The total Q1-Q3 2020 completions amounted to ***115,200 sq m****, twice lower YoY*

The vacancy rate reached ***10,4%*** *in Class A offices and* ***6,4%*** *in Class B offices*

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OFFICE MARKET REPORT. MOSCOW

Q3 2020

Maria Zimina
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Knight Frank

«According to the results of Q1-Q3 2020, we can already say that the absorption in 2020 will be at the level of a historical minimum – companies are mainly optimizing current areas and continue to release excess space. Due to the continued restrictive measures by authorities and reduced business activity, we will not see a recovery in demand until the start of 2021. Pre-crisis interest in office spaces will appear after the restrictions are completely removed and when the market recovers from their consequences. At the same time, the owners put on pause the launch of many new projects due to the reduced demand, with the aim to monitor the behavior of tenants. Taking into account the postponement of commission dates, the volume of new supply in 2020 will be twice lower than expected previously».

Key findings

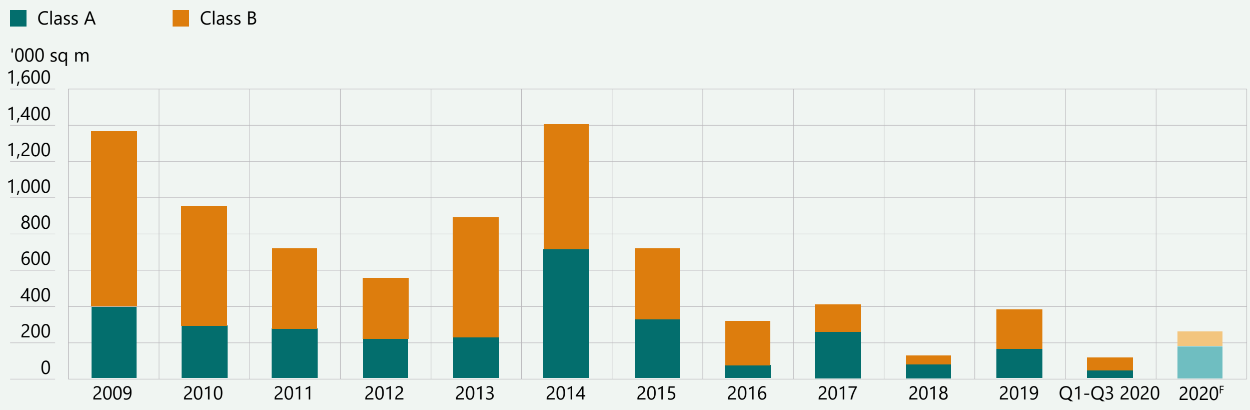
- The total Q1-Q3 2020 completions amounted to 115,200 sq m, twice lower YoY.
- The vacancy rate reached 10.4% in Class A offices and 6.4% in Class B offices.
- The asking rents were 25,305 RUB/sq m/year in Class A and 16,712 RUB/sq m/year in Class B.

Key indicators

		Q3 2020	Q2 2020
Total stock, '000 sq m		16,889	16,834
	Class A	4,509	4,480
	Class B	12,380	12,354
New supply, '000 sq m		115.2	60.9
	Class A	44.3	15.4
	Class B	70.8	45.5
Vacancy rate, %	Class A	10.4	9.0
	Class B	6.4	6.7
Average weighted asking rental rate*, RUB/sq m/year**	Class A	25,305	25,044
	Class B	16,712	16,609
OPEX rate range*, RUB/sq m/year	Class A	7,100	7,100
	Class B	4,800	4,800

