Main trends and events
The beginning of the first quarter was largely dominated by the same mood of anxiety with which the year 2014 ended. This was mainly due to the negative trends in many indicators of the office real estate market – such as the decline in demand, reductions in rental rates, and the increase in vacancy rates. However, in February and March positive changes were noted in some macroeconomic indicators – the ruble appreciated against the dollar (dollar dropped from this year’s peak level (February 3) by almost 19%, to the level of 56.4 rubles to the dollar by March 27), while the price of Brent crude first rose in February to $62.5 per barrel, but by the end of March, fell back to $54–56 per barrel. Such trends provoke assuming that, despite the difficult situation on the commercial real estate market, this market is now close to its lowest level, after which a gradual recovery may follow. The first quarter showed that demand for office premises remains at a low level. The number of concluded transactions showed an insignificant decrease, however, interest has switched to premises with small total areas. At that, two-thirds of the total volume of transactions involved the extension of rental contracts or renegotiations of lease conditions (on more favorable terms and conditions for the tenant).

During the first quarter, the Central Bank lowered its key lending rate twice, and as of March 16, it has stood at 14% (3 percentage points lower than during the beginning of the year). These measures, however, did not have a significant impact on the problems with credit financing, which remains inaccessible, and is hampering the development of the economy and leading to a decline in business activity. There have been cases of projects being frozen at the development, as well as at the construction phases. Examples of such office complexes are the Greendale BC (29,300 sq.m.\(^1\)), Kutuzov BC on Vasilisa Kozhina Street (O1 Properties is the developer of both objects), as well as Nagornoye BC (developer – Dorinda Invest). The increase in supply in 2015 will come mainly from objects that have already received credit financing.

\(^1\) Hereinafter referred to as gross leasable area (GLA)
With the introduction of a new method for calculating cadastral values for property tax purposes, which have increased the tax burden on owners of office buildings, there has been an increase in the number of cases challenging the assessed values. In the second quarter, the Ministry of Economic Development is planning to work on creating a unified methodology that will regulate the procedures used in appraising the values of land and buildings.

Other legislative initiatives include the development of a federal law that will give special status to industrial zones, which will help resolve a number of issues arising from the reorganization of such territories. In particular, this law is supposed to provide leveraging tools to apply against owners that are proving to be difficult, when it comes to reaching mutually beneficial agreements. The adoption of this law (planned for the end of 2015) may accelerate the completion terms of large-scale real estate development projects in these areas.
Investment market
Investment activity during the first quarter was at a low level, being influenced by negative factors associated with the economic recession, decline in business activity and low oil prices. Among the key transactions during this period was the purchase by the Capital Group of the right to build an MFC on Sofiyskaya Embankment. According to the project design, this complex will have a boutique hotel, residential housing, and offices with a total area of 37,000 sq.m. The transaction has been estimated at $165 million\(^2\). Other concluded transactions include the sale by the National Media Group of its share (73.35%) in the building that is home to the newspaper Izvestia, located on Tverskaya Street ($40 million), and the purchase by the Hines of an office building in the Metropolis MFC (32,000 sq.m.) from Capital Partners ($150 million).

In addition, placed on sale were such objects as the office building of Lukoil, with a total area of 5,700 sq.m. located in the Tverskaya District of Moscow on Suschevsky Val Street, and part of the ‘Class A’ Bronnaya Plaza BC (4,500 sq.m.) on the Garden Ring Road.

\(^2\) Here and afterwards, the values of investment assets are given according to appraisals made by experts at S.A. Ricci.
Supply
After the record growth in the volume of supply in the office market last year, the beginning of 2015 saw development activity slowing down. The introduction of new areas in the first quarter totaled to 195,000 sq.m. This figure is 19% lower than that for the same period in 2014, an increase that was the most insignificant throughout the last year, amounting only to 240,000 sq.m. Thus, the first months of this year, in terms of entering of new premises onto the market, are comparable, in terms of performance indicators, to the years 2011-2012, when average quarterly values were about 160–180 thousand sq.m. The total market volume for the period increased by only 1.3% – to 14.66 million sq.m. The growth of aggregate supply for the first quarter of 2014 amounted to 2%.

