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Commercial real estate: Moving forward irrespective of external and internal challenges

The commercial real estate market mirrors the state of play in the national economy. The analysis of this particular sector reveals a number of processes that are hardly detectable when viewed from the outside. Polina Afanasyeva, Director and Head of Research and Analytics at Commonwealth Partnership, describes the trends of the outgoing year with focus on economic growth of Moscow and the regions, and highlights the problems the developers have encountered after the Central Bank upticked the key interest rate.

There is a lot of talk that current high refinancing rate is severely obstructing business development. In what way does it affect the Moscow commercial real estate market?

The economic backdrop is a factor in its own right and serves as a constraint on going into business. The valuation is now being determined by the availability of sufficient financial resources without reliance on loan capital. Consequently, only large commercial property players and residential developers are announcing and commissioning new projects. We observe this trend across all commercial property segments.

On the demand side, the slowdown in business activity at the end of 2024 onwards, which is taking place in the context of the cooling down of the national economy following to certain monetary measures, leads to a more cautious initiation of new large

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deals. This is largely due to the surge in the cost of money, lack of variability of options, and blurred planning horizon. As a result, we witness an overall smooth decline in business activity.

In the office real estate segment, many players with initial interest in kick-starting construction of office spaces in 2023-2024 have already refocused on sales as a preferred marketing strategy. Similarly, sales will remain the leading strategy for new business centres developers.

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After a record year 2023, the commercial property investment market has entered a stage of transition, due to both a decline in the number of deals involving foreign investors and tighter monetary settings. In the current environment, property acquisitions are generally considered only in two circumstances: when the asset to be acquired is offered at a discount or when equity is used.

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At the same time, investors tend to adopt a wait-and-see attitude, with property transactions being used to achieve operational objectives. In the coming year, the key interest rate trend will continue to play a decisive role in determining the investment attractiveness of real estate property, and in turn it would affect the volume of transactions.

What's your take on the commercial real estate prices in the Moscow region?

If we consider the office property market, the segment is in the ‘owner and proprietor supremacy’ phase. The reason being that the share of vacant space is at minimum level. The last time the indicator was recorded below 5% was in 2007, while activity remained high until the end of the year (the last interest rate revision). As it was expected, all of the above factors led to an increase in rents: by 10% for offices and 1.5 times for warehouses in November 2024 compared with the same period last year.

Nevertheless, one should bear in mind that the average increase in market rates may not reflect the state of play in full. In fact, both in the office and warehouse segments, one of the trends noted during 2024 is not simply an increase in rates, but also a significant expansion of the upper and lower limits of the commercial terms requested. At the moment, we do not see any preconditions for a change in the course of interest rates. In view of the cooling down of demand that became noticeable towards the end of the year, the increase in interest rates may be less dynamic, but an increase within the inflation range is still guaranteed.

NOTE: Another striking trend last year was active selling. When it comes to warehouses, for example, it is important to take into account that the sale price is rising more slowly than the rental rate, which makes the purchase of a warehouse property more attractive. For example, at the end of the third quarter of 2024, sale prices were 39% higher than at the same time in 2023 (while rental rates were 44% higher). Moreover, since 2021, the cumulative growth in rental rates has exceeded inflation, in contrast to sales prices. In an increasingly expensive lending and owner-occupier market, sales are a more attractive type of operations for both developers and buyers due to fixed terms and reduced inflation risks.

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The largest increase in the share of commercial property is traditionally registered in Moscow. What about the regions of the Russian Federation?

The various aspects of government policy have contributed to making the regions more attractive for investment. The stimulus for consumer demand and import substitution have been important factors in this respect. In addition to major projects in the

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tourism sector, we have witnessed a surge in regional business activity. The share of investment deals in the regions upped during the year, while the demand for warehouse space, which is sought by both the retail and manufacturing sectors, reached the high levels typical of Moscow and St. Petersburg.

Recently, a significant number of corporate headquarters have been built in the regions, thus creating a plethora of top-notch commercial real estate outside the capital city of Moscow and St. Petersburg, and in this way furthering the comprehensiveness of the real estate market.

The shift of developer activity to the regions is particularly conspicuous in the warehouse property market. In the first three quarters of 2024, for the first time in five years, the volume of new construction in the country’s constituent entities exceeded that of the Moscow region by a factor of two.

The share of regional demand approached half of the national total. This was due to the growing purchasing power of the population in the regions and the resulting expansion of e-commerce players, which were acting as the main drivers of regional demand for warehousing property.

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As part of the strategic “Pivot to the East”, particular attention has been paid to the development of the Russian Far East region. Is it possible to assess the trends of business activity in these territories through the dynamics of commercial property figures?