* Compared to Q2 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

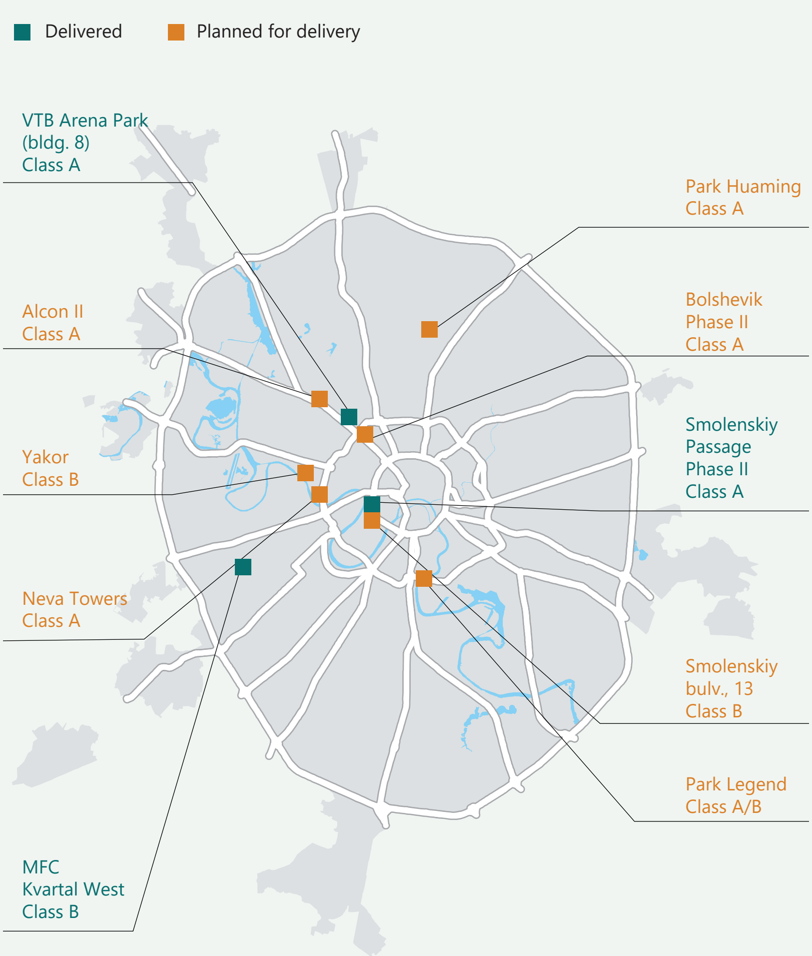
At the end of Q3 2020, the total Moscow office stock amounted to 16.9m sq m, where 4.5m sq m or 27% refers to Class A and 12.4m sq m or 73% to Class B.

Against the background of the coronavirus pandemic, the developers' activity has decreased: the completion in Q1-Q3 2020 amounted to only 115,200 sq m which is almost twice lower YoY. The largest Class A project commissioned in the first nine months of 2020 was VTB Arena Park (bldg. 8) (28,969 sq m), the largest Class B project was MFC Kvartal West (33,944 sq m).

The market expects a significant decrease in the volume of office space completed this year: while 520,000 sq m were expected before the recession at the end of 2019, the adjusted forecast is not higher than 240-280,000 sq m. Given the sharp and significant decline in absorption, developers monitor the behavior of office users and try to predict the further vector of market development, putting many of their projects on hold.

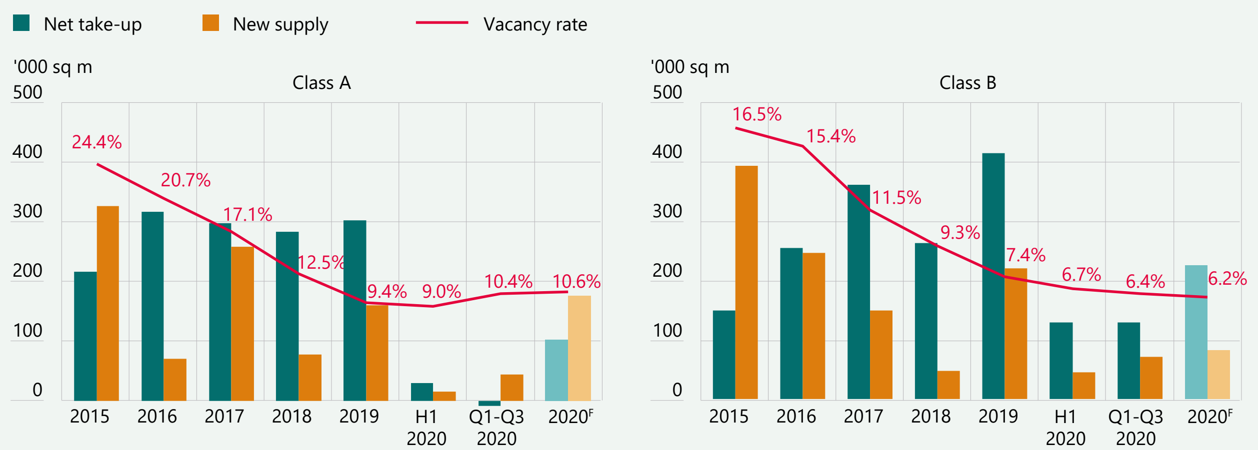
Since the start of 2020, the vacancy rate of Class A increased by 1.1 ppt (up to 10.4%). Currently, 470,000 sq m of offices is still available. On the contrary, the Class B indicator decreased by 1.1 ppt since the start of the year (to 6.4%) and the total volume of available space is 790,000 sq m. Class A vacancy rate grew by 1.4 ppt QoQ, which was the maximum quarterly increase in vacancy rate this year.

