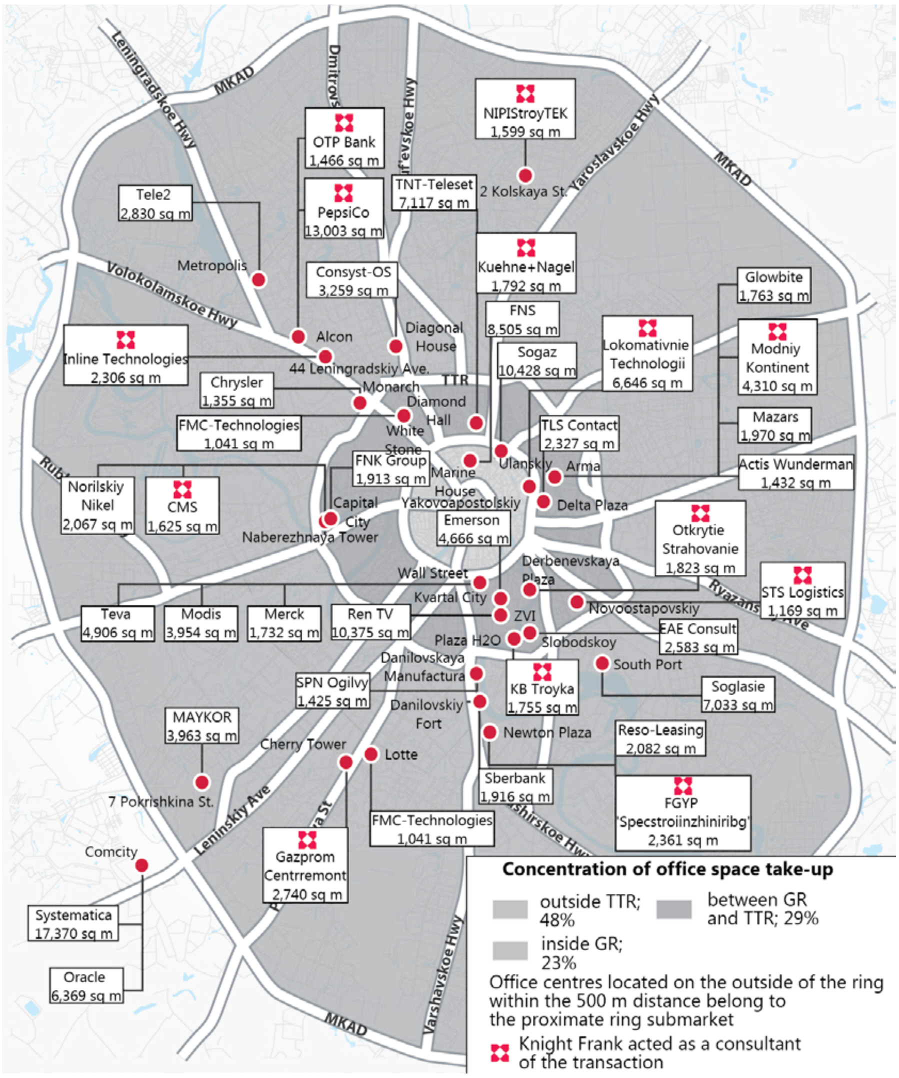
situation where the companies that signed lease agreements in dollar terms (above the current average market rates by 25–30%) in 2011–2012, during the period of market growth, tried to optimize the costs on office lease. Thus, according to the results of 2014, the share of transactions, where commercial terms have been revised, amounted to more than 40% of the total amount (compared to 32% in 2013).

Uncertainty caused by significant currency rates fluctuations resulted in a shift of companies' interest towards office buildings where proprietors have offered commercial terms in Russian rubles.

The average deal size on the office real estate market of Moscow continued to shrink. Compared with 2013, the index value has dropped by 14% amounting to 1,211 sq m. It should be noted that the proprietors of office space have tried to respond to the changes in demand and offer their clients division of facilities' space into small blocks.

