Office Market Report

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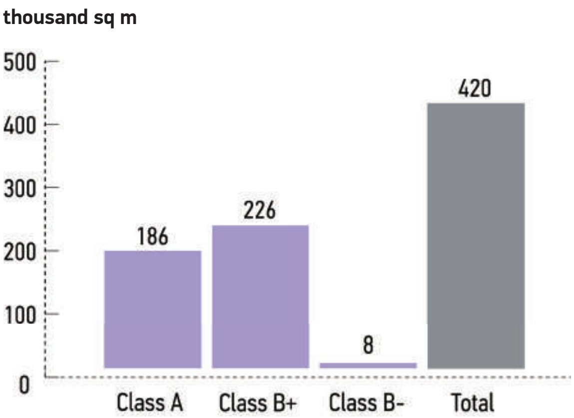
ILM
real estate intelligence

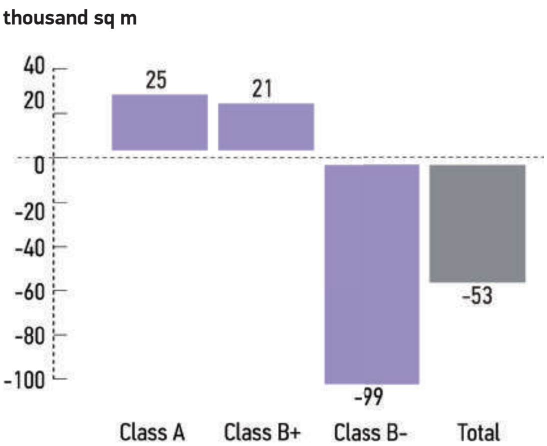
2Q. 2015
Moscow

Main Indicators, Q2 2015

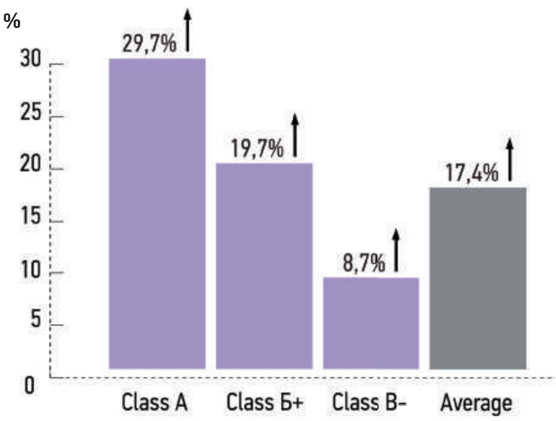
Increase in supply in Q1-Q2 2015



Net absorption, Q1-Q2 2015



Vacancy rates*

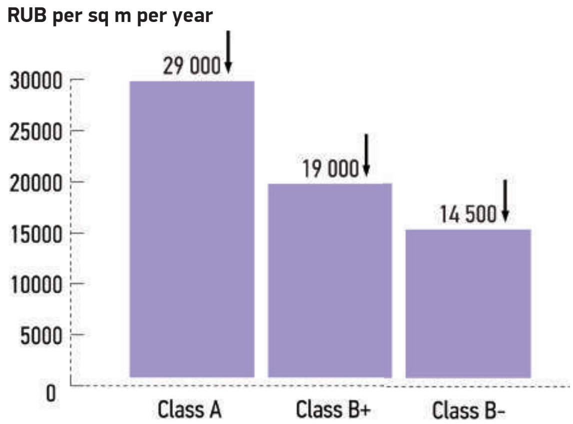


**Comparing to the end of Q1 2015*

Dmitry Myslin
Manager Partner

The vacancy rate growth will only begin to decelerate in 2016. At present, we can't see any preconditions for a rise in rental rates until 2018.

Average base rental rates, in rubles*



Rental rates excluding VAT (18%) and Operation Expensess

- After a significant supply increase during previous periods, Q2 2015 saw some new construction rate decrease: 128,000 sq. m. of office space was commissioned vs. 291,000 sq. m. in the previous quarter. However, new construction volumes significantly exceeded companies' demand in new space lease.
- To reduce costs, companies have continued optimizing office spaces and reducing occupied areas. As for the end of H1, the total amount of net absorption remains in the negative zone, and is equal to -53,000 sq. m.
- The share of vacancies during Q2 increased by 0.3 percent, and on the basis of June's results, this amounted 17.4% on average in the market, again rising up to a record value. Currently the vacancy is 3.14 million sq. m. of office space, 1.15 million sq. m. of it being Class A properties.
- We have continued to see a decrease in rental rates. Unlike the first three months, the rental rate decrease diminished during Q2. The decline in the average basic asking rental rates in Russian currency for Class A spaces amounted to 8% - down to 29,000 rubles per sq. m. per year.

