RESEARCH

H1 2015

OFFICE MARKET REPORT

Moscow

HIGHLIGHTS

H1 2015 saw a 58% year-on-year decline in the delivery of high-quality office space, which amounted to 224 thousand sq m.

Net take-up dropped by 73% in H1 2015 compared to the same period last year.

Decline in asking rents slowed down in April-July 2015 reaching 508 $/sq m/year for Class A offices and 297 $/sq m/year for Class B offices.

OFFICE MARKET REPORT MOSCOW

Konstantin Losiukov
Director, Office Department
Knight Frank

"Despite the record-breaking negative trends prevailing in the market, including a significant decline in rental rates and high vacancy rate, the current levels of tenant activity allow us to revise pessimistic forecasts provided earlier. Apart from a significant number of lease renegotiations typical of any crisis, companies continue to lease new office space, although this type of activity is at its lowest level today. This means that the key market players proved to be capable of adapting to the current environment. The key factor stimulating tenants to relocate is an opportunity to pay a lower rent. However, it is still early to say that the crisis is nearing its end. If the situation does not change, it may take quite a few years to return to the pre crisis levels".

Key indicators. Dynamics*

		Class A	Class B
Total stock, thousand sq m		14,987	
including, thousand sq m		3,584	11,403
Delivered in H1 2015, thousand sq m		224	
including, thousand sq m		167	57
Vacancy rate, %		28.2 (-1.4 p. p.)*	17.3 (+2.0 p. p.)*
Average weighted asking rental rate**	$/sq m/year	508 (-13.9%)*	297 (-5.4%)*
	rub/sq m/year	27,321 (-9.3%)*	15,731 (-8.3%)*
Rental rates range**	$/sq m/year rub/sq m/year	350–1,200 14,000–45,000	250–650 8,000–35,000
Average OPEX rate,	rub/sq m/year	4,000–6,700	2,500–4,500

* Compared to Q4 2014
** Excluding operational expenses, utility bills and VAT (18%)