Properties scheduled for delivery throughout 2020



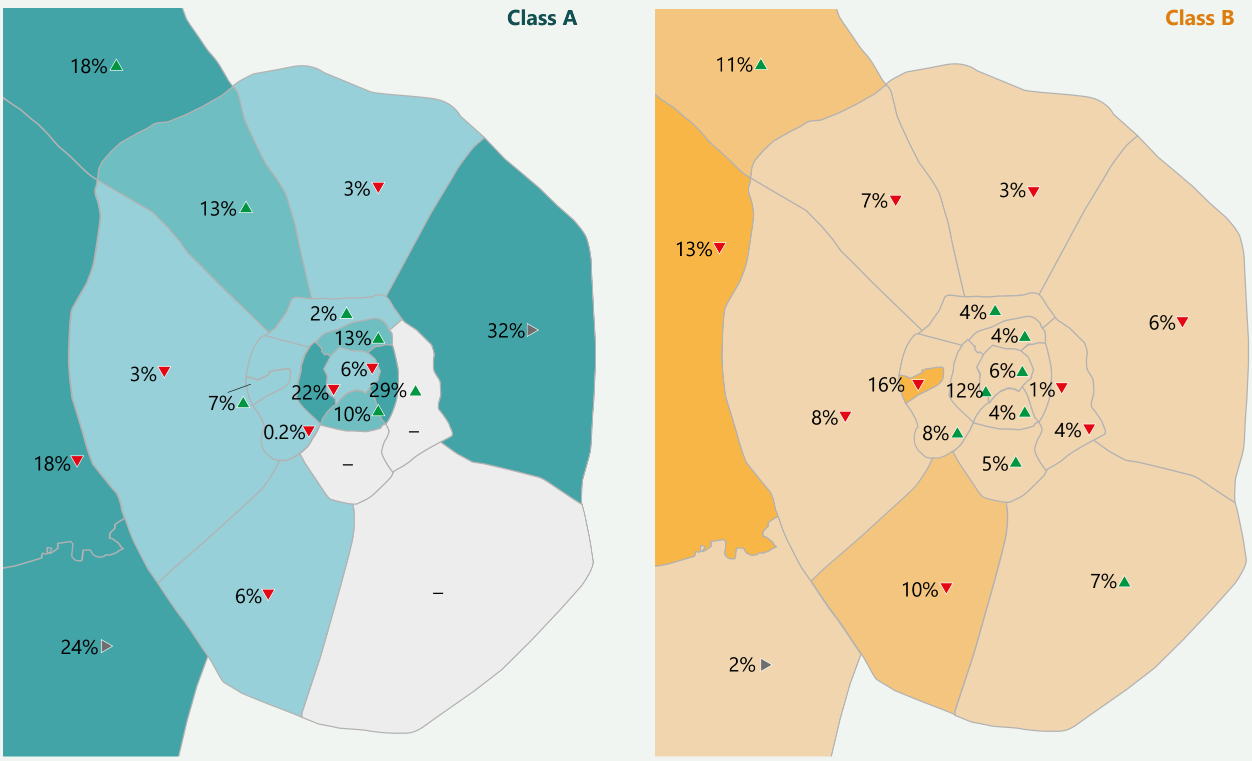
Source: Knight Frank Research, 2020

Net absorption, new supply and vacancy rate dynamics



Source: Knight Frank Research, 2020

Moscow submarket data. Vacancy rate



Source: Knight Frank Research, 2020

Further growth is expected by the end of the year, up to 10.6%. There was a slight decrease in Class B offices compared to the previous quarter (0.3 ppt). The figure will decrease a little more by the end of the year (to 6.2%) due to the small volume of offices announced for completion, as well as expected seasonal, more dynamic activity. Nevertheless, there are no preconditions for an active recovery in demand and we can hardly expect it until Q2 2021.