Andrey Lukashev
Manager Partner

Commissioning of new spaces in a 'Shell and Core' condition influences the market vacancy rate significantly. In the current market conditions, lessors heighten their competitive ability by having a readiness to provide basic finishing and also to divide spaces into 500 sq. m. units for desirable tenants.

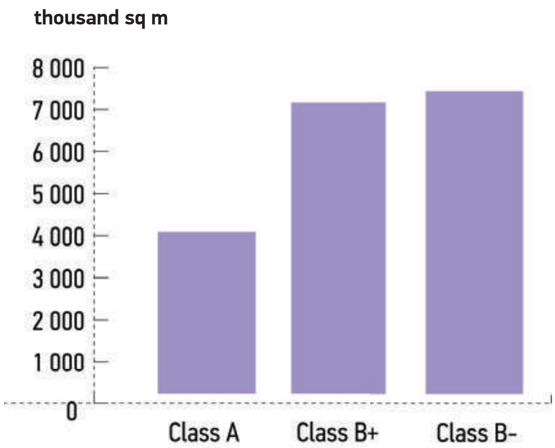
Supply

Based on the results of H1 2015, the overall market for quality office space in Moscow exceeded 18 million sq. m. The trend of space distribution in terms of classes has stayed the same: 21% of these spaces are Class A; 39% - Class B+; the rest consists of Class B- spaces.

After a significant supply increase in 2014 and during the first few months of 2015, Q2 2015 saw some new construction rate decrease: 128,000 sq. m. of office space was commissioned vs. 291,000 sq. m. in the previous quarter. In total, 8 office spaces entered the market during Q2. Almost 70% of all premises commissioned throughout this period are Class A spaces.

Examples of such spaces are: the Pallau-RB business centre on Rublevo-Uspenskoye Shosse (office area: 46,500 sq. m.); building B of the K2 business park (office area: 18,220 sq. m.); as well as the fifth structure of the multi-use centre on the territory of the Krylatskiye Kholmy business park (office area: 24,606 sq. m.). It should be noted that some of the spaces in the Pallau-RB and K2 complexes have already been sold as of the commissioning date.

Total stock, Q2 2015



Increase in supply

Major properties commissioned in Q1 2015*

Office building	Address	Developer	Class	Office area, sq m
Pallau-RB	Rublevo-Uspenskoe sh. vl. 1	Ferro Stroy	A	46 500
Krylatsky Hills, bld. 5	Krylatskaya Str. 19	CMI Development	A	24 606
K2 Business-Park, bld. B	Kaluzhskoe sh. 2 km from MKAD	Storm Properties	A	18 220
Sheremetyevsky Office Park, bld. 5	Polkovaya Str. 3, bld. 5	Bolshoy Gorod	B+	13 000
Shabolovka 31, bld. 11	Shabolovka Str. 31, bld. 11	GPZ-2	B+	7 930

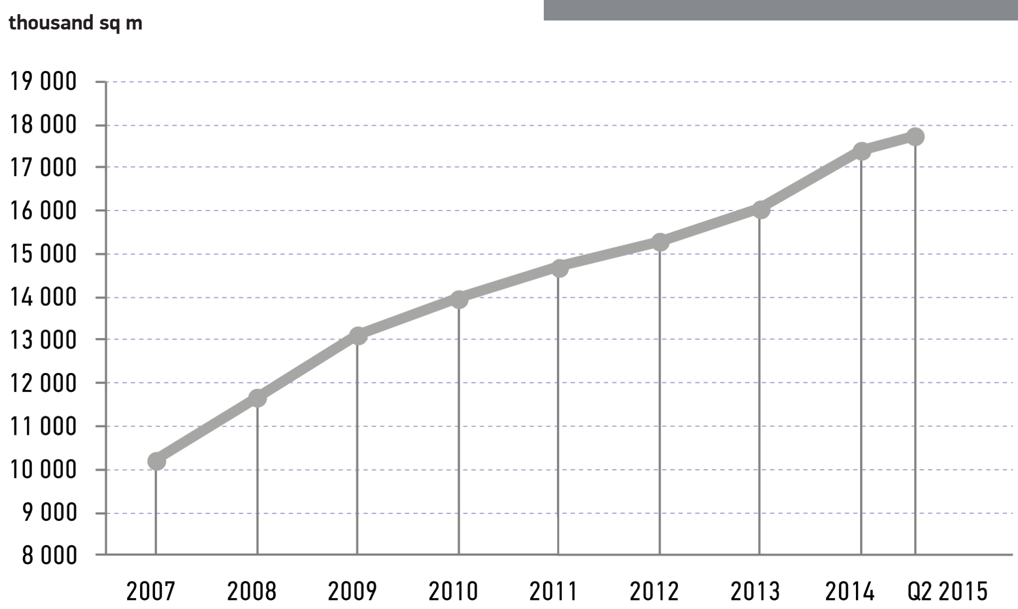
**Buildings which were commissioned as well as those which reconstruction will be completed in Q2 2015*

