

advance



JONES LANG
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Moscow Office Market Opportunities

Why?

Where?

How?



There's a lot of opportunities if you know when to take them.

Pet Shop Boys, Opportunities

Rapidly expanding Moscow office market currently offers different **opportunities** for developers. These emerge from a number of trends and factors currently influencing the market.

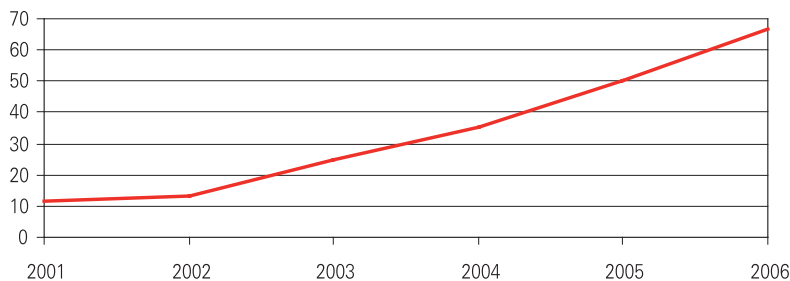
We analyse three areas within the market that offer lucrative opportunities. This report presents our views on why, where and how to use them. We explain **why** now is the right time to develop projects in the Moscow office market, **where** the opportunities to develop them are, as well as **how** to make these projects successful.

DEMAND FOR OFFICE SPACE IS GROWING

The Russian economy has been expanding by nearly 7% per annum for the past seven years. This growth has yielded positive results for Russia's commercial real estate market. Corporate revenues have increased significantly; and total net profits of listed Russian companies are now 5.8 times their level in 2001. Positive financial results have enabled **companies to expand their operations and drive demand for office space**. Moscow office take-up grew 130% in 1H 2007 vs 1H 2004, and is anticipated to maintain its brisk growth. We expect that by 2010, volumes will have increased 48% relative to 2006.

1H 2007 Moscow office take-up grew 130% relative to 1H 2004

Total net profits of Russian listed companies, \$bn

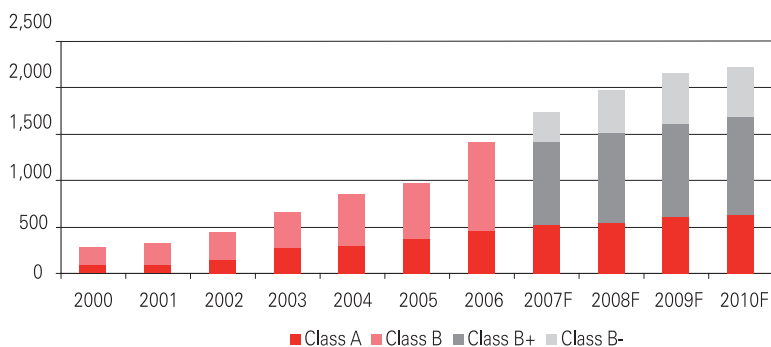


Source: Renaissance Capital, Jones Lang LaSalle Research

In 2006, approximately 36% of office market take-up in Moscow originated from international companies seeking to expand into Russia. The entrance of an increasing number of new international entrants is expected to boost demand for modern office space in Moscow over the medium to long term.

Foreign companies expanding into Russia and growth of local business are the main drivers of Moscow office demand

Take-up dynamics of the Moscow office market, '000 sq m



Source: Jones Lang LaSalle Research

The rapid pace of business expansion will contribute to office demand growth. In 2010, office market take-up is anticipated to exceed 2.2 mn sq m.

This expansion has put Moscow's real estate market firmly on developers' radar screens. We believe that the current environment offers strong advantages for office development projects, as the robust demand guarantees high absorption.

SMALL MODERN OFFICE AREAS ARE IN DEMAND

Currently, Moscow office take-up is driven by large-scale tenants who are the prime target for developers. At the same time, **there is a distinct demand for quality, small-size areas**, from different types of tenants.

Attracted by the rapid pace of economic development, a growing number of foreign companies are making an introductory entrance into the Russian market. Many of these companies do not need large spaces at this early stage and lease relatively small offices to launch their businesses. For example, in 2003 Fitch Ratings CIS entered Russia and leased about 250 sq m in the Ducat II business centre to set up a representative office. In three-five years the need to expand might arise, but there are examples of global majors keeping their presence limited to representative offices: ACI Worldwide, who leased around 200 sq m in the Riverside Towers business centre in 1998, has not required additional space since.

Small areas for representative offices are also required by large local companies entering Moscow from other Russian regions. Other tenants for this part of the property market are companies that lease a large space for their head office but need small office areas for some specific needs of their businesses (training centres, etc.).

There is one other emerging source of demand for small-scale office premises. A third of employment in Moscow, around two million people, originates from small companies. Their officially reported profits increased by 42% in 2005, illustrating the potential demand growth from them as more of them look for quality office space.

Small and medium-size enterprises tend to prefer Class B+ and B- office areas. In Q2 2006 - Q1 2007, the share of leased space less than 250 sq m comprised 1% of Class A premises, 11% of Class B+, and 18% of Class B-. The total share of small-size leases in modern office take-up was about 10%.

Demand from all the above tenants is currently underestimated by the majority of developers, who are generally interested in tenants looking to occupy at least 1,000 sq m of office space. The most overlooked type of small-size tenant is that which currently occupies Class C buildings (for example, in former Soviet scientific research institutes). Another forced location for these companies is ground floors in residential buildings. However, the growing operations of such companies are enabling them to afford rents in modern buildings. Yet limited supply is restricting potential upgrades. The biggest shortage is seen in Class A buildings, allowing landlords to raise rents. The market practice of shell & core delivery adds an additional hurdle for small-size tenants. However, despite these complications, tenants are forming queues for smaller properties, especially in the city centre.