Dynamics of increase in new supply

Thous.sq.m

<table>
<thead>
<tr>
<th>Year</th>
<th>Thous.sq.m</th>
</tr>
</thead>
<tbody>
<tr>
<td>2005</td>
<td>1000</td>
</tr>
<tr>
<td>2006</td>
<td>1200</td>
</tr>
<tr>
<td>2007</td>
<td>1400</td>
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<tr>
<td>2008</td>
<td>1800</td>
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<td>2009</td>
<td>1600</td>
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<tr>
<td>2010</td>
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</tr>
<tr>
<td>2011</td>
<td>1000</td>
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<tr>
<td>2012</td>
<td>800</td>
</tr>
<tr>
<td>2013</td>
<td>600</td>
</tr>
<tr>
<td>2014</td>
<td>1200</td>
</tr>
<tr>
<td>F2015</td>
<td>1950</td>
</tr>
</tbody>
</table>
The growth of new office premises in the first quarter, in equal shares, came from objects in Classes A and B+. An example of a large ‘Class A’ office building, which was placed into operation, was the Lotus Business Center, with total office area of 88,400 sq.m. Given the office building projects currently under construction and planned for completion in the next three quarters, it is the ‘Class A’ segment that will dominate in the structure of new supply growth in 2015.

In the first quarter, the reconstruction of a number of office buildings was completed – in Sirius Park BC (bldgs. 4 and 9) and Arma BC (bldgs. 4 and 5a). Then there was the commissioning of a new building in the Orbita-2 Technopark (24,400 sq.m.) and in the Derbenevsky BC (7,900 sq.m.), increasing the total supply of ‘Class B+’ office premises to 97,000 sq.m.
The trend towards decentralized distribution of new supply, which in 2014 was partially corrected by the commissioning of large office complexes in the area of the Moscow-City MIBC, became especially typical for the beginning of 2015. The vast majority of objects (83%), the construction of which was completed in the first quarter, were located in the area of the Third Ring Road (TRR). Almost 30,000 sq.m. (15% in absolute terms) of office premises were successfully commissioned in the area of the Moscow Ring Road (MRR).

Concentration of development activity in the area of the TRR will continue to be supported by implementation of plans calling for the reorganization of industrial zones of the city, such as AZLK Moskvich, the I.A. Likhachev Plant, and other zones, the concepts of which provide for the construction of large amounts of office premises. The area of the MRR will become the most rapidly developing one in the western direction, and in the territories newly annexed by the city, where development plans provide for the establishment of business clusters.

Breakdown of new supply by ring road zones
The unstable economic situation and the absence of access to credit financing have had a significant impact on the development of office real estate. What is expected in 2015 is the completion of those buildings which at the beginning of the year were at the active stage of construction. Large amounts of vacant office premises, in combination with declining rental rates, have forced developers to review their projects, and subsequently to abandon the office component in them, or to delay the start of work on these until more favorable conditions appear. This explains the almost complete absence, during the first quarter, of objects moving from the design stage to entering the construction site phase, as well as an increased number of projects with uncertain construction completion dates.
Examples of business centers, commissioned in the 1st quarter of 2015.

<table>
<thead>
<tr>
<th>Name</th>
<th>Address</th>
<th>GLA, thousand sq.m.</th>
<th>Class</th>
<th>Developer</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lotus</td>
<td>2 Odesskaya Street</td>
<td>88.4</td>
<td>A</td>
<td>MR Group</td>
</tr>
<tr>
<td>Kuntsevo Plaza</td>
<td>19 Yartsevskaya Street</td>
<td>4.5</td>
<td>A</td>
<td>ENKA (Enka TC)</td>
</tr>
<tr>
<td>K-PARK / Sirius Park</td>
<td>3 Kashirskoe Highway, corpus 2, bldgs. 4, 9</td>
<td>47.1</td>
<td>B+</td>
<td>Plaza Development</td>
</tr>
<tr>
<td>Technopark Orbita-2</td>
<td>20 Kulakov Street</td>
<td>24.4</td>
<td>B+</td>
<td>Technopark Orbita</td>
</tr>
<tr>
<td>ARMA, phase II</td>
<td>5 Nizhny Susalny Lane, bldgs. 4, 5a</td>
<td>17.8</td>
<td>B+</td>
<td>Bolshoy Gorod</td>
</tr>
<tr>
<td>Derbenevsky</td>
<td>15-A Derbenevskaya Street</td>
<td>7.9</td>
<td>B+</td>
<td>n/a</td>
</tr>
</tbody>
</table>
Demand
In the first quarter of 2015, about 53,000 sq.m. of office premises were absorbed. This indicator of demand is only one-quarter of that achieved in the fourth quarter of the last year (210,000 sq.m.), partly due to low seasonal activity of tenants and buyers during the first months of the year. When compared to the same periods in 2013 and 2014, one can observe the negative dynamics of the market, denoting absorption rates that are lower by 59% and 57%, respectively, which is associated with a decline of business activity in general.

