The total H1 2020 completions amounted to ***60,900*** *sq m*

The vacancy rate reached ***9.0%*** *in Class A and* ***6.7%*** *in Class B*

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OFFICE MARKET REPORT. MOSCOW

H1 2020

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«The demand slowdown in the market is derived from tenant behavior. Tenants are awaiting and asses inside processes and external market changes. The main goal of them currently is evaluation of needed and not surplus office area after which companies would be ready for any solution realization. The tendency of partial surrender is continuing and already influenced the market conditions. Landlords are ready to be flexible in negotiations upon commercial terms if tenants is ready for renewal in current buildings. The bulk of users are expecting rents and prices decline. However, even considering deterioration of the business environment, the significant drop is not forecasted, still some chance remains. The postpone of new projects delivery is forecasted strongly, the annual result could be record low again.»

Key findings

- The total H1 2020 completions amounted to 60,900 sq m, two times lower YoY.
- The vacancy rate reached 9.0% in Class A and 6.7% in Class B.
- The asking rents were 25,044 RUB/sq m/year in Class A and 16.609 RUB/sq m/year.

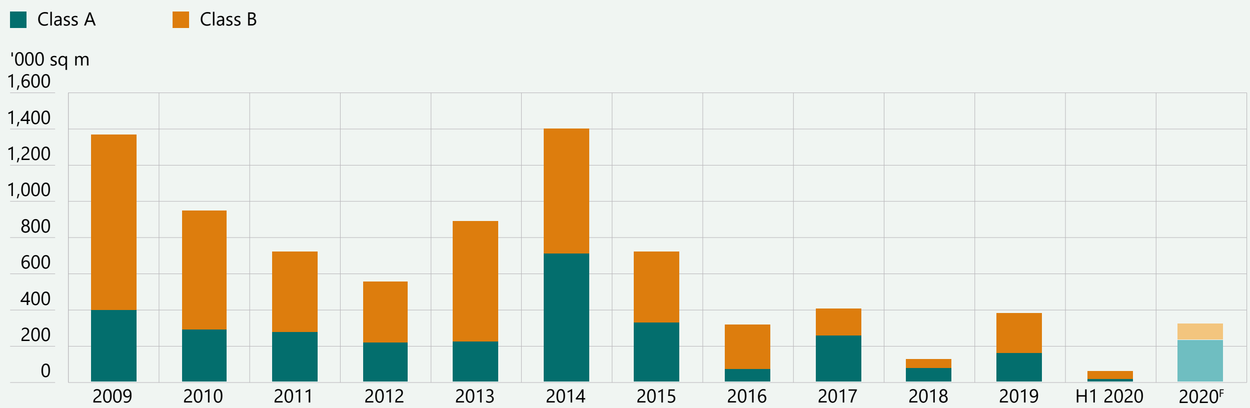
Key indicators

		Q1 2020	Q2 2020
Total stock, ‘000 sq m		16,829	16,834
	Class A	4,480	4,480
	Class B	12,349	12,354
New supply, ‘000 sq m		55.8	5.1
	Class A	15.4	0
	Class B	40.4	5.1
Vacancy rate, %	Class A	8.6	9.0
	Class B	6.6	6.7
Average weighted asking rental rate*, RUB/sq m/year**	Class A	25,101	25,044
	Class B	16,985	16,609
OPEX rate range*, RUB/sq m/year	Class A	7,100	7,100
	Class B	4,800	4,800

* Compared to Q1 2020 results.
** Excluding operational expenses, utility bills and VAT (20%)..