The “Pivot to the East” is indeed reflected in the commercial property sector. For example, transport infrastructure is changing, it has a positive effect on the logistics, and as a result we are recording changes in the warehouse and industrial property market. A notable case is the opening of the M-12 Vostok motorway in December 2023, which is part of the Europe-West China international transport route. The transport infrastructure created has opened up the potential to use land for logistics that could not be put into operation previously. Within 10 years, 1.5 million square metres of new warehouses could be built along the route (including the extension to Tyumen). It is planned to extend the motorway to Yekaterinburg in 2025 and to Tyumen in 2026.

Geographical expansion of warehousing facilities is expected at points of contact with major cities. Eventually, the route is expected to reach Vladivostok. At present, the market of Primorsky Territory, whose logistical centre is the city of Artem, is not sufficiently saturated with quality warehouses. At the same time, the largest marketplaces and representatives of the food retail segment have requested an increase in storage capacity in this region. Over the past two years, the weighted average base rent has increased twice, reaching 11,500 roubles per square metre per year, while the vacancy rate remains close to zero.

In the medium term (2-3 years), the volume of the Primorsky Territory warehouse market may increase almost twofold, and it is highly probable that the facilities will be put into operation after they have been already contracted.

What segments of Moscow’s commercial property market are currently the most dynamic in terms of growth and which of them face challenges?

After the latest round of interest rate hikes, it would be more of a wishful thinking to speak of vigorous growth in the segments. However, it should be noted that in the first three quarters of the year we have witnessed a remarkable spike in activity in both the office and warehouse segments.

Each of the markets, of course, had their own powerful drivers. In the office market, this factor amounted to the demand from state structures and state owned companies. The largest transactions of the year were the acquisition of Business Centre Moscow Towers by Russian Railways (263,000 sq. m of office space) and Business Centre Slava by the Central Bank of Russia

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(102,000 sq. m of office space).

In the warehouse real estate segment, e-commerce has become a bullish factor (based on the results of Q1-Q3 2024, transactions with players from the online trade sector accounted for 52% of demand in the Moscow region and 67% of demand in Russia). In the first 9 months of 2024, the share of vacant spaces in the retail real estate segment decreased to 7.4% (minus 4.6 p.p. compared to the same period of 2023), what manifests the finalization of the market's recovery phase. This is confirmed by the record number of new brands entering the domestic market.

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Import substitution requires the creation of new production facilities in Russia. This means building and expanding technological bases and factories. Is there any data to prove that we are really moving in that direction?

The policy of import substitution and displacement of imports from the Russian internal market is creating lucrative conditions for growth and expansion of local production facilities. The level of business activity in the regions is steadily going up, corporate headquarters are being opened, and the demand for warehouses is growing too. The full implementation of the import substitution policy is hampered by a deficit in the labour market, while the expansion of production capacity is constrained by sanctions' pressure from Western countries. In this case, production growth is hampered even by growing domestic demand, with the imbalance manifesting itself in inflationary pressures and record high-capacity utilisation (81% in Q3, according to Rosstat).

Nevertheless, growth in corporate lending and Russia's business climate index point to an increase in business activity across the country. An illustration of this process in the Moscow region is the reduction of the vacancy rate in tech parks to 5% as of November 2024. Small and medium-sized enterprises (SMEs), which receive a wide range of support from the government, are the main users of space in industrial parks. According to the Association of Industrial Parks (AIP), there was a shortage of available spaces in industrial parks in June 2024. In response to this challenge, the Russian Ministry of Economic Development announced in November the introduction of new terms and conditions to acquire grants for regional administrations to support investors in regional projects for the construction of new facilities or the revitalization of industrial buildings and tech parks. This move serves as a strong indicator of support for private entrepreneurial initiative in the manufacturing sector in Russia.

In 2022-2023, we noted relocation of some corporate teams and industries abroad. The real estate market changed accordingly. What are the dynamics at present?

The commercial property market often reflects global trends. In 2022, for example, the flexible workspace segment clearly showed a trend towards international expansion by domestic operators. Russian flexible workspace market players responded to the contraction of local business and the relocation of potential clients by announcing plans for global expansion.

Nearly all operators have chosen the United Arab Emirates as their destination. In 2024, we noticed that some players who already had the potential to expand have achieved their goals, but this trend has not yet acquired a large scale.

Now, we can judge the rather negative dynamics of Russian business relocation through the prism of key players, due to the policy of these companies regarding the recruiting of employees from Russia. In recent years, these players have augmented

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their demand for office space, including for companies' headquarters. This is clear sign of rejection of the offshoring practice, and it also highlights partial return to the office after the experience of remote work against the background of COVID restrictions.

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