

advance

Russian Regional
Office Market:

**Vector
of Evolution**



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LASALLE®

Regional office markets are quickly catching up with Moscow while becoming more diverse at the same time. Their future development will depend not just on the experience of developers but also on the growing professionalism of tenants.

Nation's capital is undoubtedly the most attractive place for doing business, drawing in a large number of companies. Moscow has already become a global business capital and a popular target for investments. However, the growing competition in Moscow, and to a lesser extent in St. Petersburg, is spurring more and

more companies to seek development opportunities outside of these two cities. Growing potential and improving transparency of the regional markets is encouraging companies to expand into the regions. This, coupled with robust local business development, forms a growing demand for office space.

Development Drivers

- + Robust economic growth
- + Regional expansion of international and local companies
- + Land availability
- + Support from local authorities (in some cities)
- + Growing interest from major developers
- + Lack of quality office projects

Constraints

- Lack of experienced developers
- Lack of quality office projects limits tenant choices
- Lack of professional property management companies
- Limited interest from potential tenants to pay higher rents for quality offices
- Low market transparency
- Lack of project financing

Currently, the supply of quality office space is limited. While the saturation levels vary, the lack of space is characteristic for all cities. This deficit makes regional cities landlord markets, stimulating rental growth. Currently rents for office space in regional cities are on a par with those for class B+ space in Moscow, exceeding those in Central and Eastern Europe.

High activity of developers is another important factor. Striving to satisfy growing demand and attracted by high returns and growing rents, developers are announcing new projects, and by 2010 the supply in the Millionniki cities will more than double to exceed 2 mn sq m. Despite the fact that this figure makes up only 14% of the expected supply in Moscow, this volume can saturate regional markets and lead to rent stabilization.

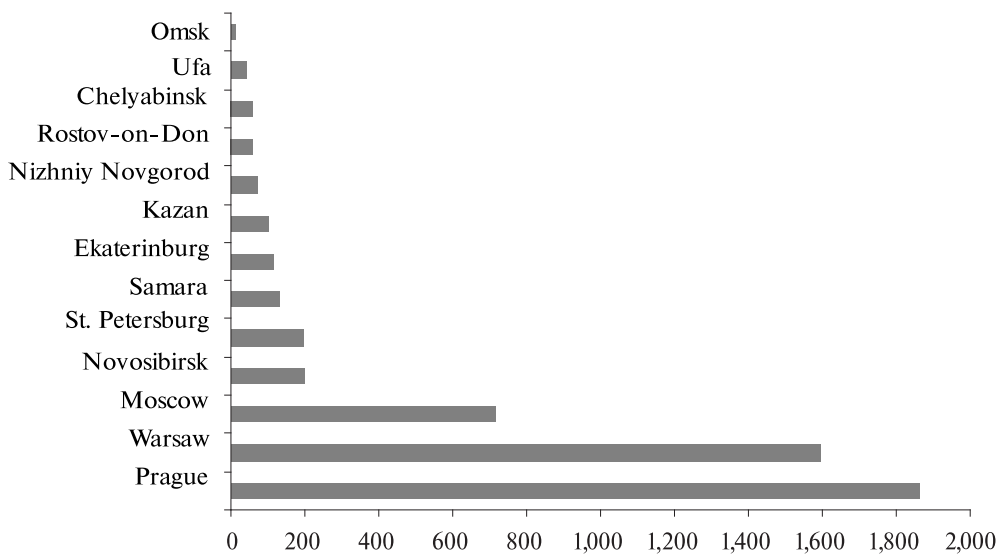


Differentiation on the Way *to Moscow*

A lower level of development in regional markets is the main driving force behind their evolution. With growing rental rates, the arrival of major international and Russian tenants and the appearance of new quality projects, the regional office market is moving closer to Moscow. At the same time, the differentiation among regional markets in terms of quality of supply and demand is increasing.

Currently markets in the Millionniki cities are quite diverse. This is reflected not only in the supply volume, which varies from 277,000 sq m in Novosibirsk to 17,000 sq m in Omsk. The difference is also in the presence of major developers and reputable tenants and in the quality of the projects themselves.