Source: Knight Frank Research, 2015

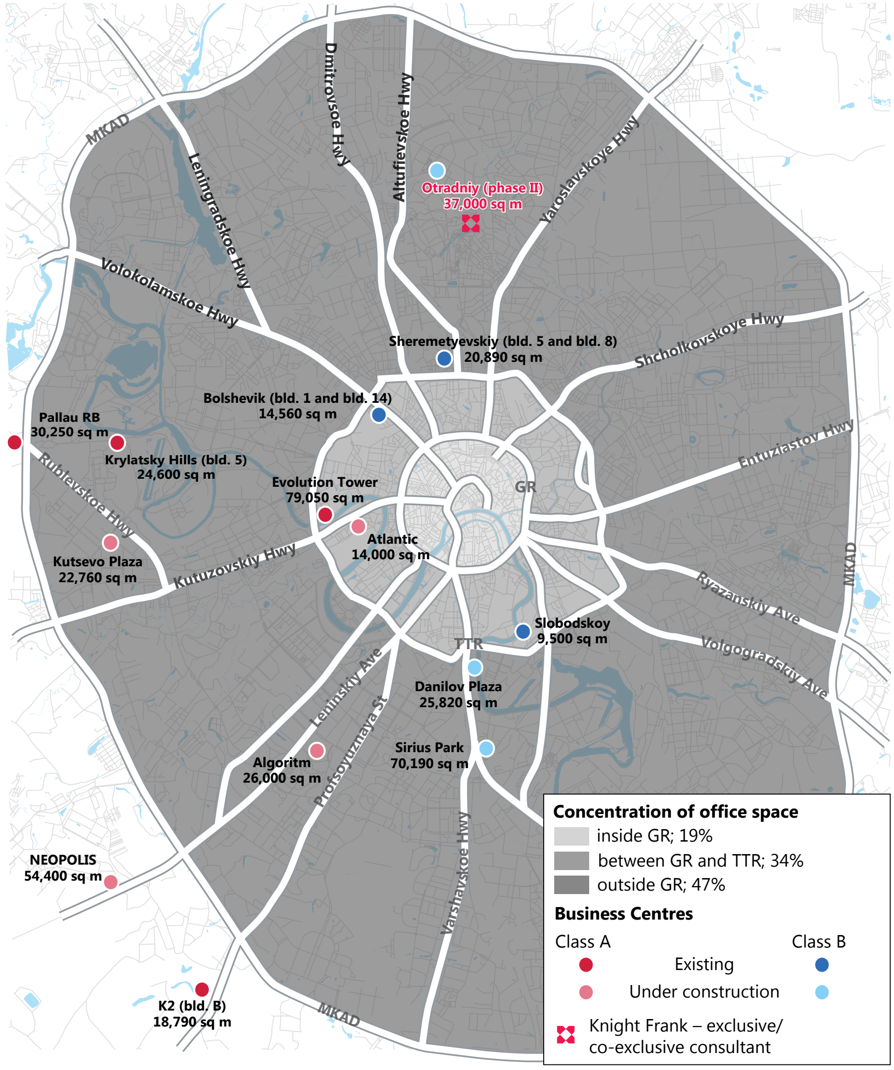
Supply

In H1 2015, new delivery of Class A and B office space dropped by 58% year-on-year to 224 thousand sq m, with Class A offices accounting for 167 thousand sq m and Class B offices – for 57 thousand sq m. By the end of the first six months of 2015, supply of completed high-quality office space reached almost 15 million sq m.

The decline in construction activity was caused by a low demand accompanied by a large number of office buildings completed in 2013–2014: these properties make up almost half (46%) of vacant Class A and Class B offices.

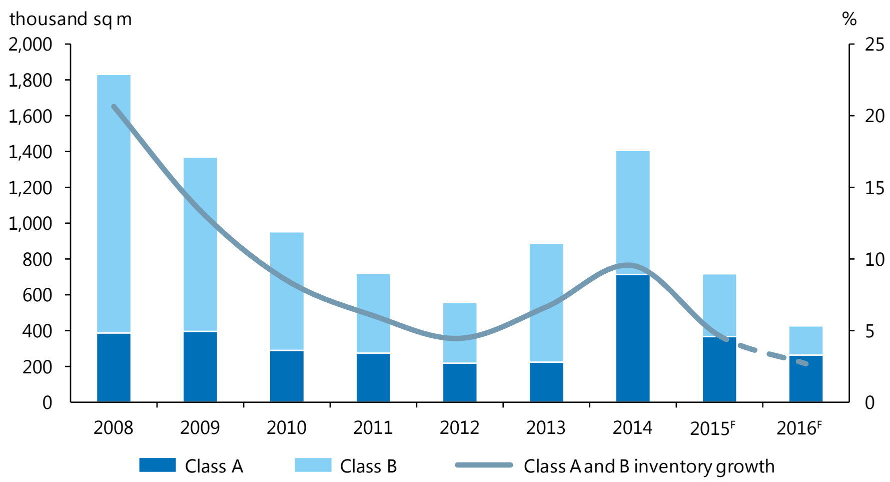
In H1 2015, Class A vacancy rate was 28.2%, with Class B vacancy rate reaching 17.3%. Several large transactions are currently pending, with the office premises withdrawn from the market, which is reflected in the slightly lower vacancy rate.

Key office projects delivered in H1 2015 and due to be commissioned in H2 2015



Source: Knight Frank Research, 2015

New delivery volume dynamics for Class A and B offices



Source: Knight Frank Research, 2015

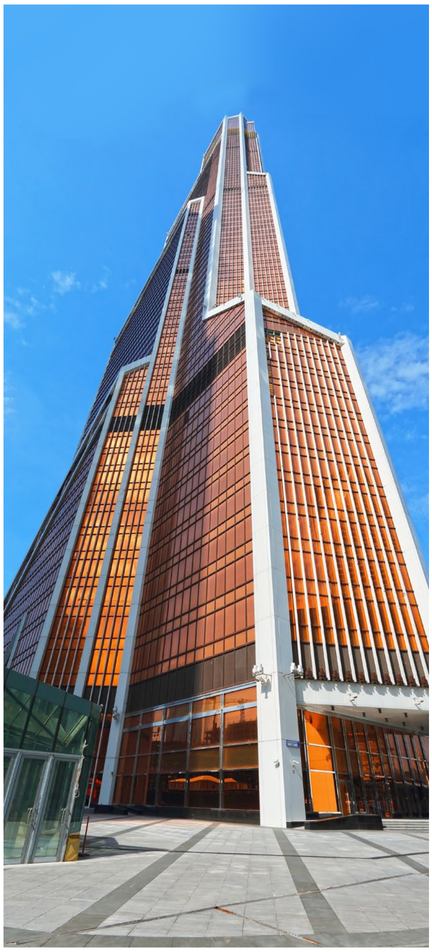
Demand

In H1 2015, take-up of high-quality office space totalled 61 thousand sq m, down 73% versus the same period last year and almost 90% versus H1 2013.

