RESEARCH

MOSCOW

OFFICE MARKET OUTLOOK

Q1 2017

OCCUPIER TRENDS | INVESTMENT TRENDS | MARKET OUTLOOK

KEY FINDINGS

Russia's economy is forecast to show a return to positive growth in 2017, though economic growth will remain low.

Occupier activity was driven by optimisation of rental costs with a clear flight to quality.

Class A and B rental rates fell to RUB24,280/sq m and RUB13,379/sq m per annum respectively.

Russian office investment volumes totalled US$3.0 billion in 2016, up 11% from the previous year.

FIGURE 1
Office take-up, sq m

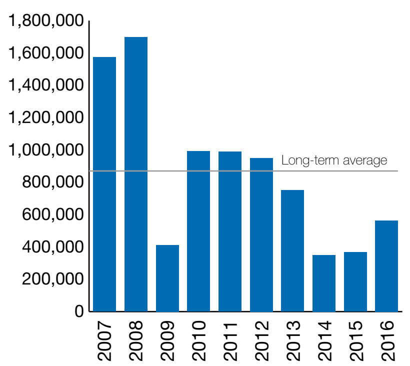
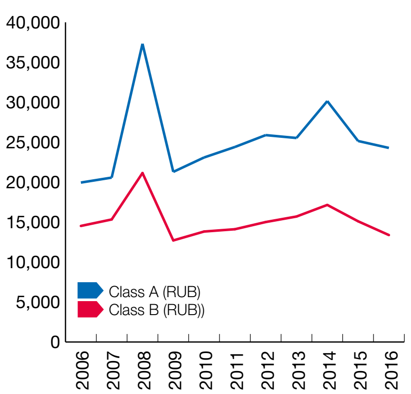


FIGURE 2
Average asking office rents
RUB per sq m per annum



Source: Knight Frank Research

OCCUPIER MARKET

Russia is slowly emerging from a two-year recession caused by low oil prices and western sanctions.

The office real estate market is adapting to these economic shocks and this year should bring further improvements, as the economy moves into positive growth territory. However, structural weaknesses, low investment and fiscal tightening will constrain GDP growth below 2% a year in over at least the medium term. Improvements in business and consumer confidence are, however, expected to reinforce economic growth.

Occupier activity improved marginally in 2016 following the previous year's trough, with take-up reaching 564,000 sq m (Figure 1). State-owned banks and government agencies were active, purchasing offices for their own occupation. Given the imbalance between oversupply in the market and subdued demand, further recovery in the occupier market will be slow to materialise. Occupier activity is being driven primarily by tenants upgrading into Class A space and capitalising on lower rental levels. It is also supported by landlord willingness to offer flexible lease terms and incentive packages to both existing and prospective tenants.

Notably, the central business area witnessed increased demand due to falling rates. However, as the city government intends to expand the limits of the paid parking area, this has prompted occupiers to consider parking requirements and widen the search area for future occupational requirements beyond the central business area.

Overall, the market is showing signs of stabilisation with the vacancy rate having declined given the 15-year low delivery volume to 17.0%. In 2016, a little over 300,000 sq m of new office space was introduced. Yet availability still remains high at around 2.6 million sq m, with the central business districts characterised by a shortage of supply, in contrast to offices in more remote business locations which remain vacant. A total of 700,000 sq m of office space is currently under construction although the completion dates of many of these projects are likely to be delayed, allowing some of the existing space to be absorbed.

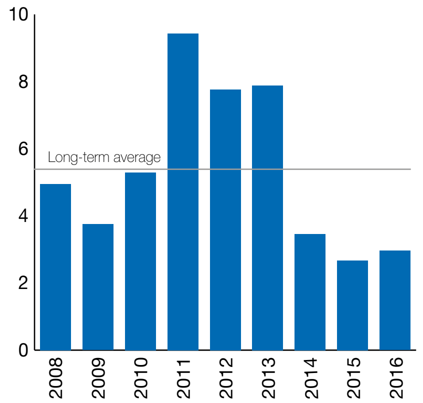
The Russian Ruble has finally become the dominant currency on lease agreements. Indexation is still subject to negotiation but generally ranges between 7-8%. The average asking rents for Class A have fallen moderately by 3.5%, in contrast to Class B rents which saw a decline of 11% over the year (Figure 2).

