

advance



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Real value in a changing world

Who's been working in this office?

Moscow office tenants



Increased demand for Moscow office real estate was the most important and noticeable trend during 2007. With Russian business development outpacing growth in the office market, demand continues to exceed supply. Currently, many tenants are prepared to rent almost any office space of good quality, and landlords continue to control the market. This often results in landlords not having a clear picture of the tenant pool for their building formats, or of the key tenant groups that are driving demand for office space in Moscow.

Nevertheless, the laws of market evolution dictate that the Moscow office market should eventually move from the rapid growth phase to stabilization. At this stage, tenants will have a better choice of office premises, and their requirements will therefore increase. In this environment, understanding the demand structure and main market trends is a key to successful project development.

Who's been working in *this office?*

Services make up the bulk of the Moscow economy, producing 78% of its GRP (gross regional product), according to official statistics. The structure of the economy determines employment composition and demand for office space.

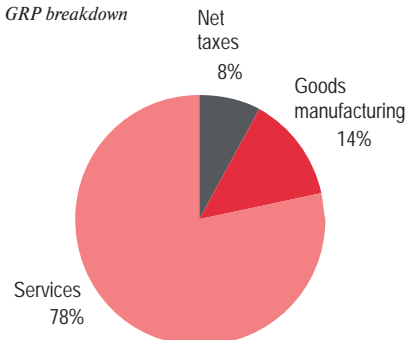
However, 62% of the services segment is represented by retail and catering companies, which make no contribution to demand growth for office real estate. So, who are the main occupiers of Moscow office space?

Today, most of the quality office tenants in Moscow are companies of the financial, natural resource extraction and processing, business services, telecommunication and FMCG sectors. In terms of tenant origin, developing Russian, new and existing foreign companies are equally important as demand sources. However, Russian companies generate a substantially higher volume of transactions than the other tenant groups. The new incoming international companies usually rent smaller premises, initially for their rep offices. However, their contribution to demand for office space should not be underestimated, as they often play an important role in this market at later stages of their development. Among foreign companies, European tenants represent the largest group (about half in the last seven years).

Most demand from the financial sector is focused on Class A offices within or close to the Garden Ring. This is due to the large number of clients these companies have and the importance of their businesses. Today, these locations represent 50% of the floor space taken up by banks. Given the deficit of office premises and insufficient differentiation between Classes A and B+ for some buildings, some financial sector companies also rent Class B+ offices. This option mostly suits smaller companies, as well as the back offices of larger ones. Demand in this segment is dominated by banks, particularly Russian ones. They often prefer to be the only tenant in the building, which has led to a real estate category known as 'banking mansion' — a detached building with a certified vault in the basement. This kind of layout guarantees security, confidentiality and respectability. The advantages of such premises are appreciated, for instance, by Raiffeisen Bank, which owns a three-story mansion on Smolensky Boulevard.

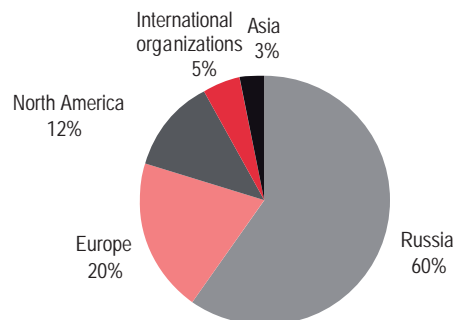


Moscow GRP breakdown



Source: Debt Committee of the City of Moscow, 2007

Take-up structure in 2007 in terms of tenant origin

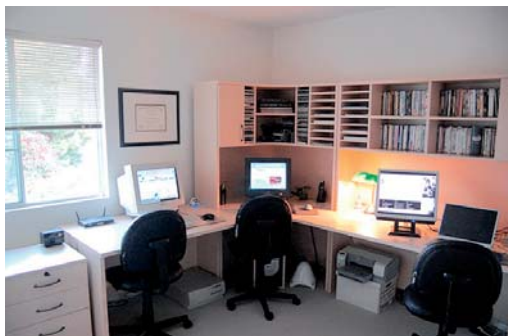


Source: Jones Lang LaSalle

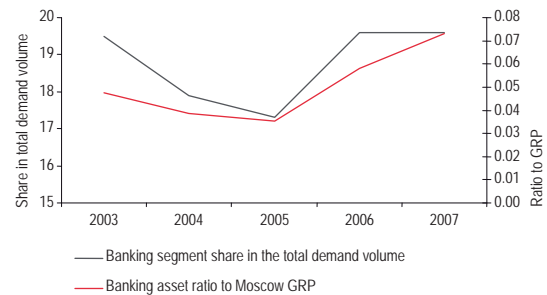
At the sector level, demand growth for office premises is primarily determined by such factors as the sector's development, its specifics and its ability to upgrade its premises. The correlation between demand and sector growth is clearly demonstrated by the financial sector (see below). We note that this analytical approach is applicable to other sectors as well.