Supply volume per 1000 residents, 2007, sq m



Against the background of generally low development level, regional markets have numerous common characteristics as well. Currently the uniting factor for all regional cities is strong centralization of the office market. Projects are concentrated in the centre and in areas close to the centre. Decentralization in a number of cities is only beginning, yet this indicates accelerated development.

Most of the projects are still built by local developers, which lag behind Russian and international majors in standards of quality.

Representatives of major domestic and foreign companies are the main source of demand for quality office space. Expanding local businesses are also gradually acquiring a taste for quality offices, although for the time being their interest is mostly limited to class C, mainly due to budget constraints. Lack of standard rental practice, simplified tax arrangements and predominance of sale over leasing are also characteristic of local markets, reflecting their immaturity.

Thanks to intense development, the situation in some cities is starting to change, approaching Moscow standards. Major developers are entering the markets (for instance, RosEuroDevelopment with the RosEuroPlaza in Novosibirsk), the geography of the projects is expanding (from Samara, Yekaterinburg to other cities), while rental practice is becoming more comparable with that in Moscow (with annual rents, exclusion of VAT and operational expenses, longer lease terms), leasing is gaining popular. These processes, however, are progressing with different levels of intensity in different cities, raising the differentiation among cities further.



The Future of Regional *Demand*

On the demand side, the future belongs to growing medium-size and large local companies. Local businesses are only beginning to actively demand quality offices. Despite a broad presence of international and major Russian companies in the regions, the size of the transactions remains small compared to Moscow. The projected supply volume can be absorbed only in case of high demand from local companies, when they start considering their offices as an important business asset. Taking the current dynamics into account, we expect continuing improvement of project quality and of tenant professionalism. This will accelerate the development of regional markets, bringing them closer to Moscow standards.



Similar or *Different?*

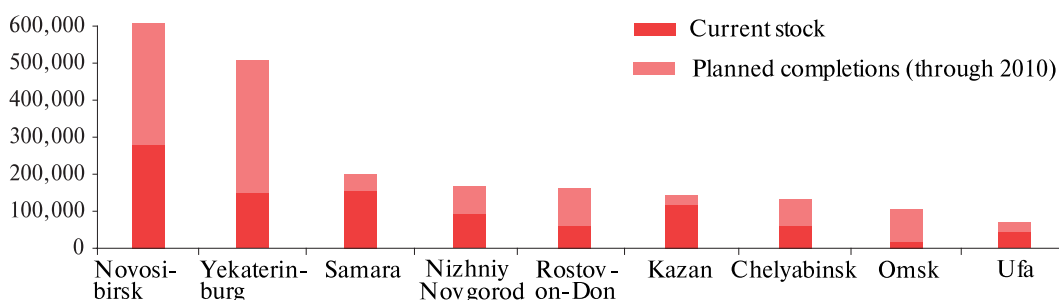
Supply

Currently Novosibirsk, Yekaterinburg, Samara and Kazan offer tenants the widest choice of quality office facilities. The supply of office space depends on the economic activity in the city, which in turn, is influenced by its geography and economic structure. From this point of view, some cities offer obvious advantages over others. For instance, Rostov-on-Don is located on the intersection of two key transportation arteries of southern Russia, Novosibirsk is the centre of business activity in Siberia, while Yekaterinburg is the capital of the Urals. This makes these cities attractive for companies expanding their business in the regions, at the same time stimulating local business growth. As demand grows, developers announce more new projects. Yet, because of different potential, markets experience uneven developer activity. Although most

cities have both regional and local developers, their presence is not the same everywhere.

Construction activity is high in all cities, and by 2010 the expected volume of quality space in many cities, except Ufa, will considerably exceed 100,000 sq m. Growth of new construction is also different depending on the city – largest supply volumes are planned for Novosibirsk, Yekaterinburg, and Rostov-on-Don, while Ufa and Kazan lag in their pace of development. Last year, the number of office buildings in Novosibirsk has doubled; the same situation is expected in Rostov-on-Don by 2010, according to the announced plans. The supply growth rate is accelerating in Yekaterinburg, and completion dates for the majority of quality buildings are set for 2009-2011.