Lease renegotiations remain the dominant type of transactions: they accounted for 75% of deals versus 45% in H1 2014 and 25% in H1 2013. Aiming to optimize costs, tenants try to change leasing terms to align with market conditions. However, it should be noted that the share of lease renegotiation deals dropped in Q2 2015 from the beginning of the year, and we expect this trend to continue if the market situation doesn't change.

Apart from the decline in the number of transactions, the first six months of 2015 has experienced a decrease in their average size, which dropped to 1,063 sq m, with only one deal totalling over 10 thousand sq m closed over this period. It is worth mentioning that the share of take-up in office buildings under construction has been declining over the past two years: H1 2015 saw no pre-lease deals in the high-quality office space market.

With the slightly strengthened ruble and more stable oil prices, forecasts for the

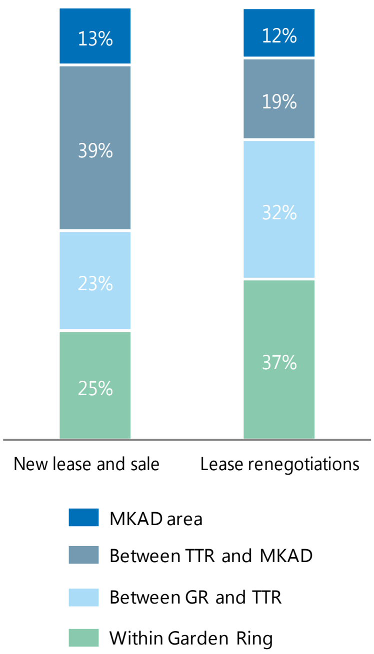


Russian economy have been improved, which encouraged a number of companies to get back to suspended deals involving lease and acquisition of office space. This marked an insignificant yet visible recovery of demand. Two largest Class A office lease deals of 2015 were closed in Q2 2015. It should be noted that both companies took up office space in office buildings located in the rapidly developing business district close to Lenigradsky Avenue.

Properties located close to the MKAD had the lowest take-up volumes. With rental rates falling companies can now afford leasing quality office space in developed business districts less distant from the city centre.

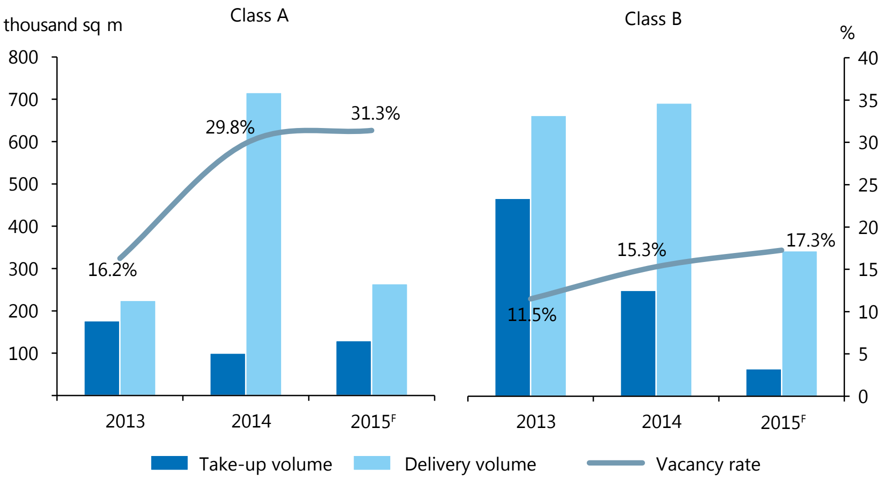
In H1 2015, demand for Class A and Class B office space was dominated by industrial companies, which accounted for 28% of lease and purchase deals. This was mainly driven by several major deals, including BASF, Caterpillar and Swatch Group taking up large office spaces. Another large transaction was completed by Mars, which leased 8,600 sq m in the Alcon office complex, raising FMCG companies' share of the total take-up to 19%. The banking sector continued to demonstrate low level of activity in the market, which was caused by sanctions imposed on the Russian banking system and a decline in loans granted to both individuals and businesses.