**Quarterly changes in absorption of vacant premises**
### Key transactions in the 1st quarter of 2015.

<table>
<thead>
<tr>
<th>Name</th>
<th>Address</th>
<th>Class</th>
<th>Area, sq.m.</th>
<th>Customer</th>
<th>Type of transaction</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mukomolny 2a BC</td>
<td>2A Mukomolny Passage,</td>
<td>B+</td>
<td>1,980</td>
<td>Confidential</td>
<td>Lease</td>
</tr>
<tr>
<td>Melnikoff BC</td>
<td>4 Olkhovskaya Street</td>
<td>A</td>
<td>1,400</td>
<td>Confidential</td>
<td>Lease*</td>
</tr>
<tr>
<td>OKO</td>
<td>21 - 1st Krasnogvardeisky Passage, bldg. 1</td>
<td>A</td>
<td>1,230</td>
<td>CBRE</td>
<td>Lease</td>
</tr>
<tr>
<td>Novodmitrovsky BC</td>
<td>5A Novodmitrovskaya Street, bldg. 8</td>
<td>B+</td>
<td>850</td>
<td>Baker Tilly Russaudit</td>
<td>Lease</td>
</tr>
<tr>
<td>Bashnya na Naberzhnoy</td>
<td>10 Presnenskaya Embankment, bldg. A</td>
<td>A</td>
<td>733</td>
<td>General Electric</td>
<td>Lease</td>
</tr>
<tr>
<td>Omega 2</td>
<td>26 Leninskaya Sloboda</td>
<td>B+</td>
<td>732</td>
<td>Crazy Panda</td>
<td>Lease</td>
</tr>
<tr>
<td>ARMA</td>
<td>5 Nizhny Susalny Lane, bldg. 19</td>
<td>B+</td>
<td>693</td>
<td>ABD architects</td>
<td>Lease</td>
</tr>
<tr>
<td>Streletskaia Sloboda</td>
<td>56 Butyrskaya Street</td>
<td>B</td>
<td>677</td>
<td>FCM travel solutions</td>
<td>Lease*</td>
</tr>
</tbody>
</table>

*Transactions of S.A. Ricci*
On the office market in the beginning of 2015, there was observed a decline in the average transaction size (double decrease, when compared to the same period of the last year – down to 820 sq.m.) and in the number of transactions (by 20% – down to 55 units in the quarter). In the first quarter, 72% of transactions, involving the lease or sale of offices, were made for premises of less than 1,000 sq.m. in total area. The average size of sales transactions went down to 360 sq.m., which is a decrease of 48%, when compared to first quarter of 2014. In lease transactions, the average size of premises decreased by 39%, in comparison with the first quarter of the last year, and amounted to 1,200 sq.m. The structure of the absorption by class was dominated by ‘Class A’ (57%) premises, which can be explained by the dropping threshold for access to high-end business centers for tenants and buyers in the current environment of falling rental rates and growing vacancy rates. Large blocks in ‘Class A’ business centers have been sold in the SkyLight Office Complex (Tower B) and the Gorod Stolits, and leased in the OKO BC, Melnikoff BC, and others. The ‘ClassB+’ objects accounted for 36% of all absorption, due to transactions in the Simonovskiy Business District, Danilovskaya Manufaktura BC, Novodmitrovsky BC, and others. The ratio of lease and sale transactions involving office premises is comparable to the first quarter of the last year, being 78% and 22%, respectively.

Changes in the structure of demand by type of transaction
Demand for office premises in the first quarter came from companies in various fields of activity, which affected the differentiated structure of the absorbed premises. The most active were the banking and financial institutions, which accounted for 23% of the absorption. The share of IT and electronics companies remained high. Thus, the Crazy Panda leased space in the Omega2 Business Center (732 sq.m.). Almost equal amounts of office premises were absorbed by companies in the fields of marketing and PR (12%), consulting and business services (11%), manufacturing (10%) and medicine (9%).

**Pattern of demand by the profile of tenants**

- Banking & Finance: 23%
- IT / Telecom / Electronic: 19%
- Advertising / Marketing / PR: 12%
- Consulting & business services: 11%
- Manufacturing & Technology: 10%
- Medical / Pharmaceutical: 9%
- Real Estate & Construction: 5%
- Government / Non-profit organizations: 4%
- Other: 7%
The structure of demand by geography shows that last year’s trend has been maintained, in terms of active absorption of office premises in the area of the TRR, which accounted for 48% of the total volume in the first quarter of this year. The area of the MRR, whose share was 28%, was also interesting to tenants and buyers. Thus, the G10 BC, located in the ‘New Moscow’, has sold a total of 1,200 sq.m. During the same period in 2014, a comparable proportion of office premises (33%) were absorbed in this area. The minimum volume, during the first quarter, was absorbed in the central districts of Moscow. The greatest interest of tenants within the area of the Garden Ring Road was shown to the business centers ARMA and Silver City. In the area of the Moscow-City MIBC, the aggregate demand was 7,500 (17%), due to transactions in the business centers Gorod Stolits, OKO, and the Bashnya na Naberzhnoy.

