RESEARCH

Knight Frank

H1 2014

INVESTMENT MARKET REPORT

Moscow

HIGHLIGHTS

- The Russian commercial real estate investment market of H1 2014 was characterized by the players’ caution and high degree of uncertainty due to the complications of geopolitical situation.
- The commercial real estate investment volume decrease in Russia for H1 2014 amounted to almost 70% compared to H1 of the previous year.
- 86% of total commercial real estate investments fell with retail and office real estate.
- Capitalization rates were revised upwards in all segments of commercial real estate.

INVESTMENT MARKET REPORT

Alan Baloev,
Director of Investment and Sales Department, Knight Frank

"The downturn of commercial real estate markets in the past year related to the slowdown in economic growth of the country has significantly worsened in H1 2014. Caution was replaced by fears pending the adoption of sectorial sanctions against Russia, which led to a significant decline in investment compared with H1 of the previous year. As a result, by the end of 2014, we expect investment into the Russian commercial real estate at $4 billion".

Key indicators of commercial real estate market in H1 2014. Dynamics

Segment	Office		Retail	Industrial
	Class A	Class B		Class A
Delivered, thousand sq m	289	244	556*/231**	540
Vacancy rate, %	17.6 ▲ +1.4 p. p.	12.4 ▲ +0.9 p. p.	3.5 ▲ +0.5 p. p.	3.9 ▲ +2.0 p. p.
Average asking rental rate***, $/sq m/year	400–1,050 ▼ -6%	250–900 ▼ -7%		120–130 ▼ -10%
Yield, %	9.25–9.75 ▲	10.00–11.00 ▲	9.50–10.00 ▲	11.25–11.50 ▲
Average sale price, $/sq m	5,200–6,500 ▼	3,500–5,500 ▼	—	1,200–1,400 ►

* Total area of the building
** Total leasable area
*** The range of asking rental rates for vacant space (triple net)
Source: Knight Frank Research, 2014

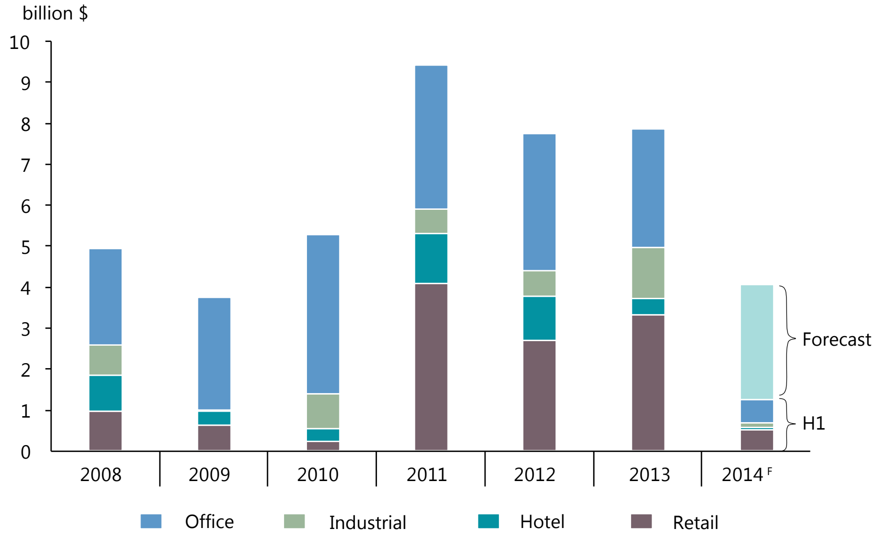
Demand and Supply

In H1 2014, a marked drop in activity was notable on the investment market of commercial real estate in Russia. Following record-high volume of demand of 2011–2013, for the first 6 months of 2014, the volume of transactions dropped by almost 70% compared to the same period previous year and amounted to about $1.3 billion. However, it is worth noting that the number of transactions has dropped only marginally. Furthermore, the volume of H1 of the previous year resulted largely from the closure of several transactions worth more than $500 million.