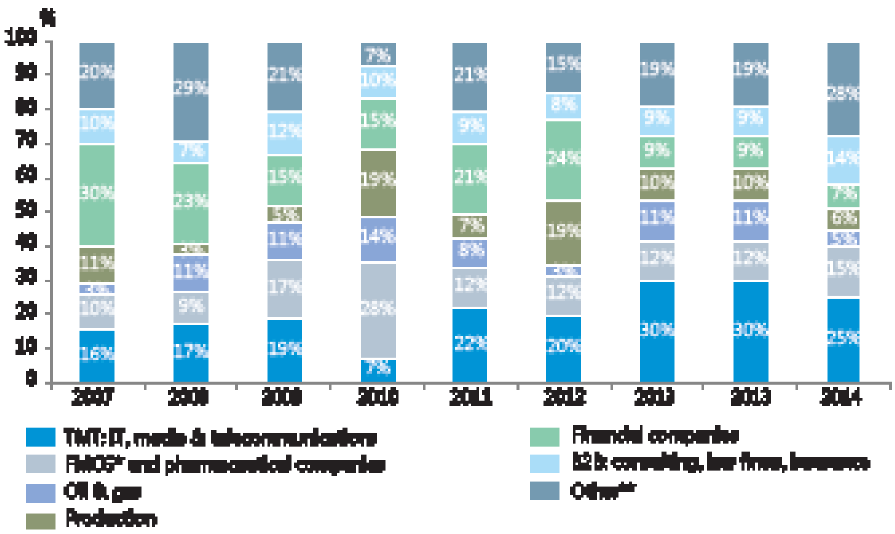
The analysis of transactions volume distribution by the company profile shows that the largest share fell on the TMT-sector representatives, who show the largest amount of take-up in each of the analyzed periods for the past four years. It is worth

Key office space lease and purchase transactions closed in 2014



Source: Knight Frank Research, 2015

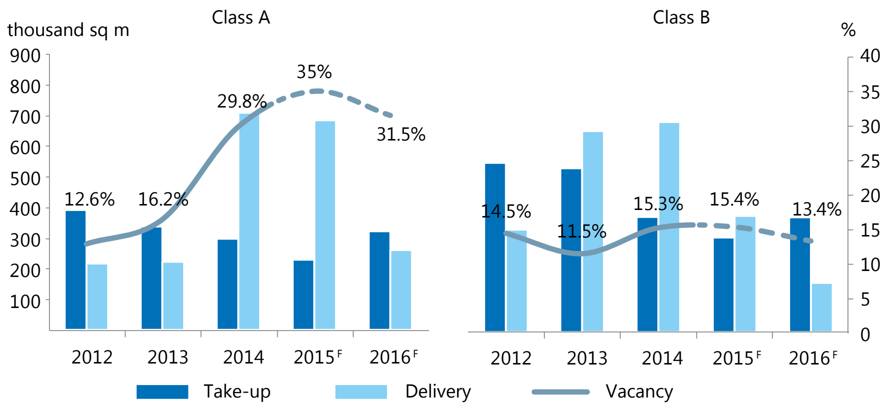
Tenant mix dynamics



* Fast-moving consumer goods
** Marketing, construction, retail, vehicles, logistics, confidential transactions