Compared to early 2020 when the pandemic had not a strong impact on the quarter's results, high-quality Class A buildings showed an increase in the vacancy share due to continued optimization of spaces by the tenants. The completion of fully vacant new project in this class, VTB Arena Park, bldg. 8 (28,969 sq m), was an additional growth factor. A significant number of companies decided to vacate a part of their premises for sublease in Q3 2020. Despite the prospect of lifting restrictive measures, large companies became more flexible and are unlikely to give up remote work for some of their employees. Therefore, they are aware of the lack of necessity in the same volume of the previously occupied space any more. The combination of these factors may lead to a further increase in the vacancy rate in Class A offices both at the end of this year and at the beginning of the next one.

A large volume of renegotiations of commercial terms, as well as on complete or partial tenants' surrender was recorded over the nine months of this year. Such an activity is expected to continue until the end of the year: tenants will continue to look for more profitable options and optimize current rental costs. Taking into account the higher rental rates, the increase in vacancy will be more noticeable in Class A segment.

Unlike flex spaces, owners of classic offices are more protected from large-scale refusal from premises by the impossibility of unilateral withdrawal of tenants of high-quality properties from contracts, which potentially restrains the dramatic growth in the vacancy rate. Moreover, despite the general growth of vacancy in Class A offices since the beginning of the year, there is still a shortage of high-quality office space demand in the key business locations of the capital, in particular MIBC Moscow-City and Central Business District. As a solution, tenants can resort to sublease the space or transferring part of their space to the management and sale by professional operators.

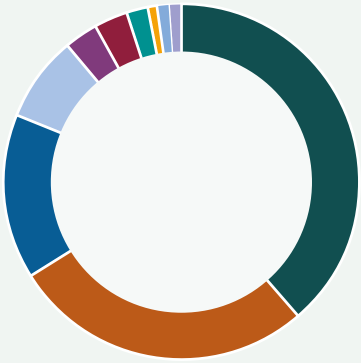
Demand

The volume of offices absorption, the 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 Q1-Q3 2020 and amounted to only 190,700 sq m, which is 61% less than a year earlier. This dynamics was affected by a decrease in rental activity and the release of part of the premises of current tenants. Similar dynamics is expected to be preserved until the end of this year and the beginning of the next one. The annual absorption rate will decrease to the post-recession 2015 level, when the figure was at the level of 367,000 sq m, or below. At the same time, there is still the possibility of selling deferred demand, which, nevertheless, is unlikely to compensate for the decline in office users' activity.

Banks and financial companies were leaders in Q1-Q3 2020 demand, with a share of 39%. 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 2022. The deal is landmark and one of the largest ever observed. The second place with the 27% share was taken by the TMT companies. The third place is taken by B2B companies with a share of 15%.

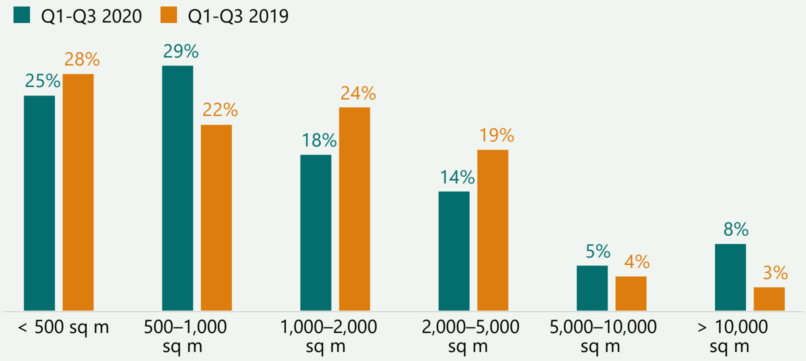
There is a significant increase in the share of transactions over 10,000 sq m: this segment accounted for only 3% of the total number of transactions last year and the share has already reached 8% and at the end of Q3 2020. Against the general slowdown in market activity, companies with a large amount of resources make decisions to lease or purchase in order to acquire or occupy the most attractive buildings, that were not previously on the market or they were not offered on such interesting terms, which is the main factor behind the growth in the share of such major transactions.