The results of H1 2014 were strongly influenced by the effects of geopolitical conflict in Ukraine, which caused heightened uncertainty and growing concerns of investors. Stagnation of economy (according to the adjusted forecast of the Ministry of Economic Development, GDP growth for the year is estimated at 0.5%), increased capital outflow (more than $100 billion, according to the forecast of the International

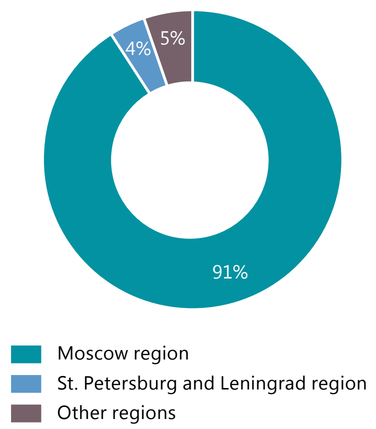
BC ALCON
72 Leningradskiy Ave

Retail and office real estate are traditionally in high demand with investors



Source: Knight Frank Research, 2014

The share of investments in commercial real estate outside Moscow region did not exceed 10%



Source: Knight Frank Research, 2014

Monetary Fund), as well as currency fluctuations became additional constraints in decision-making by the investors on closing deals under negotiation or entering the Russian market.

In H2 2014, investors' activity will largely depend on the condition of commercial real estate market, that is under pressure from geopolitical situation and the expectations of next package of sanctions against Russian companies and financial institutions. However, even in the case of investment climate improvement and market activity growth, we expect that the investment volume will not exceed $5 billion and will demonstrate the minimum value over the past 4 years. Furthermore, in 2015, we will observe the consequences of the conflict in Ukraine.

By the end of H1 2014, the largest transactions volume fell with high-quality commercial real estate in the Moscow region. Small share of investments in the cities of other regions today results from conservative disposition of investors for whom entry to regional markets is associated with high risks. Shortage of high-quality facilities and insufficient development level of infrastructure also deter the investment activity on the markets of regional cities.

Speaking of the total real estate investment distribution between different segments of the market, significant transactions volume fell to retail and office real estate: the total share of these segments accounted for 86% of the total investment. It is worth noting that during the period a number of investment transactions were conducted for acquisition of unfinished facilities, shares in projects under construction, as well as outdated objects, with a view to further redevelopment. For example, a purchase transaction of an unfinished shopping center River Mall was closed in retail segment by Praktika Development and became the largest investment deal over 6 months in 2014 in both the retail segment and the commercial real estate investment market as such. In the office segment, a share purchase transaction was closed for the Russia tower project in the MIBC Moscow-City, and in the segment of hotel real estate, Azimut Hotels controlled by Alexander Klyachin purchased hotel Belgrade.

In H1 2014, we observed the traditional predominance of Russian investors (78%) on the commercial real estate investment market. The share of foreign capital has not changed much compared to the same period last year, largely due to the closure of a number of transactions that were pending from the previous year. In general, transactions involving foreign investors are occasional and we do not observe new players on the Russian market.

The largest commercial real estate investment sales transactions of H1 2014

Buyer	Seller	Asset	Estimated Value
Praktika Development	Bank of Moscow	SEC River Mall	$325 million
TVO Europe	Capital Group	SC Rechnoy	$150 million
UFG Wealth Management	Brycetown	BC Linkor	$110 million
O1 Properties	Capital Group	BC Nevis (ex. Prizma)	$60 million
Azimut Hotels	Cinium Investments Ltd	Hotel Belgrad	$45 million

Source: Real Capital Analytics; Knight Frank Research, 2014

Business Residence
bld. 1 and 3 Dovzhenko St

Although capitalization rates on the commercial real estate market of Moscow remain high compared to most European markets, however serious risks, lack of transparency and tax issues are making the market less attractive. Several companies took a wait and we are also witnessing a situation where a part of the investment funds is leaving the market and the Russian assets. Contrary to the last year's expectations of growth in foreign investment on the market, due to the uncertain economic growth in Russia and the increased unrest within foreign politics, we have revised the forecast and expect the volume of transactions with foreign capital for the year at the level of 2009–2010 (not more than 20%) in the short run.