Distribution of deals by location



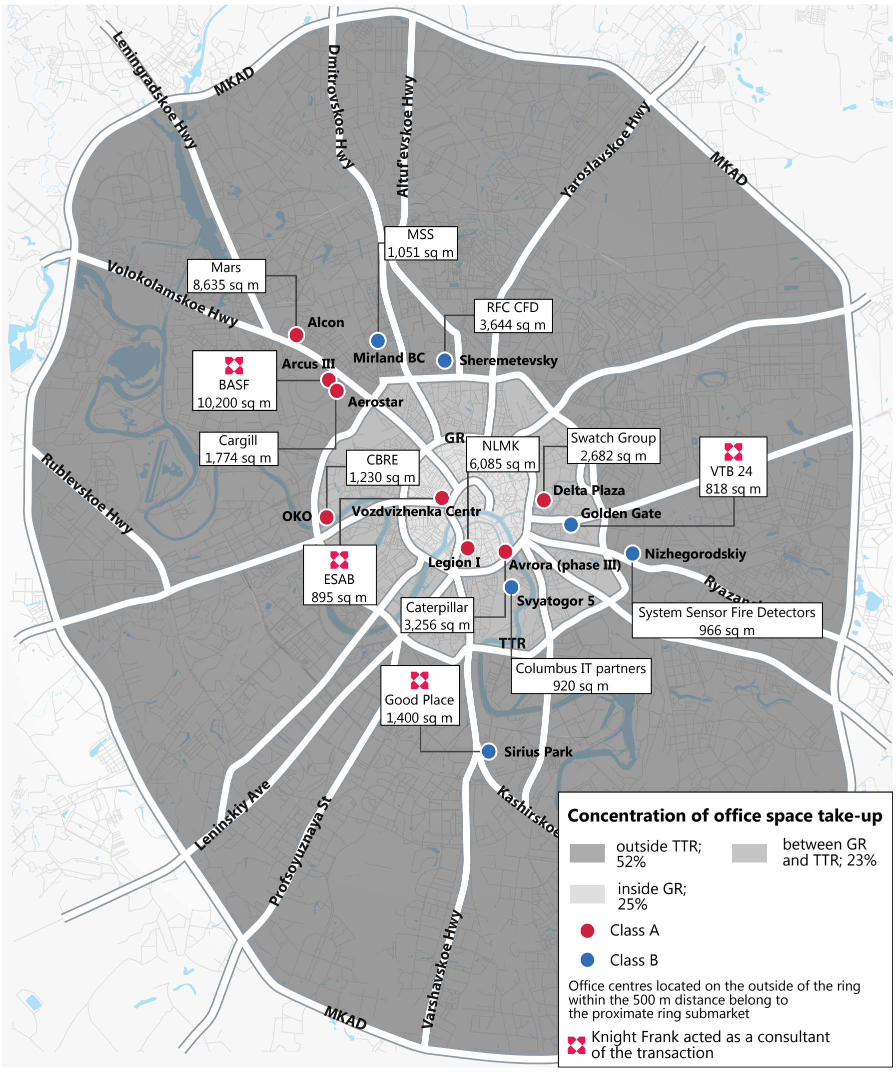
Source: Knight Frank Research, 2015

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



Source: Knight Frank Research, 2015

Key office space lease and purchase transactions closed in H1 2015



Source: Knight Frank Research, 2015

Commercial terms

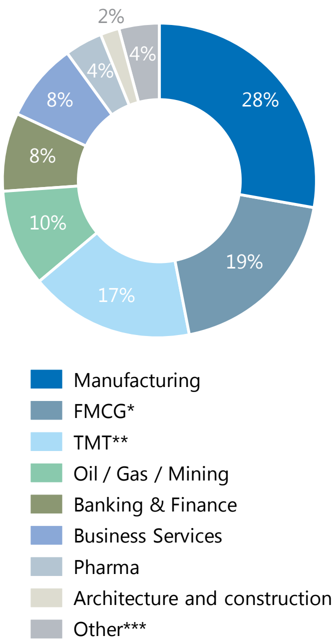
Rents for high-quality office space continued to fall in Q2 2015; however, the decline slowed down. Class A office rents dropped by 4% to 508 $/sq m/year (triple net) in April–June 2015, with Class B rents falling by 3% to 297 $/sq m/year (triple net). In Q1 2015, Class A and Class B rents declined by 14% and 5.5%, respectively. The decline in asking rents slowed down because the majority of landlords had already responded to the market changes in late 2014 and early 2015 by revising their commercial terms and reducing rents.