Take-up structure by business sector



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, Q1–Q3 2020

Company	Area, sq m	Transaction type	Office building
Tinkoff Bank	77,839	Lease	AFI Square
Alfa Strakhovanie	27,736	Sale	Park of Legends
Space 1	11,644	Lease	New Blachug
City Mobil ⌘	11,103	Lease	Alcon
Rubytech	11,022	Lease	Kalibr Technopark
Mail.ru ⌘	8,764	Lease	Alcon II
Novartis	7,621	Lease	Alcon II

⌘ Knight Frank deals

Source: Knight Frank Research, 2020

Commercial Terms

Against the background of the observed market conditions and the slowdown in the main indicators, office rental rates slightly changed compared to the beginning of the year. The requested rental rate for Class A offices is growing at a slow pace during the pandemic: the figure has grown by 1.3% compared to the beginning of the year and now is 25,305 RUB/sq m/year (excluding operating expenses and VAT). On a quarterly basis, the growth was 1.0%. The low growth rate is more likely a consequence of cheaper blocks leaving the market. However, entering the market for new buildings with a higher than average rent leads to an increase in the weighted average. The asking rents do not increase in individual objects. On the contrary, the rental rate for Class B offices has slightly decreased compared to the beginning of the year – by 0.6%, to 16,712 RUB/sq m/year (excluding operating expenses and VAT), but increased by 0.6% compared to the previous quarter.

The requested rental rates have not changed significantly following the past nine months. No significant increase in the value of currently vacant offices is expected in the future. Moreover, in buildings with much vacant space, owners will be more flexible when communicating with potential tenants in order to speed up the sale of the current vacant space. Preservation of current levels or a moderate general market decline is predicted.

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.