Strong demand for small-size areas and the lack of supply in the primary office market have prompted **the development of a sublease business in Moscow**. There are a number of companies, such as Regus, Central Offices and others, that run a sublease business as their primary activity. Demand from small enterprises is fuelling the growth of companies that lease large spaces and then split them up. For example, Regus's 2,214 sq m of leased space in 1998 had expanded to 13,500 sq m by September 2006.

Taking advantage of the situation by paying attention to small-scale tenants is a way for developers to diversify their businesses and to raise earnings. The latter is clearly demonstrated by the success of the sublease business. As small enterprises develop, an increasing number of them will require quality office space. In addition, foreign companies will continue to enter Russia by opening representative offices at the initial stage. Developers may consider tailoring part of their projects (for example, some floors in an office building) to accommodate smaller tenants.



Around 10 % of take-up in the Moscow office market comes from small-scale tenants

THE MOSCOW OFFICE MARKET IS BECOMING MORE DECENTRALIZED

The area inside the Garden Ring in Moscow has almost exhausted its office development potential due to a lack of available land plots, difficulties with utilities, engineering systems and parking spaces. This year the Moscow Committee for Architecture and Town Planning decided to prohibit new office construction in the central business district (CBD) in an effort to preserve Moscow city's historical centre and reduce transport congestion. As a result, office rents in the CBD are expected to rise significantly. In fact, the process has already begun.

Rapid rental growth, limited choice of quality office premises and traffic problems are forcing **some tenants to leave the CBD**, raising demand for non-central office properties. This factor is expected to contribute to new 'business district' formation and to accelerate Moscow office market decentralization. The acceleration has changed the stock composition and is evident already in the take-up breakdown, presented in the map below. Regarding the stock, at the end of 2006, 39% of the total was located in the CBD. We anticipate that by 2010 this share will decline below 25%.

Take-up dynamics of the Moscow office market, '000 sq m



There are lucrative **opportunities to meet growing non-central demand**. Moscow GENPLAN (General Plan) provisions for a reduction of industrial sites in Moscow from 22,000 ha in 2004 to 15,600 ha by 2020. Former industrial zones, many of which are located outside the Garden Ring, can become new centres of office development. Being generally less costly for developers, and therefore offering higher returns, the redevelopment of former industrial properties is an attractive option for new construction. Krugozor Phase I, Novospassky Dvor Phase I, Red Rose, LeFort Phase I and Stanislavsky Factory Phase I are all examples of successfully completed redevelopment projects.

Moscow's transport system is expanding, and **buildings located in non-central areas are becoming more attractive** due to improving accessibility. The construction of the Fourth Ring Road, the reconstruction of Leningradsky Prospect, new highway projects (for instance, Zvenigorodsky Prospect) are stimulating further development of non-central districts within the Moscow office market.

Areas located outside the CBD are becoming increasingly attractive for office development due to an improving transport infrastructure, availability of land for new construction and redevelopment. The quality of buildings and services provided is becoming more important than location for the majority of tenants. Current market conditions are favourable for decentralized office development.

Rapid rental growth, limited choice of quality office premise, and traffic problems are forcing some tenants to leave the CBD

Former industrial zones are becoming the new centers of office development

THE MOSCOW OFFICE MARKET IS BECOMING MORE SOPHISTICATED ON BOTH THE DEMAND AND SUPPLY SIDES

As the market develops, **demand is becoming more sophisticated**. Tenant requirements are growing as they look for better service and effective solutions. The participation of real estate consultants and property management companies is becoming a crucial factor for the success of projects. The property management industry is developing, and the integration of property management companies into the development process creates opportunities to raise the quality of project concepts and level of services provided to tenants.

New players are entering Russia's office market. Together with improvements in the country's image and more upbeat investor sentiment, increasing market transparency has been one of the primary factors opening up Russia to a new and expanding wave of international entrants. New investors and developers, followed by international property management companies and architectural bureaus, are bringing high international standards. Thus, to be competitive, greater attention should be paid to the service side of projects and to architectural solutions.

Russia's commercial real estate market has become **more transparent** for global capital market players, and **major international financial institutions continue to enter the market**. German and Austrian banks are currently the most active in the Moscow office real estate market, already represented by such heavyweights as Hypo Real Estate International, Aareal Bank, Raiffeisen, and Eurohypo AG. These banks offer a considerably lower cost of financing relative to local lenders, enabling developers to borrow more and to upgrade the quality of their projects.

Currently, the Moscow office market is seeing the appearance of such projects as Metropolis, Western Gate and White Square, which offer a level of quality on a par with the best European properties. Their introduction has become possible by, among other things, the fast development of the construction industry, as it rapidly matures. Over the last seven years, construction volumes in Russia have grown by more than 10% per annum. This has occurred alongside a simultaneous reduction in the number of construction companies. The survivors are becoming larger and more sophisticated. This, along with the industry's greater experience, allows developers to get a better service from construction companies and to raise the construction quality of their projects.

Until recently, tight supply forced companies to move into almost any available quality space. We believe that growing supply and variety of projects will allow companies to optimize their placement and will result in **stronger tenant segmentation**, typical for mature markets. For example, IT companies currently scattered around the city will utilize the convenience of business parks while large FMCG multinationals will be able to consolidate operations in a single building, primarily outside the CBD.

The current market is seeing improving standards of construction and services due to growing tenant expectations. Higher standards are being spurred by the entry of international development companies and growing opportunities for Russian players to improve the quality of their projects. Taking advantage of existing opportunities to build high-quality offices is the way for developers to remain competitive over the long term. For tenants, we see opportunities to optimize their placement.



Tenants' expectations are growing

Market standards are approaching international levels

Market will likely evolve towards stronger tenant segmentation

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