Demand from natural resource extraction and processing companies derives mostly from Russian market players, given that their businesses tend to develop faster. As international companies have limited access to Russian natural resources, their businesses are smaller, thus limiting their demand for office premises. In this sector the top players are oil companies such as LUKOIL, Rosneft and Slavneft. Major commodity exporters prefer to acquire office buildings in order to consolidate various departments. For instance, in 2005, United Metallurgical Company bought the Aquamarine I office centre on Ozerkovskaya Embankment. Overall, Class A offices are preferred, while B+ premises are also a popular second option.

Business service providers as a tenant category include a wide range of businesses grouped within the B2B services market. International business service companies have been developing more rapidly than those of Russian origin due to the financial support from their head offices and their experience in Western markets. In the last seven years, their take-up amounted to more than 56% of the total volume of transactions. International companies lease larger offices as they often have higher staff levels than their Russian counterparts. In this segment, Russian companies are widely represented by travel agencies and law firms, neither of which requires large floor space. However, in the last four years, demand from Russian companies has considerably increased, and their share in the total volume of transactions has been rising as well.



Correlation of financial sector take-up and banking assets' growth in Moscow (%)

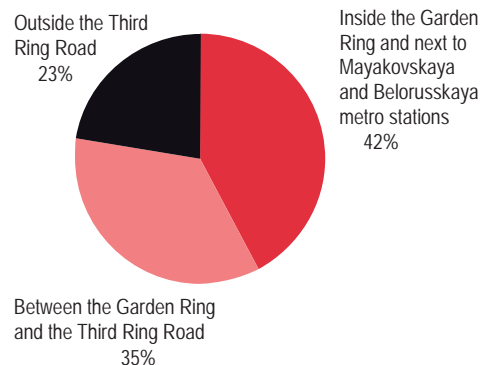


Source: Jones Lang LaSalle, CBR, Rosstat

The Russian market for telecommunication services is developing rapidly, positively impacting office demand from this segment. Russian companies are leaders in this market, and the take-up volume demonstrates a stable upward trend. In addition to the mobile operators, strong demand has derived from the mobile content, digital television and internet providers. However, we note that the need for some companies in this sector (primarily fixed-line operators) to have sufficient space for equipment and technical support, means that in most cases they prefer Class B- and Class C offices.

For a long time, most telecommunication companies were located in the city centre. However, since 2003, when the office space deficit and rental growth became acute, the distribution of these companies around the city has become more even (see below).

Geographic take-up breakdown among telecommunication companies



Source: Jones Lang LaSalle



Overall, this sector is characterized by the dispersion of their business segments in various Moscow regions: the head offices in the centre, call centres in the outskirts, and technical support in various locations where the facilities match their technical requirements. For instance, MTS rented 16,300 sq m in the Semenovskiy office park on Bolshaya Semenovskaya for its back office functions, mainly the call centre.

Russia's consumer boom and income growth has contributed to the rapid development of FMCG businesses, which is reflected in their strong demand for office premises. Other consumer manufacturing companies (for instance, automobiles) have also been more active. However, in Moscow, the largest group of tenants is represented by FMCG manufacturers. This could be due to their dynamic growth as well as to the fact that these companies have high staff levels, most of which are office workers. This compares to automobile company employees who mostly work in showrooms. Faced with the deficit in office space, these tenants are generally not picky in terms of Class A or B+ offices. Nor do they have any particular requirements with respect to office location. Currently, these companies are spread throughout Moscow more or less evenly: 37% are located within the Garden Ring and next to Mayakovskaya and Belorusskaya metro stations, 33% are situated between the Garden Ring and the Third Ring Road, and the rest (30%) have settled outside the Third Ring Road.

The current demand pattern has to a large extent been formed by the deficit in quality space, which has intensified due to rapid economic growth. In this environment, it is rather difficult for tenants to impose their requirements and comply with strict corporate standards for premises — tenants have to be flexible. However, the office stock continues to grow, and since 2008 the completion volume is expected to be at least 2 mn sq m. This gives greater opportunity for tenants to satisfy their needs and specify their requirements. In addition, developments within the various economic segments are feeding into the evolution of the market's demand volumes and structure.