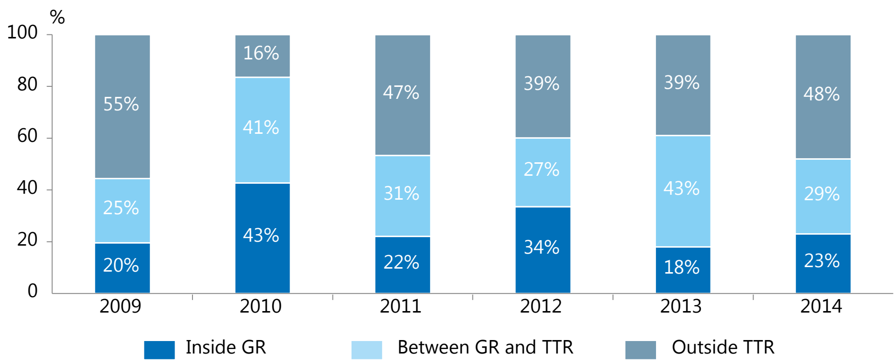
Source: Knight Frank Research, 2015

Dynamics of delivery, take-up and vacancy rates of Classes A and B offices



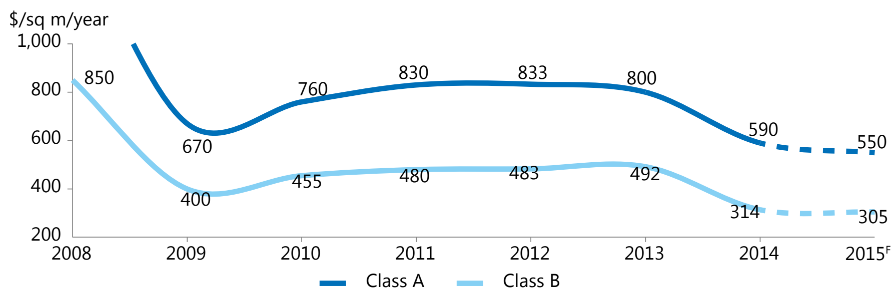
Source: Knight Frank Research, 2015

Dynamics of office lease and sale transations in terms of location



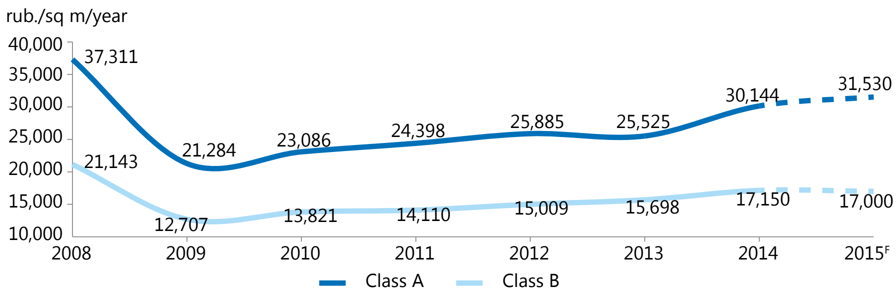
Source: Knight Frank Research, 2015

Average asking lease rates dynamics for Class A and B offices denominated in USD



Source: Knight Frank Research, 2015

Average asking lease rates dynamics for Class A and B offices denominated in RUB



Source: Knight Frank Research, 2015

noting that the financial companies sector share in 2014 has dropped to a minimum value, which resulted from negative dynamics of macroeconomic indicators and external constraints that had a significant impact on the banking sector and the country's investment climate. Moreover, it is the share of companies working in the field of banking and financial services that came out as the largest within the total volume of transactions for which terms and conditions were renegotiated.

Commercial terms

By the end of 2014, the average asking lease rate for Class A offices in US dollars has dropped by 25% to 590 $/sq m/year (triple net), reaching its lowest value since 2004. However, it is worth noting that at that time indicators demonstrated positive dynamics, because high-quality office space market was at the initial stage of development. Today, by contrast, we observe sharp downward dynamics of the indicator associated with internal processes taking place on the market, as well as with the unstable geopolitical situation and the negative dynamics of macroeconomic indicators. Lease rates for Class A office space denominated in Russian rubles at the end of 2014 amounted to 30,144 rub./sq m/year (triple net).

At the end of 2014, in Moscow the average asking lease for Class B office space denominated in US dollars amounted to 314 $/sq m/year (triple net), and in Russian rubles – to 17,150 rub./sq m/year (triple net).

The office lease market has become less transparent and predictable. Today, a number of proprietors, whose lease rates for office space are denominated in US dollars, are not ready to reduce officially the asking lease rates, and in some cases even announce them in advance, however if a potential client shows interest in negotiations, they are ready to discuss attractive commercial terms and provide significant discounts. By the end of 2014, 34% of vacant Class A office space was offered in ruble-denominated lease rates. The terms of credit agreements create the main barrier for proprietors when it comes to nominating lease rates in rubles. In turn, because of the greater willingness of proprietors to fix commercial terms in the domestic currency, Class B office space market becomes more attractive: besides low lease rates, currency fluctuations are also countered.