It should be noted that Class A and Class B office rents started falling back in 2013. In 2014, they dropped below the level observed during the crisis in 2008–2009.

Large exchange rate fluctuations and falling demand has formed the "ruble market": seeking to reduce the vacancy rate, landlords not only decreased rents, but also suggested signing ruble-denominated contracts, fixing exchange rates or introducing a currency band. However, in most cases such terms were offered for the lease contracts that did not exceed two years. It is worth noting that another weakening of the Russian ruble forced some office landlords to revise their exchange rate fixation terms.

In H1 2015, the weighted average rent denominated in rubles was 27,321 rub/sq m/year (triple net) for Class A offices and 15,731 rub/sq m/year (triple net) for Class B office space, down 9% and 8% versus Q4 2014, respectively.

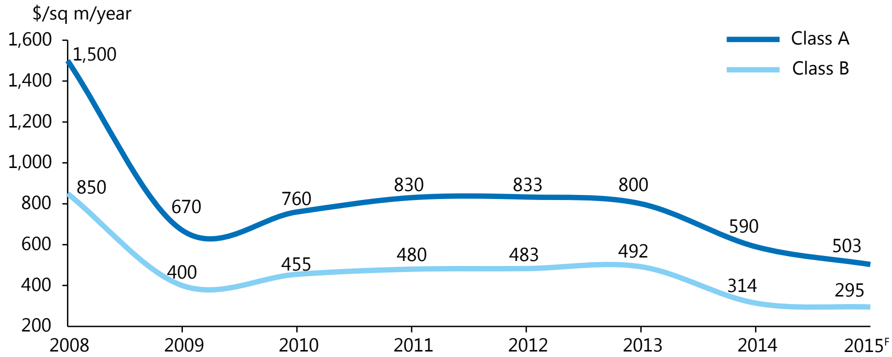
Tenant mix



* Fast moving consumer goods and services
** IT, media and telecommunications
*** Transport & Logistics