Commercial real estate market today is characterized by an absolute imbalance in favor of tenants. Landlords are willing to make concessions and provide more attractive lease terms, especially when it comes to the newly commissioned facilities where vacancy rate is high.

In 2014, about 1.1 million sq m of office space are expected to be delivered on the office real estate market, which would be the highest figure since 2009. Moreover, according to our forecasts, over 3.5 million sq m of space will be delivered by 2017. Such a significant growth in supply against the decline of demand cannot help but affect the dynamics of main indicators.

Today, due to companies willing to optimize office space and reduce rental rates, we witness a situation where a significant amount of demand falls with Class B offices. Furthermore, following the market development and general improvement of facilities quality, the companies that are renting premises in low-quality office buildings now have an opportunity to move to Class B offices without significant changes in commercial terms.

The segment of Class A and B+ offices represents the main stock share of office buildings for sale, while the supply stock of premium objects distinguished by technical characteristics, location and a set of tenants is almost absent. Due to the relocation of companies from low-quality office and industrial buildings, we expect acquisitions of these assets for the purpose of redevelopment.

Retail real estate segment is presently in the active phase of quantitative and qualitative development: competition is getting stronger, which, against the background of a growing number of aging shopping centers (often with good location), leads to growth in the number of objects whose owners are thinking about redevelopment. Today we see only a few examples, but in the near future, this trend may grow stronger. Delivery of about 940 thousand sq m of space (GLA), which is almost a quarter of the existing supply stock, is planned for delivery in Moscow until the end of 2014. The vacancy rate also tends to grow – at the end of the year the figure could reach 4%. We register interest of developers, including foreign companies, towards suburban towns of the Moscow region: about 50 projects in various stages of are currently under construction.

We also note record delivery volumes for the market in the warehousing segment, which resulted in growth of vacancy rates against the backdrop of shrinking take-up. However, this figure is still far from critical, and we do not see a significant downward correction in average rental rates.

Despite the negative dynamics of the main indicators for the commercial real estate market, delivery of projects under construction may become an incentive for some growth of investment market. Although delivery of facilities in the central part of the city could act as a premise to this, such projects are rare due to the shortage of sites, as well as due to a prohibitation on construction within the Third Transport Ring. The office real estate market is characterized by growth of demand for high-quality projects located at a distance from the center. Demand is formed by the companies moving their back-offices or consolidating business units in decentralized facilities to reduce lease expenses. In order to stimulate investor activity, the growth of new supply must be accompanied by certain demand, including one for decentralized offices,