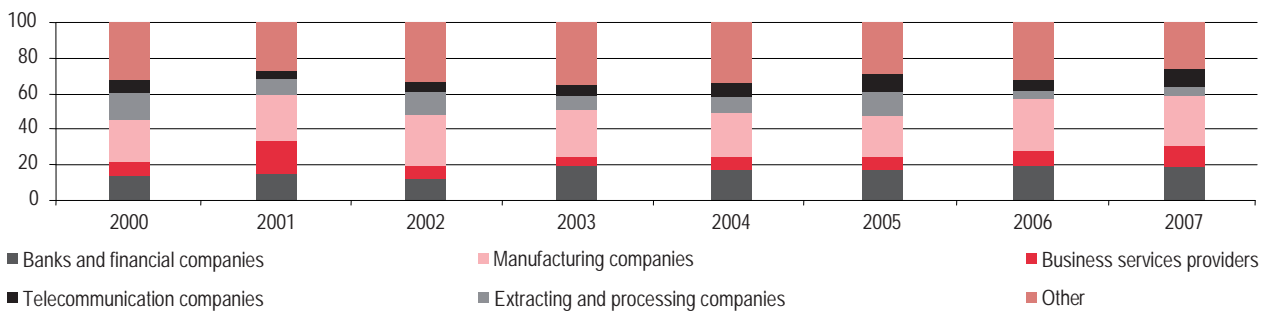


Tomorrow's *neighbours*

The demand trends of the sectors we have analysed reflect the different dynamics of their development. The business services sector is demonstrating steady growth on the back of Moscow service sector development and its increasing share in the city's GRP. In the last three years, the share of professional services businesses in total take-up almost doubled, from 6.3% in 2004 to 11.4% in 2007. Banks, financial and manufacturing companies have demonstrated overall positive dynamics, although we note some variations due to specific intra-sector developments. The take-up volume by telecommunication sectors is also increasing. On the back of the developing telecommunications market, we expect further demand growth from this segment, albeit at a moderate pace given that part of its rented space is still in Class C. The recent trend of asset consolidation among the fixed-line operators should result in staff dismissals and lower demand for office premises in the longer run. We see the most potential in telecommunication solutions and equipment providers, internet solution companies and mobile operators. Meanwhile, the extracting and processing companies have almost exhausted their demand growth potential. The majority of large companies in this sector have already obtained sufficient space, including their head offices. Therefore we do not expect a large number of deals to happen in this segment.



Shares of major segments in the total take-up volume (%)



Source: Jones Lang LaSalle

Consumer purchasing power in Russia continues to rise, supporting the growth of FMCG manufacturing companies and their demand for office premises. However, as the quality of life in Russia is improving, people are beginning to spend more on non-essential goods and services (insurance, etc.) This trend is contributing to the growth of other manufacturers (for example, automobiles), insurance companies, and their demand for office space. Official forecasts indicate a higher employment rate in the telecommunication and financial segments, which will further boost demand for office space.

A constraining factor for demand growth for quality office space remains the large share of personnel employed in the retail sector. According to official statistics, this sector is expected to enjoy the strongest growth in employment share (from 18.9% in 2000 to 24.4% in 2010).

An increasing number of companies are beginning to separate their front and back offices, renting Class A space for the former and Class B+/B- for the latter. Thus, financial companies, along with business service providers that have traditionally been prominent in the Class A segment, should gain more weight in other classes of office premises.

Increasing rents in the centre of the city, road congestion and deteriorating ecological environment are forcing some companies to move their offices outside the centre. For example, we expect manufacturing companies to gradually migrate to the Third Ring Road and the Moscow Ring Road. A good example is Procter&Gamble — it has rented 18,000 sq m in the Class A Metropolis business and retail centre which is under construction on Leningradskoe Shosse. The process of demand decentralization has already begun. The movement of back offices to business parks, which are relatively common in Europe, is likely to be increasingly adopted by Russian companies.

The Moscow office market is rapidly developing. It is demonstrating changing tenant occupancy, class preferences and requirements for office space. We believe that the demand trend for Moscow offices in the next few years will continue to change, and become more diverse and complex. With growing stock, companies will gain the opportunity to satisfy their preferences. This should result in a better-defined tenant segmentation and demand trends in this market.



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