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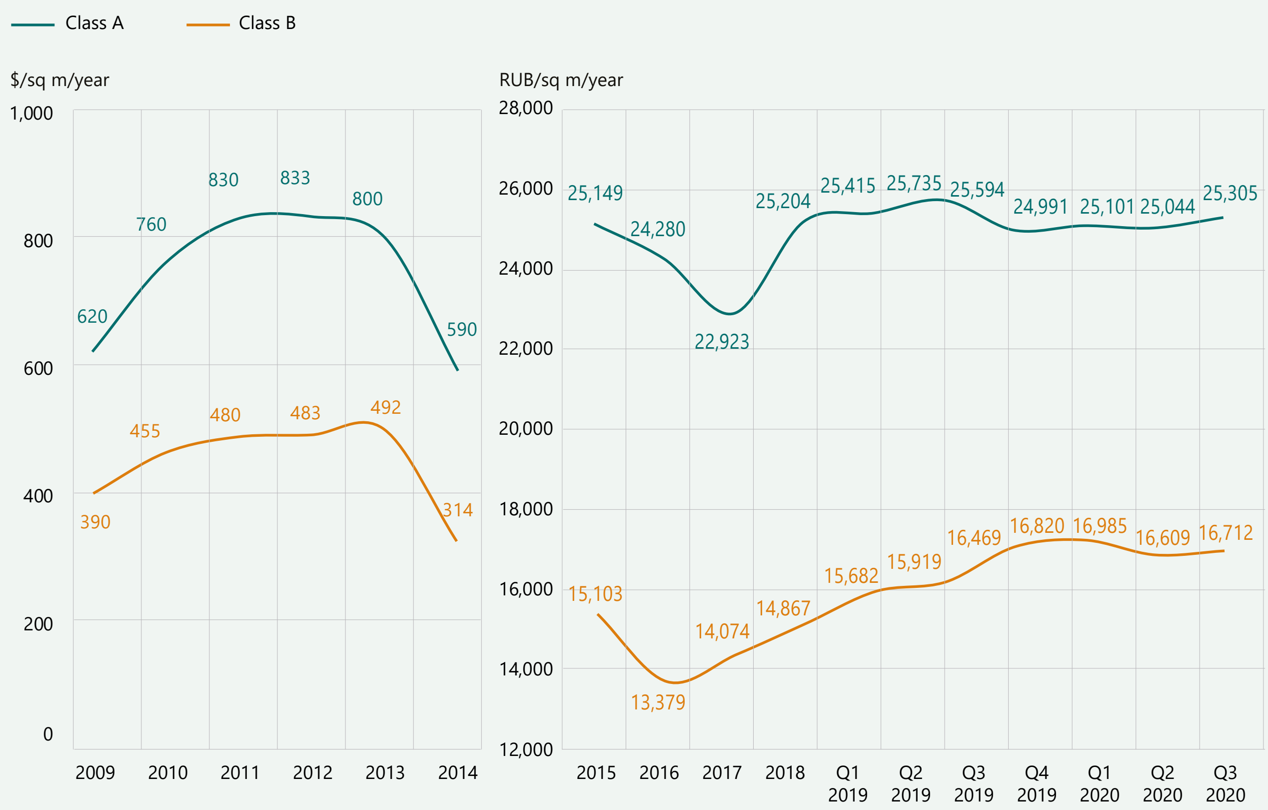
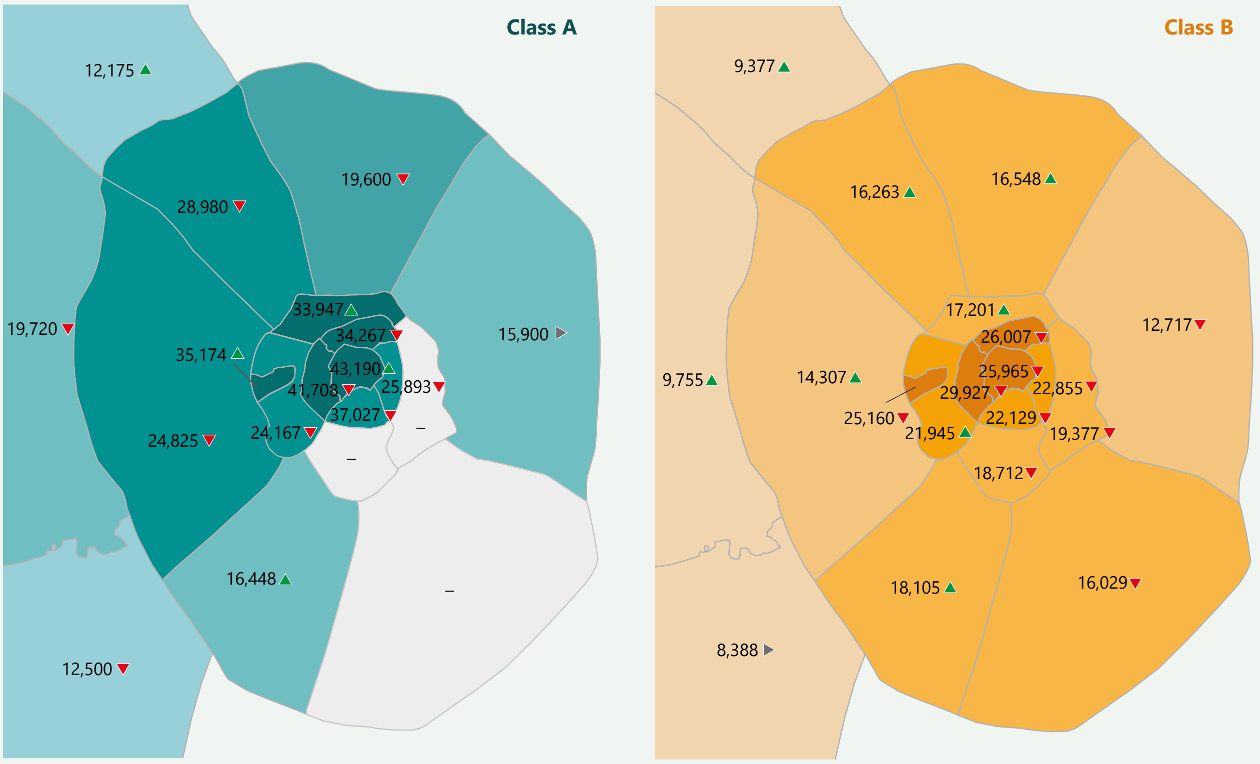
Offices are rented mostly "as is", while the reimbursements for the finishing expenses from the owners are minimal or missing.

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

Due to the serious decrease in demand for offices, developers decided to suspend many projects and postpone their commissioning in order to monitor tenant behaviour. With the previously forecasted commissioning level of about 520,000 sq m, the annual result at the moment is expected at the level of about 240–280,000 sq m which will be almost two times lower than in the previous year. If the current situation which has a negative impact on the industry remains the same or worsens, the figure may turn out to be even lower at the end of the year.