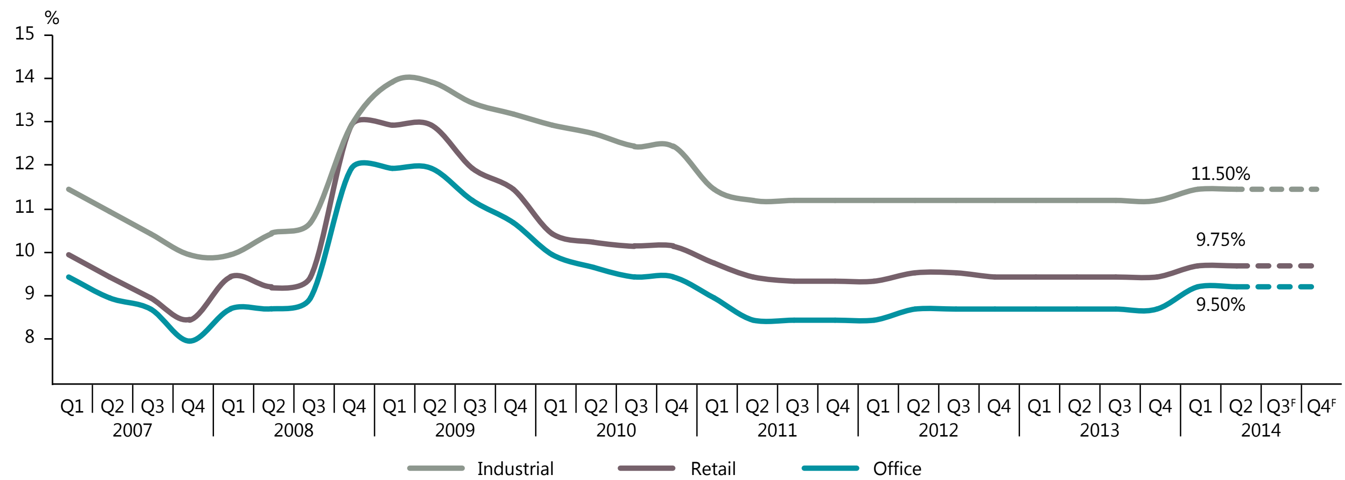

BC Lotos
2 Odesskaya St

as well as by stabilization of rental rates. Affordable financing of commercial real estate is also an important condition for the development of the market, but today it is mainly available to major players and is still mainly provided by the state-owned banks. It should be noted that in April 2014 the international rating agencies downgraded the credit rating of Russia, also changing further forecast to "negative", which is caused by sanctions against Russia. It is highly likely going to limit access to financial markets further.

Today downward dynamics of commercial indicators is observed in all segments: the average rental rates for Class A offices have dropped by 6% compared to the end of the previous year, while in warehouse real estate segment the decline amounted to about 10%.

According to our expectations, there was a slight drop in capitalization rates due to negative economic outlook and declining demand by the end of H1 2014. Capitalization rates for premium office premises amount to 9.25–9.75%; in warehouse real estate segment – 11.25–11.50%; in retail segment – 9.50–10.00%. We do not exclude the possibility of further growth in the case of negative forecasts of economic development within 1 p. p.

Capitalization rates dynamics according to the commercial real estate segments



Source: Knight Frank Research, 2014

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Americas & Canada
Bermuda
Caribbean
Canada
USA

Newmark Knight Frank Global

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

Warehouse and land
Viacheslav Kholopov
Partner, Director, Russia & CIS
viacheslav.kholopov@ru.knightfrank.com

Retail
Sergey Gipsh
Partner, Director, Russia & CIS
sergey.gipsh@ru.knightfrank.com

Residential
Andrey Solovyev
Director
andrey.solovyev@ru.knightfrank.com

International Investments
Heiko Davids
Partner
heiko.davids@ru.knightfrank.com

Investment and Sales
Alan Baloev
Director
alan.baloev@ru.knightfrank.com

Business Development
Andrey Petrov
Partner
andrey.petrov@ru.knightfrank.com

Strategic Consulting
Konstantin Romanov
Partner, Director, Russia & CIS
konstantin.romanov@ru.knightfrank.com

Valuation
Olga Kochetova
Director, Russia & CIS
olga.kochetova@ru.knightfrank.com

Property Management
Dmitry Atopshev
Partner, Director
dmitry.atopshev@ru.knightfrank.com

Project Management
Andrew Zakrewsky
Partner
andrew.zakrewsky@ru.knightfrank.com

Marketing, PR
Izabella Atoyan
Director, Russia & CIS
izabella.atoyan@ru.knightfrank.com

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

Saint Petersburg
Nikolai Pashkov
General Director
nikolai.pashkov@ru.knightfrank.com

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MOSCOW

Russia, 115054,
26 Valovaya St
Lighthouse BC

Phone: +7 (495) 981 0000
Fax: +7 (495) 981 0011

ST. PETERSBURG

Russia, 191025,
3B Mayakovskogo St
Alia Tempora BC

Phone: +7 (812) 363 2222
Fax: +7 (812) 363 2223