**Dynamics of absorption by ring road zones**

- **MRR**: 2015 - 28%, 2014 - 14%, 2013 - 12%, 2012 - 9%
- **MIBC**: 2015 - 17%, 2014 - 6%, 2013 - 3%, 2012 - 3%
- **TTR**: 2015 - 48%, 2014 - 49%, 2013 - 38%, 2012 - 11%
- **GR**: 2015 - 6%, 2014 - 14%, 2013 - 26%, 2012 - 3%
- **BR**: 2015 - 2%, 2014 - 3%, 2013 - 11%
At the beginning of 2015, there was observed an increased activity of tenants, motivated by a desire to move into the offices of a higher class, or to more favorable locations, or remaining in their current premises, but renegotiating their leases on better terms and conditions. For example, the Rostelecom succeed in the negotiation process to change the conditions of its lease, from the rent rate being denominated in foreign currency in euros to rubles, the amount of which would thus be approximately 8% lower than the original lease. The company will now take 48,130 sq.m. in the Comcity Business Park in the ‘New Moscow’.

The owners of office buildings that cannot implement ruble rental rates due to their foreign currency agreements with the banks are willing to provide discounts to current tenants with leases denominated in foreign currencies. In such cases, the discounts are being offered for 6 months to 2–3 years, depending on the conditions and opportunities for withdrawal from the lease contracts.
Vacancy
The office market is characterized by an imbalance between supply and demand. Empty office premises, the growth of which became particularly evident in the second half of 2014, at the beginning of this year, due to low demand indicators, for the most part, were unable to find their tenants. The vacancy rates remain high. The average rate in the market in the first quarter of 2015 was 19%.

Dynamics of vacancy rates by class of object
In the ‘Class A’ objects, the vacancy rate remained at the same level as before, 28% of office premises remain empty. There were changes observed in the area of the TRR, where, because of new supply, the vacancy rate for ‘Class A’ premises increased from 21% to 24%.

In Classes B+ and B, the vacancy rate showed a negative trend, compared to the fourth quarter. In ‘Class B+’ office complexes, the vacancy rate increased by 1 percentage point and reached the level of 17%, in ‘Class B’ by 2 percentage points – up to 11%. This change is the result of a number of tenants moving into business centers of a higher class, and the result of the low volume of new construction in these classes.
Rental rates
The weighted average rental rates for office premises in the first quarter continued their downward trend. Activity of tenants remained at a low level, forcing the owners to look for new approaches to enhance the attractiveness of their objects. In business centers with large amounts of empty premises, this is achieved mainly by lowering the rental rates, while objects with insignificant vacancy rates offered various additional incentives (e.g., relocation assistance, partial finishing work).

The drop in rental rates was observed in all market segments. In areas of the Boulevard Ring Road and the Garden Ring Road, in the business centers of classes A and B+, in some objects the rental rates dropped to 40–42 thousand rubles/sq.m./year and 23–35 thousand rubles/sq.m./year, respectively for finished premises with the inclusion of all expenses in the rental rate (other than electricity) and VAT. Thus, the base rate is at a level of $300 to $550 per sq.m./year, which is 20–25% lower than at the end of the last year. In areas of the TRR and MRR, the rates decreased by 10–15%, reaching the level of $300–470 per sq.m./year and $200–290 per sq.m./year, respectively. The rental rates at objects in these areas will continue to fall.

The trend of setting rental rates in rubles is still typical for the office market. In objects of classes B+ and B, especially prevalent are rental rates denominated in the national currency.

Ruble rates for vacant ‘Class A’ premises are changing in the following ranges:
- 25,000–29,000 rubles/sq.m./year within the Boulevard Ring Road and the Garden Ring Road;
- 17,000–19,000 rubles/sq.m./year in the area of the TRR;
- 12,000–15,000 rubles/sq.m./year in the area of the MRR.

For ‘Class B+’ premises, the ruble rate is set in the following ranges:
- 15,000–19,000 rubles/sq.m./year within the Boulevard Ring Road and the Garden Ring Road;
- 10,000–15,000 rubles/sq.m./year in the area of the TRR;
- 6,000–9,000 rubles/sq.m./year in the area of the MRR.

On the territory of Moscow-City MIBC, the cost of renting office premises in the last quarter fell by 10–18%, office premises in business center of this area are being offered from $450–500 per sq.m./year to $650–700 per sq.m./year.

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3 Here and afterwards, the rental rates are indicated in the shell and core condition, excluding VAT and operating expenses.
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