Overall, during six months of the present year, new construction volumes remained at a high level and amounted to 420,000 sq. m. This is 20% less than for the same period last year, when the amount peaked at its highest compared to the previous 5 years. On average, from 2010 until 2014, the new supply volumes in H1 amounted to 355,000 sq. m.

Thus, at the end of H1, the total volume of the office space market increased by 3.2% due to new construction. For Class A spaces this increase amounted to 5.1%; for Class B the increase amounted to 1.7%.

The visible trend in the current Moscow office space market is its decentralization; and this trend is still gaining ground. During Q2, only 5% of office spaces were commissioned within the Central Administrative District. The maximum new supply amount, at 70%, took place in districts near the Moscow Ring Road in western and south-western directions.

Total stock trend



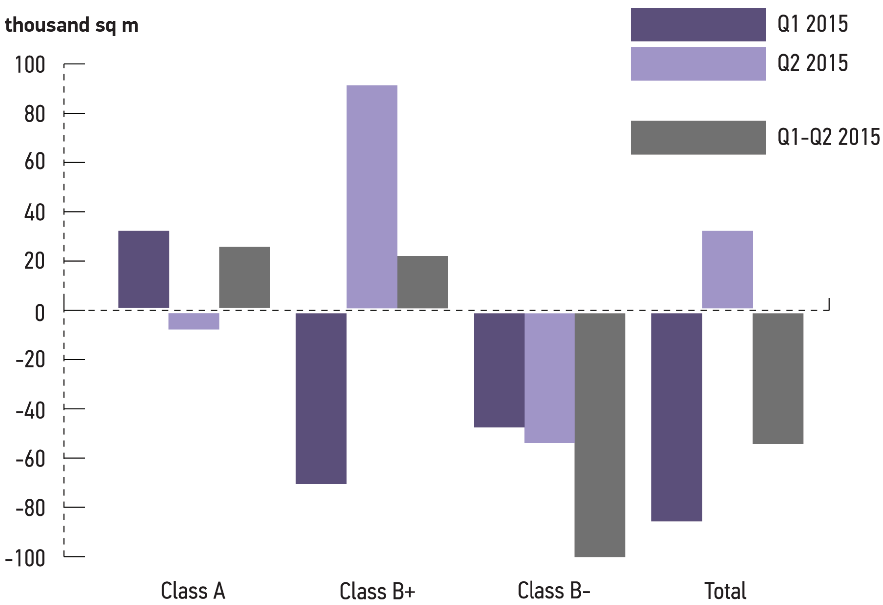
During H2 2015, developers announced an additional 600,000 sq. m. of high-quality office spaces in the Moscow market. However, we can already see that construction of some projects has been decelerating, and commissioning deadlines are being postponed. In some cases, the owners freeze construction and postpone the building commissioning while waiting for anchor tenants. Entrance of scheduled projects to the market will result in a further rise in excess supply and growth of vacant spaces in low absorption conditions. According to our estimates, at the end of 2015, the total volume of the Class A space market may exceed 4 million sq. m.