Source: Knight Frank Research, 2020

Class A and B new supply dynamics



Source: Knight Frank Research, 2020

Supply

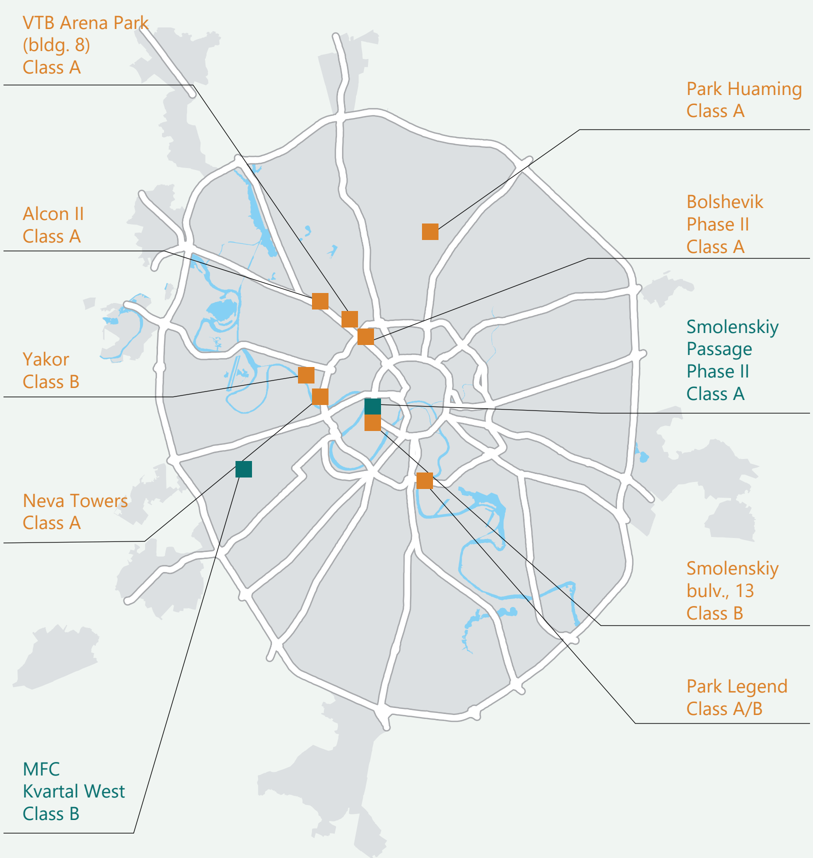
In H1 2020, the total Moscow office stock amounted to 16.8m sq m, where 4.5m sq m or 27% refers to Class A and 12.3m sq m or 73% to Class B.

Due to the coronavirus pandemic the development activity dropped, the total new supply volume accounted for only 60,900 sq m, two times lower YoY. The only project delivered in Class A in H1 2020 was Smolenskiy Passage Phase II (15,351 sq m), in Class B the largest project was MFC Kvartal West (33 944 sq m).

The uncertainty of the market and the economy which has already caused a sharp drop in demand, has led to the postponement of the commissioning of some objects, profile developers are watching the behavior of users and trying to predict the future vector of market development. Since 2017, the volume of new offices has been steadily decreasing, despite the relatively high result of the previous year, the market can again expect a long decline in the volume of new offices.

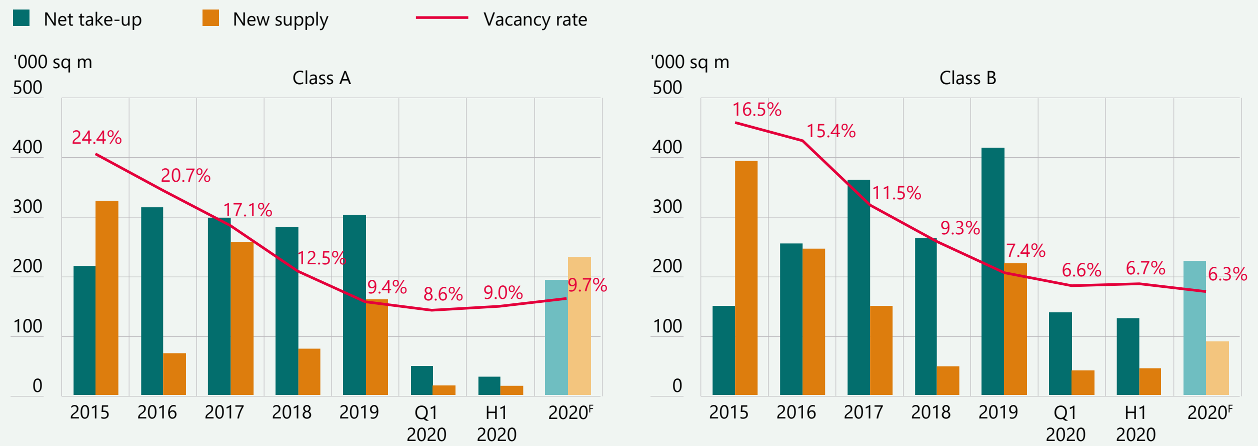
The vacancy rate has demonstrated the growth in both Classes despite the decline comparably the end of 2019. In H1 2020, the Class A vacancy rate accounted for 9.0% against 8.6% in Q1, 403,000 sq m of office space is still available. In Class B the indicator has also rose, from 6.6% to 6.7%, 831,000 sq m is still available in the market. In Class A, the vacancy rate is expected to increase at the end of the year. In Class B, a moderate decline is expected due to the small volume of offices announced for commissioning, but it will not be comparable to the dynamics