Forecast

Office real estate market is adapting to the new conditions in 2015. In case of a negative development scenario, we expect further weakness of the Russian ruble and possible strengthening of sanctions, which will result in continuation of expenditure optimization with the companies, including lease expenses, staff cuts and withdrawal from the Russian market of a number of foreign companies. All this will have an impact on the office real estate market: a drop in demand, growth in vacancy rates and a further decline in lease rates are expected. It is likely, as the experience of 2008–2009 demonstrates, we will witness a change of plans concerning projects development, suspension of activity on construction sites, as well as the inability of some developers to fulfill credit obligations.

Regardless of the sanctions, further reduction or persistence of low oil prices coupled with slow economic growth pace in Russia will continue to hinder the development of economy and business.

In case the restrictions on access to debt funding are lifted and the key rate of the Central Bank is lowered, a number of companies will be able to continue their growth, while developers will not suspend activity in ongoing projects.

A decline in the activity of development companies during the recession will limit supply and lead to a drop in vacancy rates over the term of 2–3 years, which in the future will act as a catalyst for gradual resumption of growth in lease rates and sales prices.

The conversion of the office market to lease rates denominated in Russian rubles will continue and may finalize the formation of the ruble lease market. During 2015, the asking lease rates denominated in US dollars will decline further leading to a transition to conventional units with both sides agreeing to a fixed rate or adopting an exchange rate band. Existing ruble lease rates will drop to a lesser extent.

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Moscow submarket data. Key indicators

Submarket		Lease Area, thousand sq m	Class A						Class B					
			Average rent				Vacancy Rate, %		Average rent				Vacancy Rate, %	
			$/sq m/ year		rub./sq m/ year				$/sq m/ year		rub./sq m/ year			
Boulevard Ring	Central business district	711	976		45,875		15.4		436		23,501		10.8	
Garden Ring	South	845	578	621	33,551	34,419	22.9%	16	461	450	25,051	24,484	9%	16.8
	West	275	950		-		4.4%		847		43,949		12%	
	North	574	772		40,847		5.5%		616		31,176		11%	
	East	355	648		31,888		19.1%		321		18,705		34%	
Third Transport Ring	Leninskiy	258	750	646	-	32,058	9.1%	48	400	369	21,319	19,586	17%	12.7
	Tulskiy	1,035	-		-		-		385		19,221		15%	
	Khamovniki	258	1,027		48,284		21%		-		-		2%	
	Kievskiy	376	850		25,000		100%		430		22,875		26%	
	Presnenskiy	327	772		35,000		11%		496		27,188		7%	
	Prospekt Mira	172	540		25,387		24%		298		17,825		15%	
	Tverskoy-Novoslobodskiy	737	860		41,296		29%		298		18,598		5%	
	Basmanniy	469	-		-		-		323		18,570		15%	
	Taganskiy	228	450		-		83%		172		10,089		21%	
	Volgogradskiy	376	-		21,525		100%		316		16,354		6%	
	MIBC Moscow-City	771	646		30,574		49.9		640		-		6.4	
TTR-MKAD	North	597	-	549	25,000	27,693	2%	23	217	290	13,783	16,263	18%	14.2
	South	1,731	603		29,218		49.9%		283		15,811		15.9%	
	West	1,234	611		31,169		16.3%		403		21,661		11%	
	East	632	447		-		49.3%		343		17,228		9.1%	
MKAD	North	687	-	317	-	17,410	0%	30	129	216	7,950	12,208	10.5%	20.3
	South	307	445		23,697		64%		180		10,070		17.2%	
	West	1,555	314		17,603		22.4%		234		13,117		29%	
	East	248	-		-		0%		103		7,004		10%	
Total		**14,758**	**590**		**30,144**		**29.8**		**314**		**17,150**		**15.3**	

Source: Knight Frank Research, 2015