Major properties expected to be commissioned in 2015

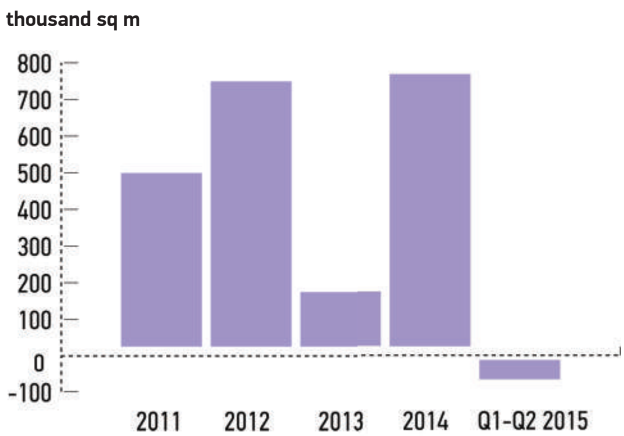
Property	Address	Developer	Class	Office area, sq m
Oruzheiny	Oruzheiny per. 41	Sadovoe Koltso	A	90 000
Simonov Plaza	Leninskaya Sloboda Str. 26	City&Malls PFM	B+	65 500
Suvorov Plaza	Kutuzovsky pr-t 32	Stroygazconsulting	A	60 000
Neopolis	Kievskoe sh., 3 km from MKAD	A-Store Estates	A	52 700
Atlantic	Mozhaisky Val Str. vl. 8	Dallas Development & Construction	A	48 500
Nagatino i-Land, ph. II, Dekart	Andropova pr-t 18	Moscow business incubator	B+	31 000
Biznes-park G10, ph. I	Kievskoe sh., 0,5 km from MKAD	Comstrin	A	30 200
Algoritm	Akademika Pilyugina Str. 22	BIN	B+	28 713
Kuntsevo Plaza	Yartsevskaya Str. 19	Enka	A	28 110
Otradnoe, ph. II	Otradnaya Str. 2B	Motek-C	B+	25 300
Novator	Khimki, Kirova Str.	MDK Group	B+	24 000
Bolshevik, ph. Ib	Leningradsky pr-t 15, bld. 1	O1 Properties	A	19 700
K2 Business-Park, bld. C	Kaluzhskoe sh. 2 km from MKAD	Storm Properties	A	18 220
Danilov Plaza	Novodanilovskaya emb. vl. 6	MR Group	B+	13 539

Demand

Net absorption, Q1-Q2 2015*



Net absorption trend



During conditions of economic uncertainty, companies continue optimizing office spaces and reducing occupied areas in order to reduce costs.

As at the end of H1, the total volume of net absorption showing the change of office spaces currently occupied by tenants remains in the negative zone and is equal to -53,000 sq. m., which is 313,000 sq. m. less than the value from the last quarter. The greatest influence on the negative value of the total net absorption volume is the significant vacation of premises in Class B- properties. Here, an additional 99,000 sq. m. were added to the already available vacancies during the half-year.

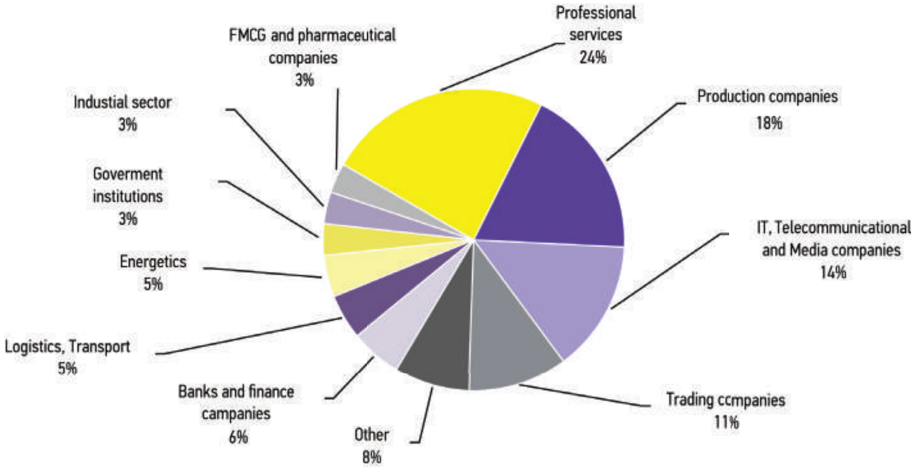
However, the positive trend of the total net absorption volume only in H2 2015 should be noted. At the end of three months, net absorption amounted to 31,000 sq. m., which is 115,000 sq. m. more than the value from the previous quarter, when the net absorption was in the negative.

**Net absorption show changes in the absorption of office spacey tenants for a certain period. Net absorption is calculated as: S1 + Shew - S, where S1 – vacant office premises at the beginning of the given period, Sw - new supply of officepremis for the given period, S2 - vacant office premises at the end of the given period.*

In whole, at the end of H1, the demand for new office spaces was characterized by vacation of a significant percentage of Class B-premises and a positive value for the net absorption in Class A/B+ properties. All this reflects an increase in affordability of high-class properties and a migration of tenants up to higher quality properties.

As previously, a significant portion of the deals in the current market are for revision of lease terms. Many tenants prefer to renew the current building lease, obtaining comfortable commercial terms. To retain their tenants, owners must meet the wishes of these companies, decreasing rental rates or fixing parities of currencies.