Properties scheduled for delivery throughout 2020



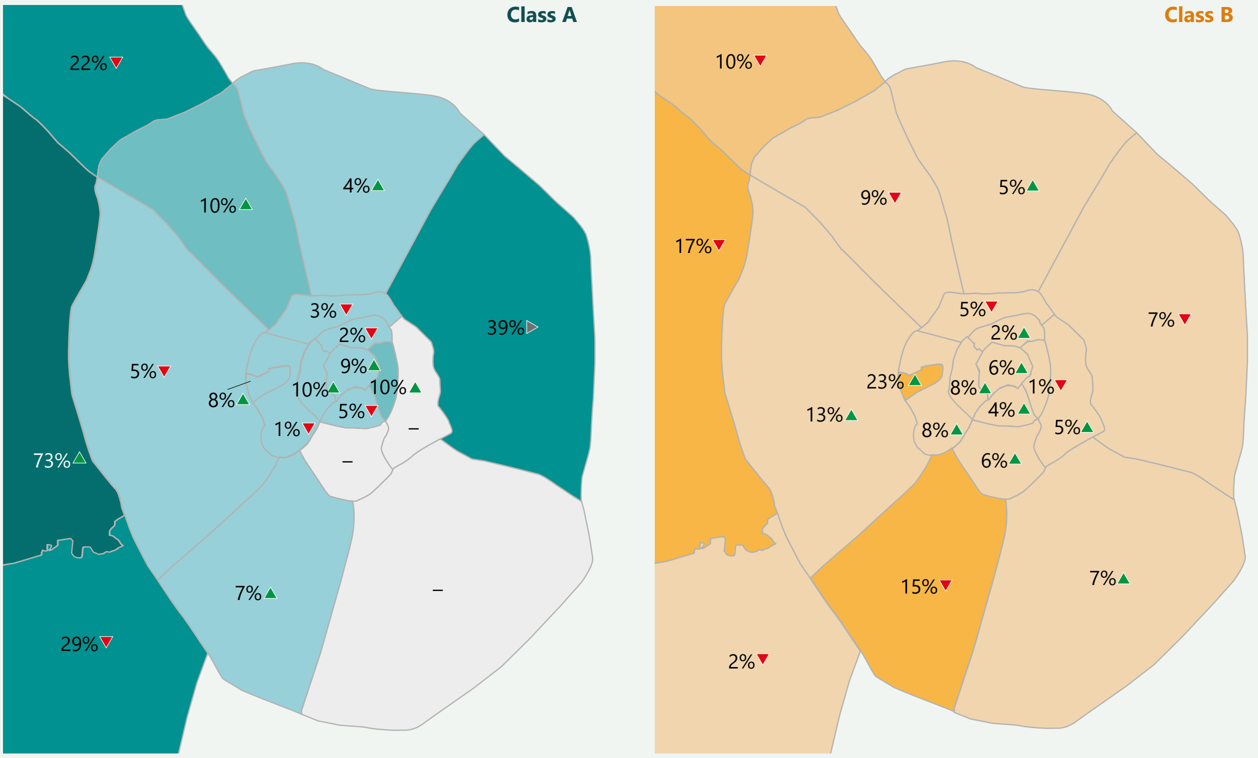
Source: Knight Frank Research, 2020

Net absorption, new supply and vacancy rate dynamics



Source: Knight Frank Research, 2020

Moscow submarket data. Vacancy rate



Source: Knight Frank Research, 2020

of recent years. There are no prerequisites for the recovery of demand in Q3-Q4 2020. Reduced user activity and no growth in demand is expected until the end of the year.

Firstly, offices that stopped marketing at the beginning of the year due to the presence of a potential tenant have re-entered the market, as most transactions in the early stages of negotiations were moved to a later period of less uncertainty. Secondly, some users, including large ones, give up all or part of their space: during the pandemic many companies introduced distance working and decided to continue this approach which led to a sharp decrease in the need for space. Most companies try to assess their capabilities and needs before making any decision about moving or giving up space. Separately, it is worth noting the readiness of many landlords to make partial concessions and place sub-tenants. The combination of these factors led to an increase in vacancies in the Q2 2020, although the indicator is still at a lower level compared to the beginning of the year.

This year, an increase in the volume of renegotiation deals is expected as well as the complete or partial surrenders. By the end of the year, the further growth of vacancy rate is possible, companies will either look for cheaper options or move to a smaller area, if possible, considering the terms of their current contracts.

A limiting factor in the growth of vacancy rate is the inability of tenants to unilaterally surrender in high-quality objects and the lack of quality and suitable premises, despite the increase of vacancy and reduced demand, the deficit persists and there are few alternatives for tenants in the market. Those who can't leave the current office can resort to sublease of space or transferring part of their space to the management of professional operator.