The figure of net absorption for the year, previously forecasted at the level of 700-750,000 sq m, will definitely not reach such a high level and will not exceed 350,000 thousand sq m, which will be below the level of 2015, when the figure turned out to be the lowest in the history of observations. At the same time, there is no comparable large volume of commissioning, as was observed in 2015, which means that project owners will not be flexible when communicating with tenants, especially in the city areas sought-after.


VTB Arena Park

Taking into account the sharply reduced demand for office space as well as the continuing uncertainty and restrictions that do not contribute to the resumption of business activity, further growth in the vacancy of Class A offices is expected at the end of the year, where the figure may reach 10.6%. A moderate decline is expected in Class B offices due to the small volume of offices announced for commissioning as well as the continued rental activity in this Class. The vacancy will be about 6.3%.

Office Space Sales Market

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 weighted average price for office clusters in Class A projects is 231,975 RUB/sq m, in Class B offices – 147,907 RUB/sq m, in mansions – 312,446 RUB/sq m. The weighted average price of the general purpose area on the ground floors of residential complexes is 144,483 RUB/sq m.

Moscow submarkets. Average weighted sale price*.

	Class A	Class B	Mansion	Premises for free use
Boulevard Ring	–	377,762	383,757	454,283
Garden Ring	305,664	205,576	344,016	310,879
Third Transport Ring	236,410	177,395	218,359	150,747
TTR-MKAD	201,031	123,838	230,146	109,147
Outside MKAD	129,600	85,166	–	100,097

* Excluding VAT (20%).

Source: Knight Frank Research, 2020


iCITY

Moscow submarket data. Key indicators*

<table>
<tr><th colspan="2" rowspan="2">Submarket</th><th rowspan="2">Lease Area, thousand. sqm</th><th colspan="4">Class A</th><th colspan="4">Class B</th></tr>
<tr><th colspan="2">Average rent, RUB/sq m/year*</th><th colspan="2">Vacancy rate, %</th><th colspan="2">Average rent, RUB/sq m/year*</th><th colspan="2">Vacancy rate, %</th></tr>
<tr><td>Boulevard Ring</td><td>Central business district</td><td>712</td><td colspan="2">43,190</td><td colspan="2">5.8</td><td colspan="2">25,965</td><td colspan="2">5.6</td></tr>
<tr><td rowspan="4">Garden Ring</td><td>South</td><td>999</td><td>37,027</td><td rowspan="4">35,303</td><td>10.4</td><td rowspan="4">14.1</td><td>22,129</td><td rowspan="4">27,555</td><td>3.6</td><td rowspan="4">6.1</td></tr>
<tr><td>West</td><td>561</td><td>41,708</td><td>22.5</td><td>29,927</td><td>12.0</td></tr>
<tr><td>North</td><td>667</td><td>35,814</td><td>13.2</td><td>26,007</td><td>4.4</td></tr>
<tr><td>East</td><td>407</td><td>26,553</td><td>28.6</td><td>22,855</td><td>1.1</td></tr>
<tr><td rowspan="5">Third Transport Ring</td><td>South</td><td>1,282</td><td>-</td><td rowspan="4">29,574</td><td>-</td><td rowspan="4">1.3</td><td>18,712</td><td rowspan="4">19,652</td><td>5.5</td><td rowspan="4">5.1</td></tr>
<tr><td>West</td><td>797</td><td>24,167</td><td>0.2</td><td>21,945</td><td>7.7</td></tr>
<tr><td>North</td><td>975</td><td>33,947</td><td>2.0</td><td>17,201</td><td>3.8</td></tr>
<tr><td>East</td><td>1,133</td><td>-</td><td></td><td>19,377</td><td>3.6</td></tr>
<tr><td>MIBC Moscow-City</td><td>1,173</td><td colspan="2">35,174</td><td colspan="2">6.8</td><td colspan="2">25,160</td><td colspan="2">15.6</td></tr>
<tr><td rowspan="6">TTR-MKAD</td><td>North</td><td>1,052</td><td>19,600</td><td rowspan="6">24,616</td><td>3.2</td><td rowspan="6">9.8</td><td>16,548</td><td rowspan="6">15,853</td><td>3.4</td><td rowspan="6">7.0</td></tr>
<tr><td>Northwest</td><td>845</td><td>28,980</td><td>12.8</td><td>16,263</td><td>7.4</td></tr>
<tr><td>South</td><td>2,048</td><td>24,825</td><td>2.8</td><td>14,307</td><td>8.3</td></tr>
<tr><td>West</td><td>1,442</td><td>-</td><td>-</td><td>16,029</td><td>6.7</td></tr>
<tr><td>Southwest</td><td>662</td><td>16,448</td><td>5.6</td><td>18,105</td><td>10.0</td></tr>
<tr><td>Preobrazhenskiy</td><td>1005</td><td>15,900</td><td>32.3</td><td>12,717</td><td>5.9</td></tr>
<tr><td rowspan="3">Out MKAD</td><td>Khimki</td><td>266</td><td>12,175</td><td rowspan="3">15,155</td><td>18.0</td><td rowspan="3">20.6</td><td>9,377</td><td rowspan="3">9,549</td><td>10.9</td><td rowspan="3">10.5</td></tr>
<tr><td>West</td><td>515</td><td>19,889</td><td>17.7</td><td>9,755</td><td>13.4</td></tr>
<tr><td>New Moscow</td><td>345</td><td>12,500</td><td>23.7</td><td>,8,388</td><td>2.0</td></tr>
<tr><td colspan="2">Total</td><td>16,889</td><td colspan="2">25,305</td><td colspan="2">10.4</td><td colspan="2">16,712</td><td colspan="2">6.4</td></tr>
</table>