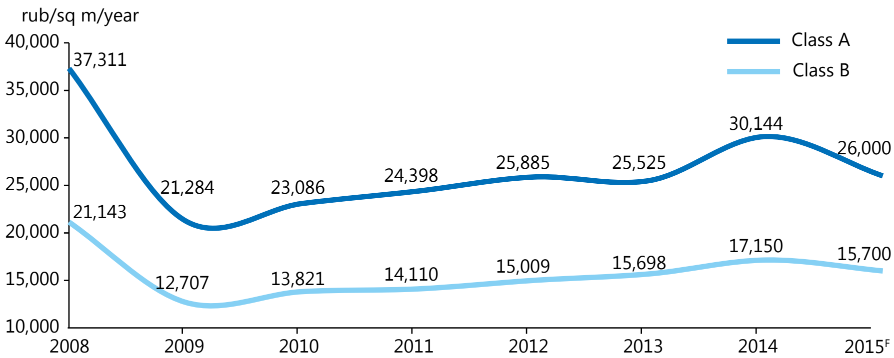
Source: Knight Frank Research, 2015

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

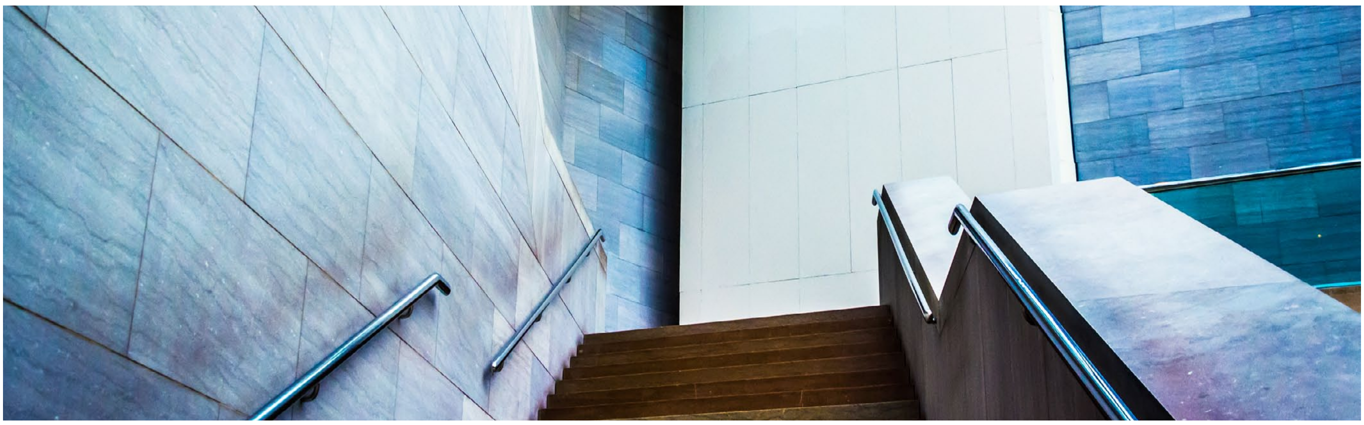


Source: Knight Frank Research, 2015

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



Source: Knight Frank Research, 2015



Forecast

Unless the Russian economy experiences some other shock due to either external or internal factors before the end of 2015, we do not expect a significant deterioration in the key office market indicators. With deadlines for construction of office buildings extended, we believe that new delivery in 2015 will decline by 30% from the level forecasted in late 2014 to approximately 730 thousand sq m. Besides, high level of uncertainty and lack of possibility to attract affordable debt financing forced companies to freeze the majority of construction projects being at the initial construction or design stages. Just like in 2008–2009, this may bring office delivery down to an extremely low level in 2–3 years.

After reducing asking rental rates to record-low levels, office landlords are most likely to take a temporizing approach, while completion of properties can slightly change the weighted average rent.

With current conditions remain unchanged, demand for high-quality office space, which depends heavily on the macroeconomic and geopolitical environment, may start its recovery. High vacancy rate and lower rents allow companies to consolidate their offices in one building or move to a higher quality office building with a better lease terms offered.

Moscow submarket data. Key indicators

Submarket		Lease area, thousand sq m	Class A: Average rent $/sq m/year		Class A: Average rent rub/sq m/year		Class A: Vacancy Rate, %		Class B: Average rent $/sq m/year		Class B: Average rent rub/sq m/year		Class B: Vacancy Rate, %	
Boulevard Ring	Central business district	712	753		40,101		13.9		530		28,104		7.2	
Garden Ring	South	918	606	652	32,251	34,650	20.3	17.0	491	467	26,011	24,930	9.9	13.0
	West	273	–		48,646		7.2		621		32,913		8.3	
	North	560	757		40,195		6.7		567		30,025		12.6	
	East	401	–		27,054		24.2		380		20,123		21.3	
Third Transport Ring	Leninskiy	278	–	602	28,000	32,049	20.7	33.7	404	342	21,415	20,992	23.0	18.9
	Tulskiy	908	–		–		–		365		19,342		13.8	
	Khamovniki	260	970		51,423		20.8		–		31,381		3.4	
	Kievskiy	393	–		25,000		100		–		18,567		61.9	
	Presnenskiy	357	–		28,000		7.3		511		27,078		10.4	
	Prospekt Mira	160	463		24,585		35.8		422		17,825		15.3	
	Tverskoy-Novoslobodskiy	752	817		43,318		17.6		392		21,340		5.3	
	Basmanniy	502	–		–		–		349		18,473		18.9	
	Taganskiy	227	450		–		82.9		223		11,830		15.4	
	Volgogradskiy	383	–		30,000		32.8		317		16,824		21.8	
	MIBC Moscow-City	858	514		27,260		41.4		–		–		0.7	
TTK-MKAD	North	680	506	426	27,003	22,736	1.9	21.4	242	269	12,804	14,779	18.2	15.6
	South	1,614	381		20,231		50.5		254		13,461		19.3	
	West	1,144	490		26,319		13.9		379		20,098		14.9	
	East	658			18,000		46.0		218		11,576		14.1	
MKAD	North	525	–	319	–	18,350	–	34.7	145	203	7,691	11,358	13.9	20.8
	South	432	321		17,014		62.9		182		9,653		18.1	
	West	1,743	319		18,673		27.8		240		12,709		27.1	
	East	248	–		–		–		–		2,726		11.4	
Total		**14,987**	**513**		**27,743**		**28.2**		**297**		**15,750**		**17.3**	

For certain business districts rental rates are not provided because of the 0% of vacant areas as well as the lack of supply nominated in specific currency

Source: Knight Frank Research, 2015

Knight Frank

RESEARCH
Olga Yasko
Director, Russia & CIS
olga.yasko@ru.knightfrank.com

OFFICES
Konstantin Losiukov
Director
konstantin.losiukov@ru.knightfrank.com

+7 (495) 981 0000