The structure of demand according to the branch of buisiness activity, Q2 2015



The analysis is based on the total number of applications received by ILM by the represented buisiness Q1-Q2 2015

Key deals in Q2 2015

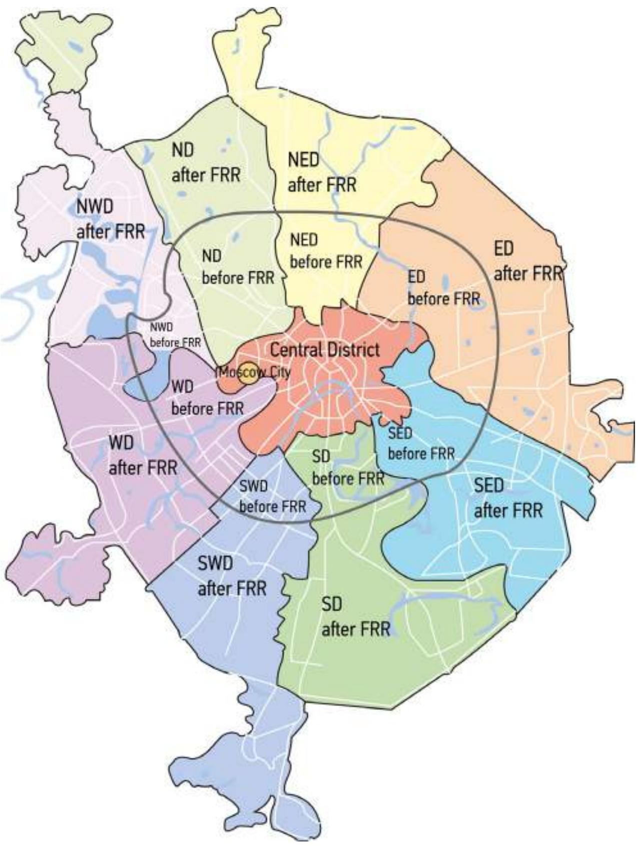
Company	Area, sq m	Type of deal	Property	Adress
O'Key	9 000	lease	Simonov Plaza	Leninskaya Sloboda Str. 26
BASF, Engelhard Metals Russia	7 500	lease	Arcus III	Leningradsky pr-t 37A
Swatch	2 682	lease	Delta Plaza	2 Syromyatnichesky per. 1
Comedy Club*	2 645	lease	Mishina Str. 24 bld. 1	Mishina Str. 24 bld. 1
RFC CFD	2 500	lease	Sheremetyevsky Office Park, bld. 5	Polkovaya Str. 3, bld. 5
KamaGames*	1 635	lease	Central City Tower, Phase I	Ovchinnikovskaya emb. 20/1
Rosnefteflot*	1 100	lease	Imperia Tower	Presnenskaya emb. 6, bld. 2
Mils Solutions*	997	lease	Barklay Park	Barklaya Str. 6, bld. 3

** ILM acted as a consultant of the transaction*

Reviewing the distribution of demand across industries of office space users, it is possible to see that the internal structure has not changed when compared with Q1 data. As before, the primary consumers of office spaces are service companies. They account for 24% of all queries, which is 7% greater than the amount from the same period last year.

A steady demand is demonstrated by industrial and IT companies. At the end of June, the volume of queries from such companies amounted to 18% and 14%, respectively. Financial sector companies continue to remain cautious during conditions of economic uncertainty. Throughout the year, the quantity decreased by a factor of two, and at the end of H1, amounted to 6% of all queries.

Net absorption in various Moscow districts at the end of Q2 2015



District	Class A	Class B+	Class B-
Central District	-29,3	-19,0	-27,0
Moscow-City	50,2	-2,6	-*
NED before FRR	0,6	-6,4	-5,8
NED after FRR	-*	-7,3	-7,1
ED before FRR	8,2	-11,3	10,2
ED after FRR	-*	0,0	0,5
SED before FRR	1,2	-3,5	-1,4
SED after FRR	-*	0,6	2,0
SD before FRR	-5,2	10,0	-23,0
SD after FRR	-*	-7,0	-7,1
SWD before FRR	0,0	2,8	-2,8
SWD after FRR	12,1	60,7	-9,1
WD before FRR	-43,8	-2,9	-5,7
WD after FRR	27,1	-29,3	-2,3
NWD before FRR	-*	-*	1,3
NWD after FRR	1,8	29,4	-3,3
ND before FRR	1,0	2,4	-18,3
ND after FRR	0,8	6,3	-1,0

**Buildings not applicable in the indicated district*
***FRR - Fourth Ring Road*

Vacancies

New construction volumes have significantly exceeded companies' demand in new office space lease. The negative value of the total net absorption volume only aggravates the situation in the market, resulting in an excess of supply which leads to a further rise in vacant spaces.