* Excluding OPEX and VAT (20%)

Source: Knight Frank Research, 2020

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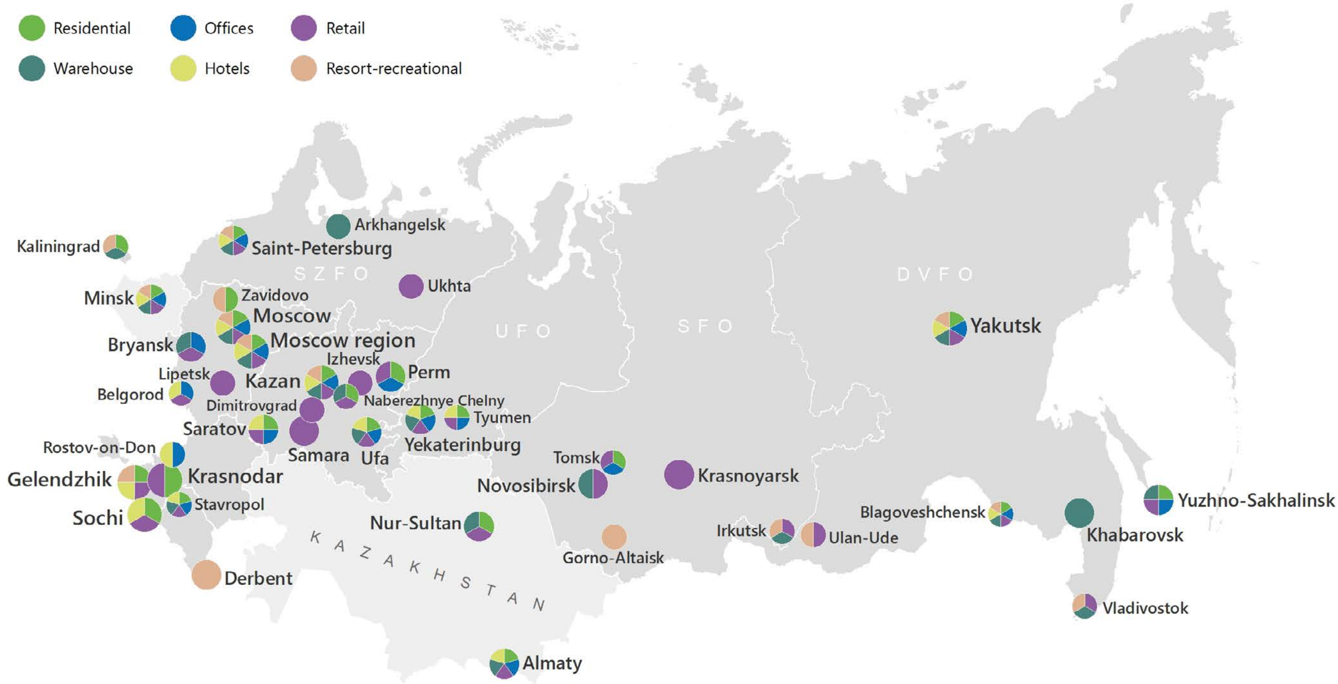

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