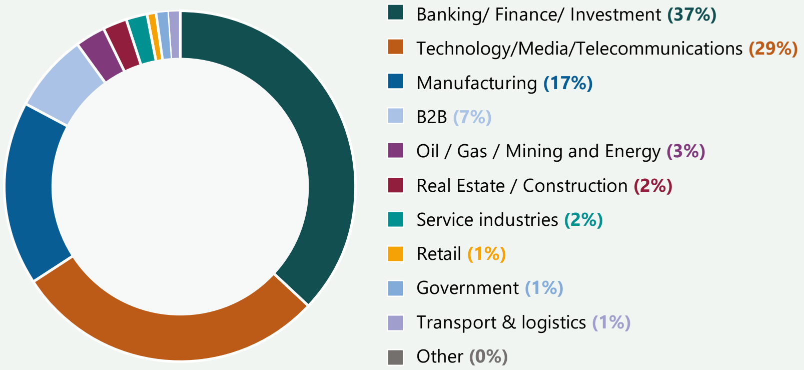
Demand

According to forecasts, the volume of net absorption, a key indicator of demand that shows the difference between all areas that have become filled and all that have entered the market empty, decreased significantly in H1 2020 and amounted to only 160,300 sq m, 46% lower YoY. Such dynamics was influenced by a decrease in rental activity and the release of some space of tenants. In H2 2020, similar dynamics are expected to continue, the annual net absorption level is likely to fall to the level of the post-crisis 2015 when the figure did not exceed 367,000 sq m. At the same time, the deferred demand remains possible which, however, is unlikely to compensate the decline in office users' activity.

In the demand structure of H1 2020, banks and finance companies were the leaders with the share at 37%. The largest deal closed by that sector were the lease of Tinkoff Bank the whole office area of AFI Square, the completions of which is expected in 2020. The deal is a landmark and one of the largest ever observed. The second place with the share of 29% was taken by TMT sector, the third place by manufacturing companies, 17% of all deals done.

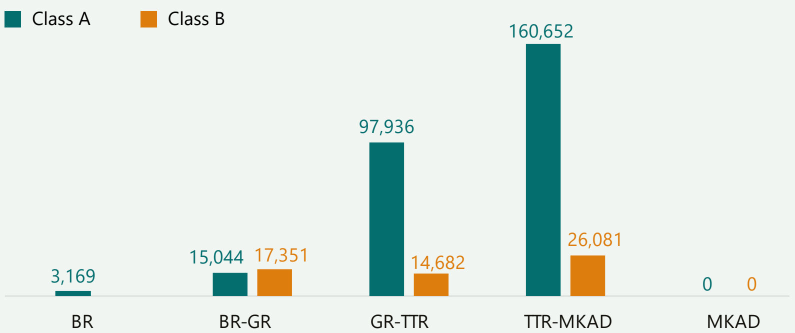
The significant growth of deals more than 10,000 sq m was observed, 8% in H1 2020 against 8% YoY. Against the background of a general slowdown in market activity, companies with a large amount of resources decide to lease or to purchase in order to locate in the most attractive properties which was the main factor in the growth of the share of such large transactions. On the contrary, user demand for small offices is decreasing, the share of the office segment of 500 sq m offices and less decreased from 32% to the current 23%.