Key office leasing transactions in 2016

Building	Occupier	Building Class	Size (sq m)
Aurora Business Park	Yandex	A	10,333
Novinsky Passage	Samsung	A	10,000
Ina House	CDIIS (Transeft)	B+	9,000
Danilovskaya Manufaktura	Sberbank	B+	8,500
Port Plaza	Rosenergoatom	B+	8,449
Vereyskaya Plaza I	Gazprom-Media Holding	B+	7,991

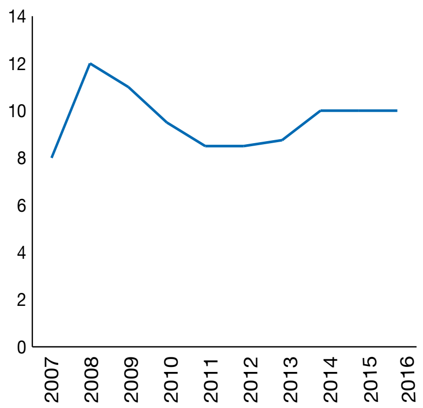
Source: Knight Frank Research

FIGURE 3
Russia office investment volumes
US$ billion



Source: Knight Frank Research

FIGURE 4
Prime office yields
%



Source: Knight Frank Research


The Evolution Tower purchased by Transneft in 2016

INVESTMENT MARKET

Russia's investment market is becoming more active, with the return of domestic investors and the increased willingness of vendors to dispose of prime assets. This has been against the backdrop of gradual improvement in the key macroeconomic indicators and a strengthening national currency.

The office sector remains dominant, accounting for over 70% of the total transaction volume. In 2016, US$3.0 billion was invested into Russia's office sector, up 11% on 2015 volumes but well below the long-term average (Figure 3). The largest deals to close were for the acquisition of office buildings or office space for owner occupation, such as the Evolution Tower sale. Debt transactions also featured prominently, including President Plaza and Eurasia Tower to which Sberbank and VTB will locate their offices.

Foreign investors have remained risk averse with the market witnessing virtually no deployed foreign capital during 2016. A multi-directional trend is however expected this year. Foreign companies and funds who have decided to reduce their business presence in Russia will continue to dispose of assets. At the same time, a number of deals are expected to close involving foreign investors who are continuing their development in the Russian market despite some economic uncertainty. A joint venture between a Hong Kong offshore company and Avica recently acquired Voentorg which had been in negotiations since autumn last year. The sale of Metropolis II is also currently pending and if settled, will be jointly owned by American investor Hines and Czech fund PPF Real Estate.

Prime yields remained at 10.0% in 2016 (Figure 4) and are expected to remain stable throughout 2017. The office sector will continue to be dominant particularly in end-user purchases and non-cash deals are also expected to be prevalent.

Key office investment transactions in 2016

Building	Vendor	Purchaser	Price (USD million)
Evolution Tower	Snegiri Development	Transneft	960.0
Eurasia Tower	Nafta Moskva	VTB	723.5
President Plaza	Raslan Baysarov	Sberbank	302.8
OKO Tower	Capital Group	Moscow City Government	223.7

Source: Knight Frank Research

KNIGHT FRANK VIEW

Some improvements to the occupational market are expected in 2017, albeit the pace will be slow. The market is now bottoming out – rental rates are expected to stabilise in 2017, with owners testing market conditions on the acceptance of higher rates.

Though there has been growing interest in the investment market, activity throughout 2017 is likely to be comparable to 2016 volumes. Local players will continue to be the most active and dominate the market, with a clear focus on quality assets. This year will however see increased activity from foreign investors particularly as several deals from 2016 are expected to close.

The demand cycle is passing through the trough, and yields are expected to stabilise for the remainder of the year.

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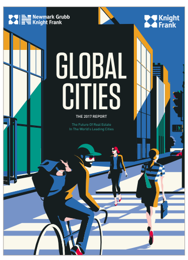

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