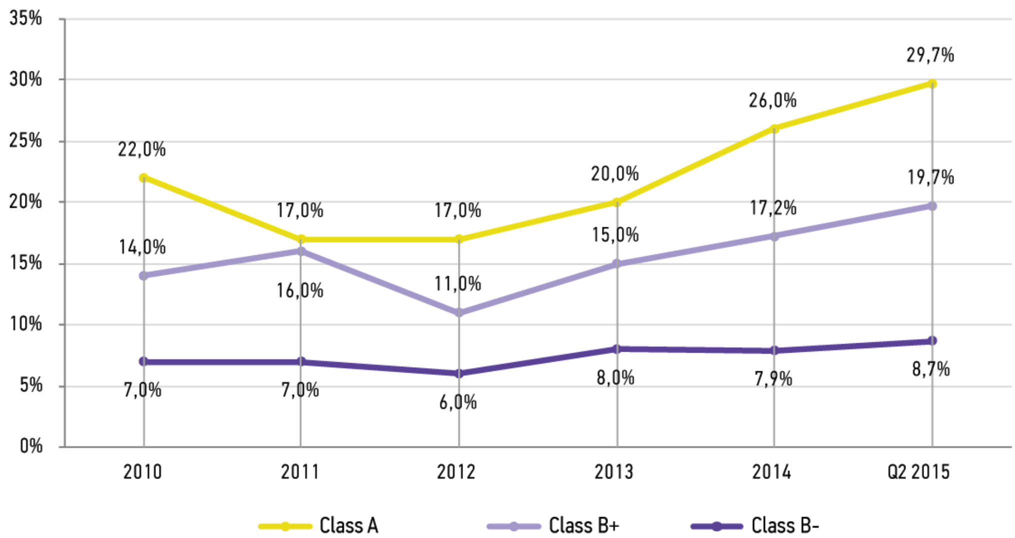
The share of vacancies in the Moscow office space market during Q2 2015 increased by 0.3 percentage points, and on the basis of June's results, this amounted 17.4% on average in the market, again rising to a record value. At present, vacancy comes to 3.14 million sq. m. of office space, 1.15 million sq. m. of it being Class A.

The behaviour of space vacation varies, depending upon class. For example, in Class A the index reached its maximum — 29.7%. The growth of vacancies during three months amounted to 1.9 percentage points, which is greater than that of the previous quarter by 0.3 percentage points, while in Class B+ a slight vacancy share decrease took place: by 0.4 percentage points – down to 19.7%. This was a consequence of a low new construction volume (39,000 sq. m.) together with the growth of net absorption in such properties.

Due to the vacation of occupied spaces and relocation of companies, the vacancy rate in Class B- properties has risen by 0.4 percentage points, and as of the end of Q2, it amounted to 8.7%.

As previously, the maximum amount of vacant Class A office spaces is in the Western District before FRR (96.6%) and in the North-Western District after FRR (63.4%) (FRR stands for "Fourth Ring Road"). These are the districts where major properties with substantial or 100% vacancy are concentrated.

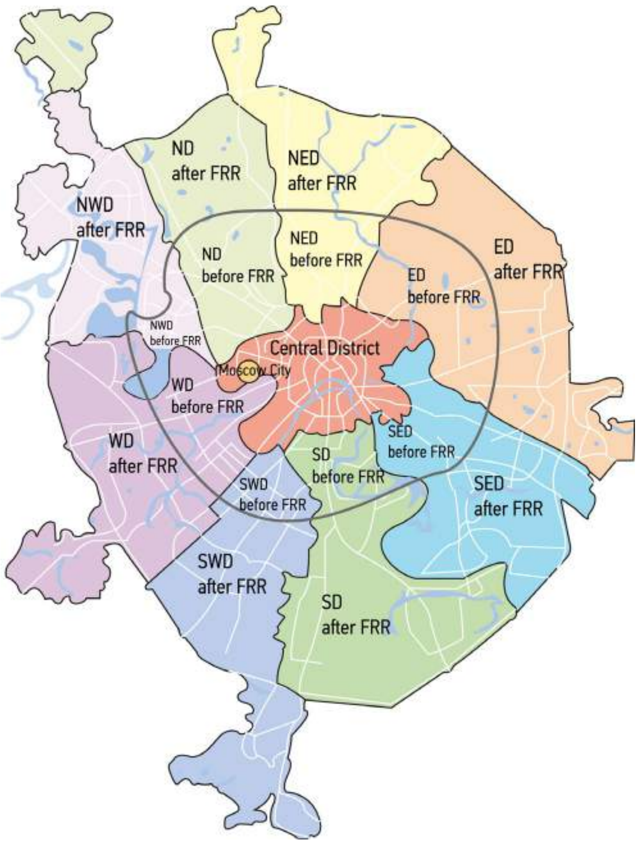
Vacancy rate trend



Despite the maximum value of the net absorption in the total demand volume, a high level of vacancy remains in Moscow City: the aggregate area of vacant spaces at the end of March amounted to 42.9%; this is in excess of 400,000 sq. m. Such an amount of vacancies is primarily due to the large volume of the total supply, which is only expected to grow higher in the years to come.