Take-up structure by business sector



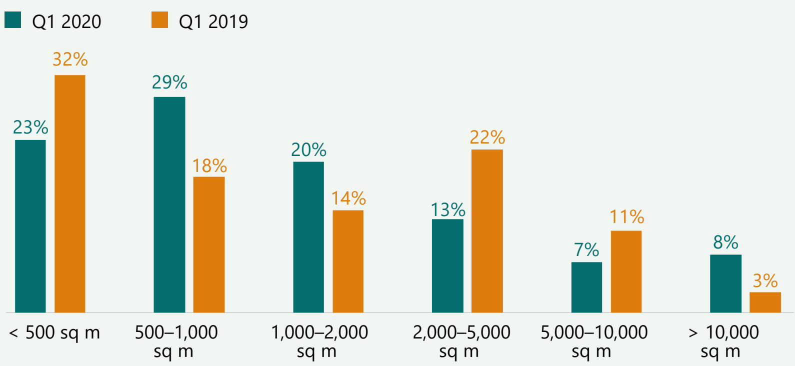
Source: Knight Frank Research, 2020

Distribution of leased space by location



Source: Knight Frank Research, 2020

Distribution of leased office units by size



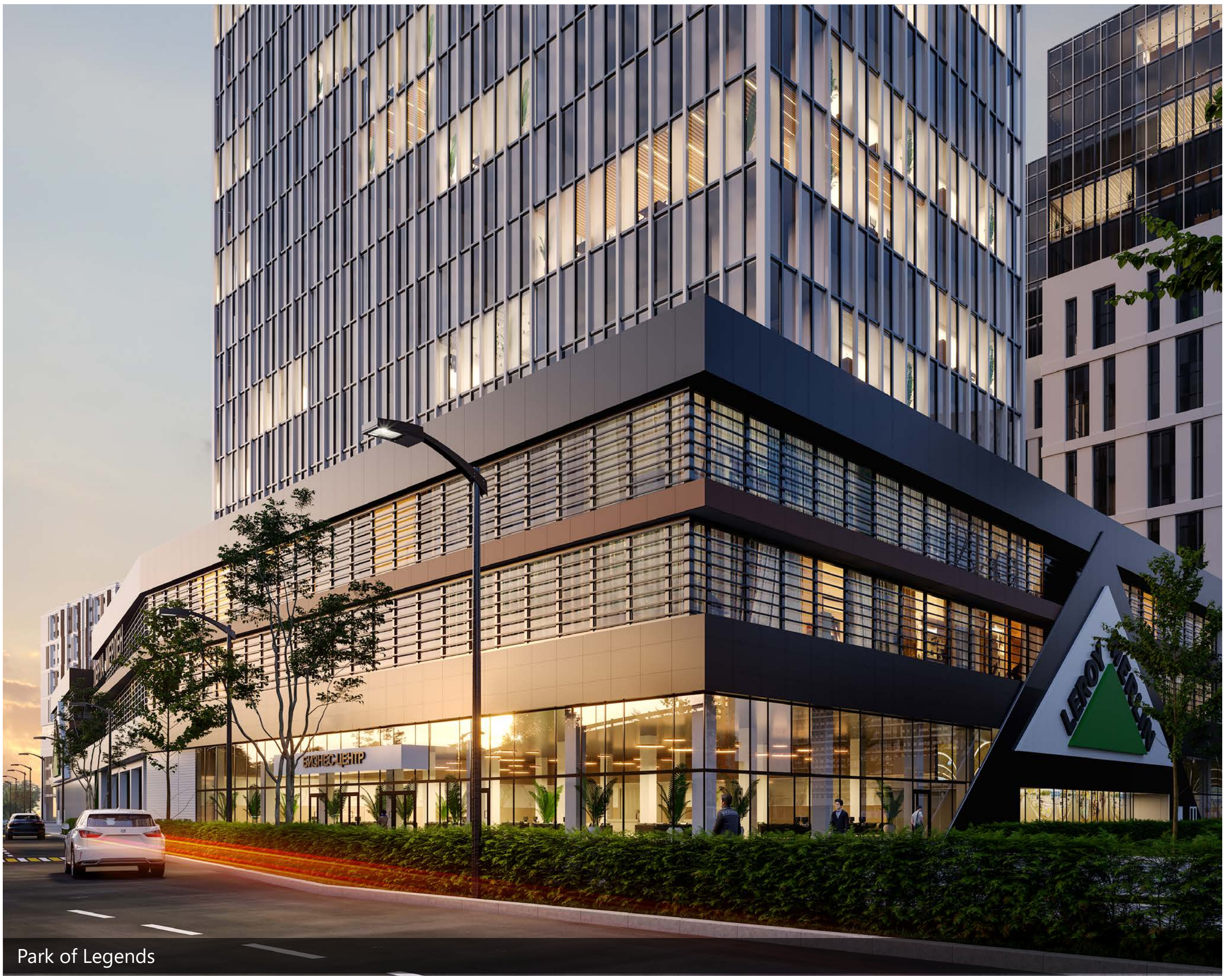
Source: Knight Frank Research, 2020

Key lease and sale deals in Moscow office market, H1 2020

Company	Area, sq m	Transaction type	Class	Business sector	Office building
Tinkoff Bank	77,839	Lease	A	Banking/ Finance/ Investment	AFI Square
Alfa Strakhovanie	27,736	Sale	A	Banking/ Finance/ Investment	Park of Legends
Confidential	11,103	Lease	A	TMT	Alcon
Confidential	8,764	Lease	A	TMT	Alcon Phase II
Novartis	7,621	Lease	A	Manufacturing	Alcon Phase II
Royal Dutch Shell	5,873	Lease	A	Oil / Gas / Mining and Energy	White Gardens
LocoTech	4,776	Lease	B	Manufacturing	Goncharniy 1st Ln, 8 bldg. 6

Knight Frank deals

Source: Knight Frank Research, 2020



Park of Legends

Commercial terms

Against the background of the observed market conditions and the slowdown in key indicators, office rental rates have undergone a slight decrease. In Class A the asking rental rate declined 0.2% QoQ to 25,044 RUB/sq m/year (excluding OPEX and VAT). In Class B the decline was observed at 2.2% to 16,609 RUB/sq m/year (excluding OPEX and VAT) but the current level is still high, the indicator could be compared to the level of 2014 when the asking rent amounted to 17,150 RUB/sq m/year (excluding OPEX and VAT), the highest level since 2009.