Current and future office stock, sq m



The growing number of office projects in the regions comes along with an increase in quality. Developers become more experienced and pay more attention to quality characteristics, as they aspire to give their projects a competitive edge. Some markets are ahead of others, offering buildings close to Moscow's standards. For example, 2007 saw the arrival of RosEuroPlaza in Novosibirsk. In terms of quality,

this project considerably surpassed all other in the city and conformed to Moscow standards. In the coming years markets in a number of cities will see the arrival of projects offering new standards of quality: the Palladium (Yekaterinburg, 2008), Yekaterinburg-City (Yekaterinburg, 2008-2014), Iron Hills Centre and Manhattan (Novosibirsk, 2009), Lobachevsky Plaza (Nizhny Novgorod, 2008).

In a majority of regional cities, the office market remains very centralized. For example, in Samara, Yekaterinburg, Novosibirsk, Nizhny Novgorod and Omsk existing office space is located primarily in the city centre. However, geographical expansion has already begun in a number of cities. In Samara, Novosibirsk, and Nizhny Novgorod construction is spreading beyond the limits of the city centre, and business neighbourhoods are beginning to form on the outskirts. This signals that the markets are entering a stage of accelerated development as they move closer to Moscow.

Demand

Today a large part of the demand for quality facilities in cities with a population of over a million is formed by representatives of international companies (for example, Ernst&Young, Coca-Cola) and major Russian companies (Rosgosstrakh, Troika Dialog and others). But their presence is different from city to city. The largest number of companies is in Novosibirsk, Yekaterinburg, Nizhny Novgorod, Samara, Chelyabinsk, Rostov-on-Don.

Low quality space continues to be in demand among local companies, since most local tenants have considerable budget constraints when it comes to leasing, while their low professional level makes them reluctant to lease better office space at higher rates. Many local businesses still lack the culture of conducting business activity in comfortable environment. However, a number of cities, like Samara and Nizhny Novgorod, are witnessing a trend of tenants moving to higher quality offices. This tendency is a key factor for regional market development, since mid-sized and major local business will be main future tenants in projects that are under construction. Growing professionalism of tenants eager to improve the conditions in which they do business will considerably accelerate market development.

A majority of companies prefers to buy offices instead of leasing them. The leasing market is particularly weak in Ufa, and a considerable fraction of local companies in Samara, Novosibirsk and Omsk tends to purchase office space. This practice is supported by developers who prefer to sell offices in their projects, which makes them less attractive for investors. As they develop, some cities are approaching the Moscow market, where the majority of office space is leased out. This practice is becoming more popular in Yekaterinburg and Novosibirsk.

Markets that demonstrate the fastest development rates also boast tougher competitiveness among office projects. Alongside an increase in quality, this stimulates longer lease terms. For example, new quality projects in Novosibirsk have a minimal lease term of five years, which is consistent with the Moscow practice.

Lease and Purchase Rates

In a majority of regional markets lease rates depend more on location than on technical characteristics of a building or services offered. As tenants become more professional and projects grow more varied in quality, a tendency to differentiate rates based on quality is nascent, but only in certain cities (for example, Novosibirsk).

Today average lease rates for quality space in the Millionniki cities vary from \$200 per sq m per year (Omsk and Kazan) to \$690 (Yekaterinburg). Average prices per square metre start from \$1,100 in Omsk and \$1,200 in Samara and can reach up to \$4,000 (Nizhny Novgorod and Novosibirsk). In terms of rates, some regional markets (like higher quality projects in Novosibirsk and Yekaterinburg) have reached Moscow's class B+ levels. Generally, the differentiation in rates across cities is considerable.



We are witnessing the regional office market becoming increasingly similar to the one in Moscow, while heterogeneity among cities is growing. The regional market is seeing the arrival of projects conforming to Moscow standards of quality that are priced accordingly, the market geography is expanding, and leasing conditions are evolving as companies begin to lease rather than buy office space. These processes, however, are unravelling in different markets with different intensities and cause increasing differentiation. In spite of this, the future development of all markets depends on the same factors. We believe that it will be determined not just by increasing experience among developers, but to a large extent will depend on evolving demands among tenants.

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