In the Central District, Class A vacancies decreased by 0.6 percentage points, down to 18.4%. The situation in Class B is quite the opposite: in three months, the index grew by 0.5% and amounted to 10.5%.

Vacancy rate in various Moscow districts at the end of Q2 2015



District	Class A	Class B
Central District	18,4%	10,5%
Moscow-City	42,9%	14,6%
NED before FRR	0,0%	16,9%
NED after FRR	-*	20,6%
ED before FRR	43,5%	8,6%
ED after FRR	-*	4,2%
SED before FRR	47,9%	14,7%
SED after FRR	-*	8,5%
SD before FRR	20,0%	15,7%
SD after FRR	-*	17,7%
SWD before FRR	46,1%	12,1%
SWD after FRR	32,4%	13,7%
WD before FRR	96,6%	31,8%
WD after FRR	21,8%	22,9%
NWD before FRR	-*	0,0%
NWD after FRR	63,4%	17,3%
ND before FRR	14,3%	9,6%
ND after FRR	33,7%	8,5%

**Buildings not applicable in the indicated district*
***FRR - Fourth Ring Road*

Rental rates

Q2 2015 again saw a decrease in average quality office space rental rates.

The rental cost decrease Y/Y was significant. The average rental rates for Class A premises in US dollar terms amounts to $520 per sq. m. per year vs. $750 per sq. m. per year at the end of Q2 last year. However, according to our forecasts, this decrease will slow down in the next one to two years.

Unlike the first three months, the rental rate decrease diminished during Q2. The decline in average basic asking rental rates in rubles for Class A spaces amounted to 8% vs. 12.5% in Q1 - down to 29,000 rubles per sq. m. per year. Against the background of the strengthening of the ruble, the rental rate in the segment of premises of this class, in terms of US dollars, decreased in Q2, falling by as much as 4%.

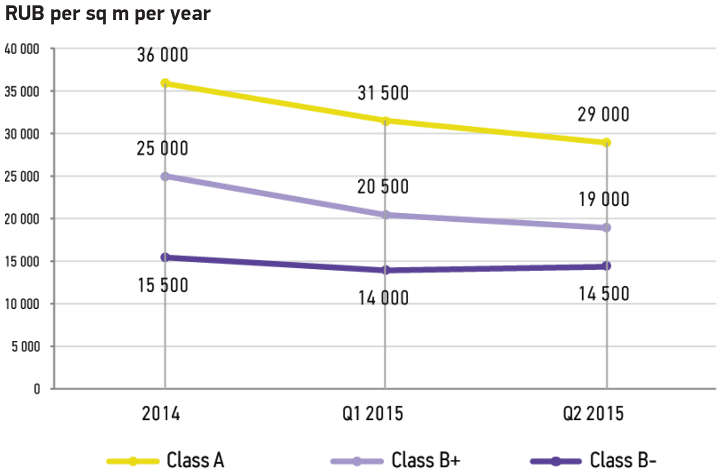
In Class B+ offices, the average asking rental rate has also decreased and at the end of H1 amounted to:

- in ruble terms, 19,000 rubles per sq. m. per year (-6% from Q1 last year);

- in US dollar terms, $345 per sq. m. per year (-1.5%).

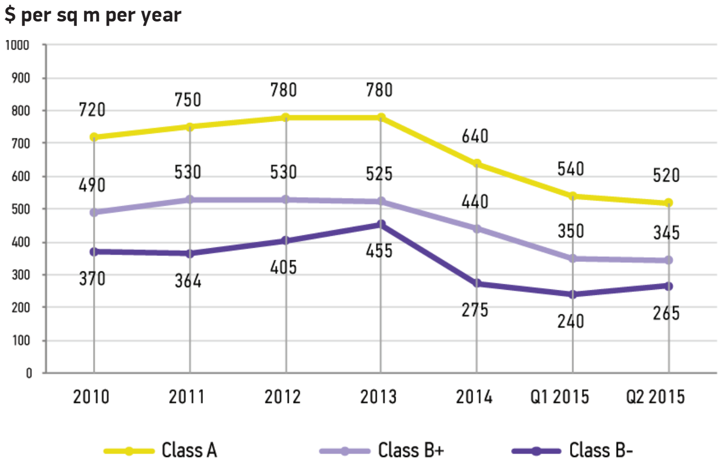
The situation in Class B- is quite the opposite. The average basic asking rental rate in Russian currency grew by 4%, rising to 14,500 rubles per sq. m. per year during Q2. This was caused by a structural change of supply. In conditions of affordability of high-class premises in Class B-, more expensive spaces became vacant. They determine the average rental rates in this segment. The growth of property tax influences rental cost in this class as well.