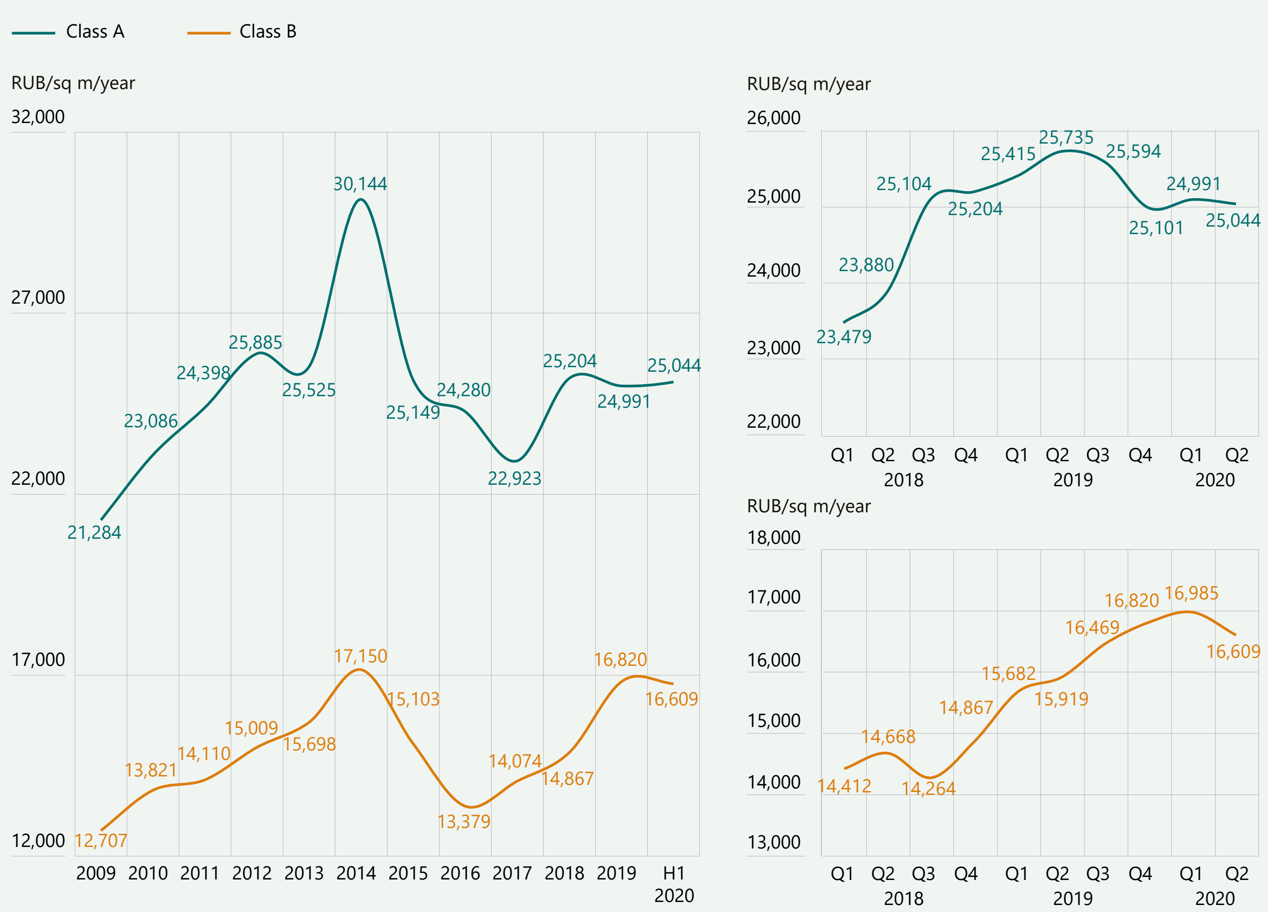
The annual change in the asking rental rates is still a matter of dispute but no increase is expected. Moreover, in buildings with a high volume of available space landlords will be more flexible in communicating with potential tenants in order to accelerate the vacancy rate of their buildings decrease. It is predicted that the current levels will remain unchanged or that there will be a moderate market decline.

The existing practices of the market remain unchanged. The average term of an office lease contract is still within five years, with an early termination possibility. The indexation of rent rates in most contracts is linked to the consumer price index, but it remains subject to negotiating, since both the tenants and the owners of business centers realize that the rent rates and the inflation rate might grow over the five-year period.

The size of a rental office block is the key factor causing the final rent rate of the transaction to shift from the asking rent rate. The developers often prefer to lease the building to several large tenants instead of a single tenant or to divide the space into much smaller blocks. It creates a solid rental income, which is less dependent on the rotation, on the one hand, and is not so complicated to administer, on the other hand.

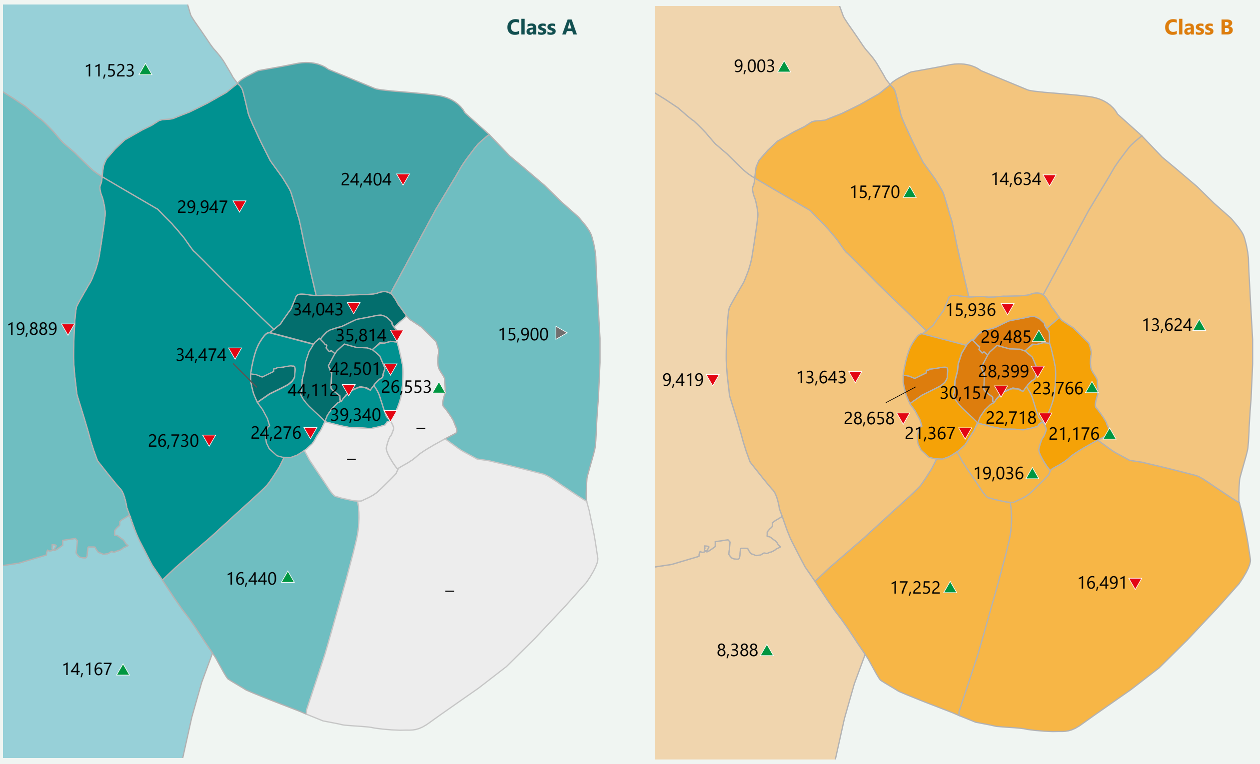
The offices are rented mainly ‘as is’, while the reimbursements for the finishing expenses from the owners are minimal or missing.

Class A and B average weighted asking rents dynamics



Source: Knight Frank Research, 2020

Moscow submarket data. Average weighed rent



Source: Knight Frank Research, 2020

Forecast

By the end of the year the stalled completions volume continuing is expected, the bulk of developers will move the completions dates of their projects for risk minimizing when entering the market which characterized by low demand now. Against the previously forecasted completions at 520,000 sq m the annual level is expected at not higher than 300-320,000 sq m which could be lower YoY. If the current situation continues, the annual result can even be lower.

The net absorption level wouldn't exceed 400-450,000 sq m against 700-750,000 sq m which were forecasted in the beginning of the year. This could be the lowest level since 2015, when the indicator where record low. But the comparable high completions are not expected as was observed in 2015, so the landlords of buildings won't be so flexible in negotiations.

The vacancy rate, even considering the low completion volume, could rose by the end of the year due the surrender of some tenants and low demand. By the end of the year the increase of Class A vacancy is expected, at about 9.7%. In Class B a slight decrease is expected but the dynamics can't be the same as in previous years. If the current market conditions continue, the increase in this market segment is possible too.

MFC Kvartal West

Office sales

The office sales market of Moscow can be subdivided into two sectors, namely that of the sales transactions of so-called 'retail offices' of smaller areas (under 500 sq m) and that of the major sales of whole buildings. The latter have not occurred too often as of lately. In both cases, the premises can be targeted by end users as well as for further lease to other companies. Also, the transaction price is close to the asking price in case of purchasing smaller offices, while it is likely to be cut significantly in case of larger sales both for Class A and Class B offices.

The average weighted prices amounted to 241,274 RUB/sq m for Class A offices, 147,719 RUB/sq m for Class B properties, and 304,420 RUB/sq m for mansions. The average weighted price for general purpose premises on the ground floors of residential complexes currently stands at 141,841 RUB/sq m.

Moscow submarkets. Average weighted sale price*.

	Class A	Class B	Mansion	Premises for free use
Boulevard Ring	-	376,955	379,594	454,283
Garden Ring	332,575	180,535	347,936	371,127
Third Transport Ring	238,666	177,635	213,920	151,731
TTR-MKAD	199,552	125,564	208,793	110,295
Outside MKAD	129,600	85,221	-	99,204

* Excluding VAT (20%).