Average base rental rates, in rubles



Rental rates excluding VAT (18%) and Operation Expensess

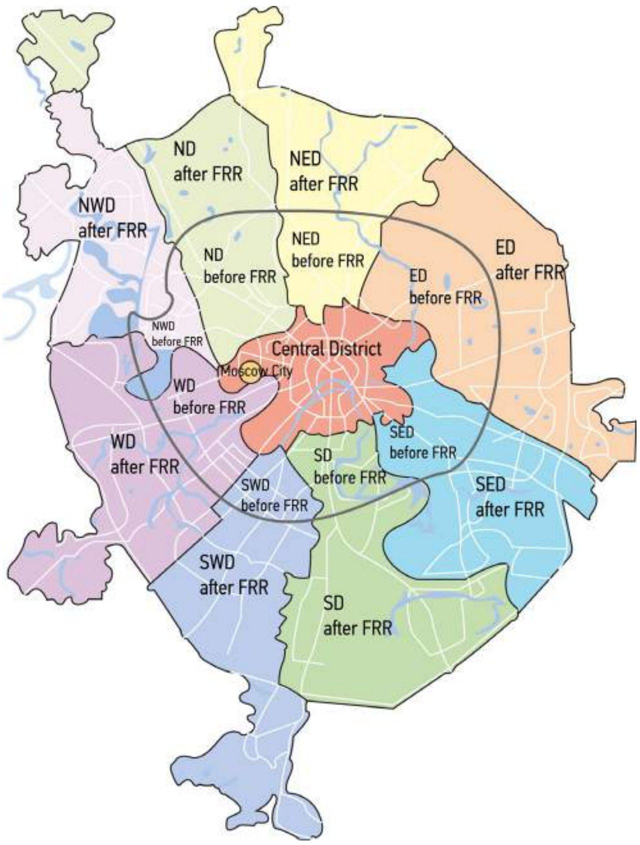
Dynamics of average base rental rates, at the end of th quarter



Rental rates excluding VAT (18%) and Operation Expensess

The signing of ruble-based rental agreements remains the basic trend in today's market. Taking into consideration the current economic situation, a significant percentage of premise owners agree to tenants having their rental rates in rubles or fixing the parities of currencies. However, the majority of Class A property owners are not ready for a dramatic change in commercial conditions for long rental periods, and more often they sign agreements fixing parities of currencies for either one or two years.

Avarage base rental rates in various Moscow districts at the end of Q2 2015



District	Class A	Class B+	Class B-
Central District	40 500 RUB	27 500 RUB	19 200 RUB
Moscow-City	30 300 RUB	26 600 RUB	-*
NED before FRR	-*	13 600 RUB	13 325 RUB
NED after FRR	-*	9 400 RUB	13 047 RUB
ED before FRR	19 200 RUB	17 200 RUB	10 800 RUB
ED after FRR	-*	13 900 RUB	10 800 RUB
SED before FRR	26 100 RUB	15 800 RUB	10 800 RUB
SED after FRR	-*	13 900 RUB	13 000 RUB
SD before FRR	30 000 RUB	17 500 RUB	13 000 RUB
SD after FRR	-*	10 000 RUB	11 100 RUB
SWD before FRR	24 400 RUB	30 300 RUB	16 700 RUB
SWD after FRR	21 400 RUB	20 800 RUB	18 100 RUB
WD before FRR	23 600 RUB	23 000 RUB	16 400 RUB
WD after FRR	20 800 RUB	13 300 RUB	10 300 RUB
NWD before FRR	-*	-*	-*
NWD after FRR	13 300 RUB	19 700 RUB	15 800 RUB
ND before FRR	33 300 RUB	22 500 RUB	14 400 RUB
ND after FRR	15 500 RUB	14 400 RUB	10 800 RUB

Rental rates excluding VAT (18%) and Operation Expensess.
**Buildings not applicable in the indicated district*
***FRR - Fourth Ring Road*

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