Source: Knight Frank Research, 2020

Moscow submarket data. Key indicators*

Район		Lease Area, thousand. sqm	Class A: Average rent, RUB/sq m/year*		Class A: Vacancy rate, %		Class B: Average rent, RUB/sq m/year*		Class B: Vacancy rate, %	
Boulevard Ring	Central business district	712	42,501		9.5		28,399		6.1	
Garden Ring	South	999	39,340	38,373	4.8	5.3	22,718	28,626	3.6	4.8
	West	561	44,112		9.9		30,157		8.3	
	North	667	35,814		1.6		29,485		2.2	
	East	407	26,553		9.7		23,766		1.2	
Third Transport Ring	South	1,282	-	29,759	-	6.1	19,036	19,769	6.3	7.6
	West	797	24,276		0.9		21,367		8.4	
	North	975	34,043		2.8		15,936		4.9	
	East	1,133	-		-		21,176		4.5	
	MIBC Moscow-City	1,173	34,474		7.7		28,658		22.6	
TTR-MKAD	North	1,032	24,404	23,022	4.3	9.8	14,634	15,404	5.4	9.5
	Northwest	816	29,947		10.0		15,770		9.2	
	South	2,048	26,730		5.2		13,643		12.6	
	West	1,442	-		-		16,491		6.9	
	Southwest	662	16,440		7.0		17,252		15.2	
	Preobrazhenskiy	999	15,900		39.0		13,624		7.1	
Out MKAD	Khimki	266	11,523	16,315	22.1	36.9	9,003	9,235	10.2	11.7
	West	515	19,889		73.4		9,419		16.7	
	New Moscow	345	14,167							
Total		**16,834**	**25,044**		**9.0**		**16,609**		**6.7**	

* Excluding OPEX and VAT (20%)

Source: Knight Frank Research, 2020

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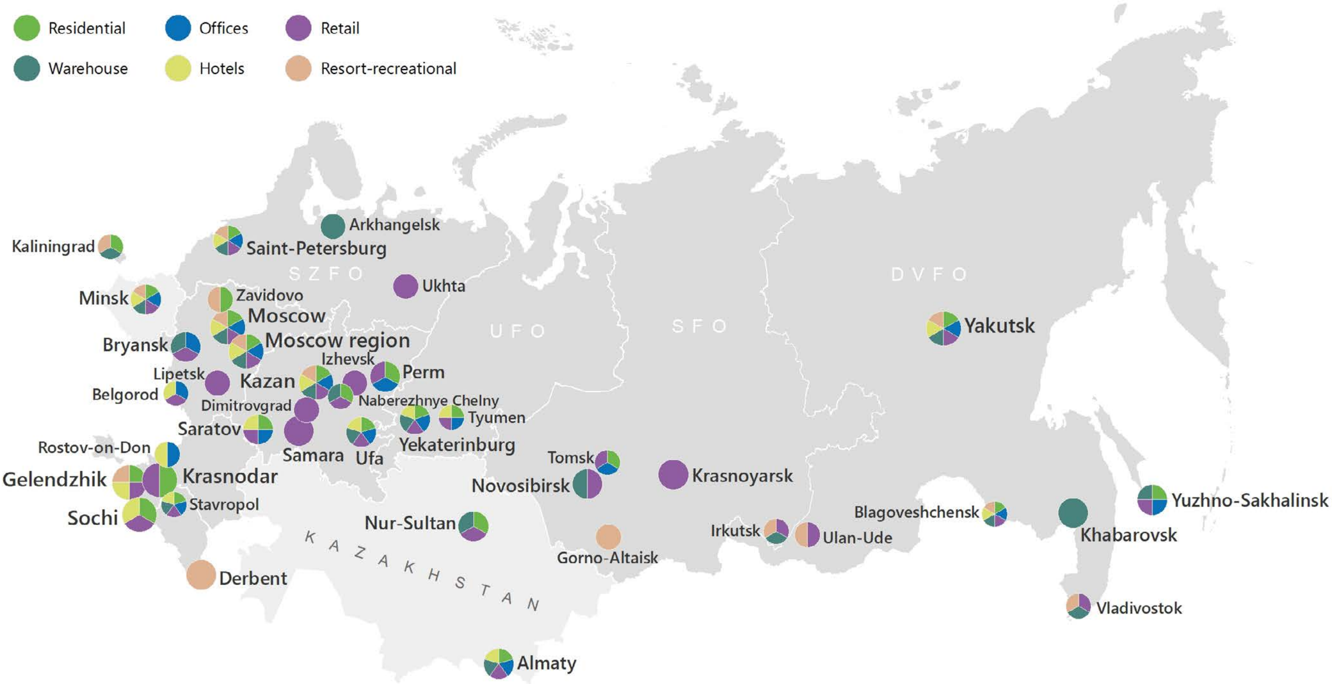

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