The Russian Investment Environment

Moscow could become a strategically important investment market for institutional real estate investors.

DAVID SKINNER

THE ACCESSION OF ten countries to the European Union (EU) in 2004 has increased the volume of real estate capital targeting Central European markets. These markets, however, are small relative to those of Western Europe, and increased investor interest has led to dramatic yield compression. It is likely that Central European markets will not absorb existing capital allocations at pricing that delivers a comparable risk-adjusted return. More adventurous investors are attracted to opportunities farther east, in the largely untapped market of Russia. Against a backdrop of growing economic and political stability, improving business and investment

environments, and rising transparency, the case for investing in Russia is increasingly compelling. While not large in terms of the existing stock of institutional-grade real estate, the Russian real estate market has the capacity to become strategically important in a pan-European context over the medium to long term.

Russia emerged as one of fifteen newly independent states following the fall of the Soviet Union in 1991. With more than 17 million square kilometers, Russia is the world's largest country, larger than Canada, China, or the United States. About one-quarter of Russia lies within the European continent and accounts for almost 40 percent of the latter's area. Russia's population is about 143 million; since 106 million live in the European portion, that part of Russia is 30 percent larger than Germany, the EU's largest country by population.

The first post-Communist government in Russia inherited very severe economic weaknesses. The subsequent depression saw real GDP fall from 1991 to 1996 by more than one-third, making this contraction in output deeper and longer than those in most other Central and Eastern Europe countries. The collapse in output, plus several years of triple-digit inflation, had a severe impact on living standards: household incomes were reduced by increasing unemployment and severely eroded by inflation. The economy saw positive output growth in 1997, but the decline in output had resumed before the financial collapse in the second half of 1998. Falling prices for Russia's main export commodities, investor nervousness, and aggressive monetary tightening as the Russian Central Bank tried to defend the ruble were among the factors contributing to the decline.

After the abandonment of the adjustable peg in favor of a floating exchange rate in August 1998, the ruble fell by more than 40 percent in the course of the year. The government then defaulted on its domestic securities and demanded foreign debt restructuring. The devaluation, however, delivered a stronger-than-expected stimulus to economic growth and a large improvement in government finances. The improved competitiveness of Russian companies resulted in a growth of gross industrial output of more than 10 percent in 1999 (the first annual rise in the post-Communist era); record international oil and gas prices have subsequently sustained the recovery. Real GDP rose by 6.7 percent per year from 1999 to 2005—the best performance in thirty years and a sharp contrast to an average annual fall of 6.6 percent from 1991 to 1998.

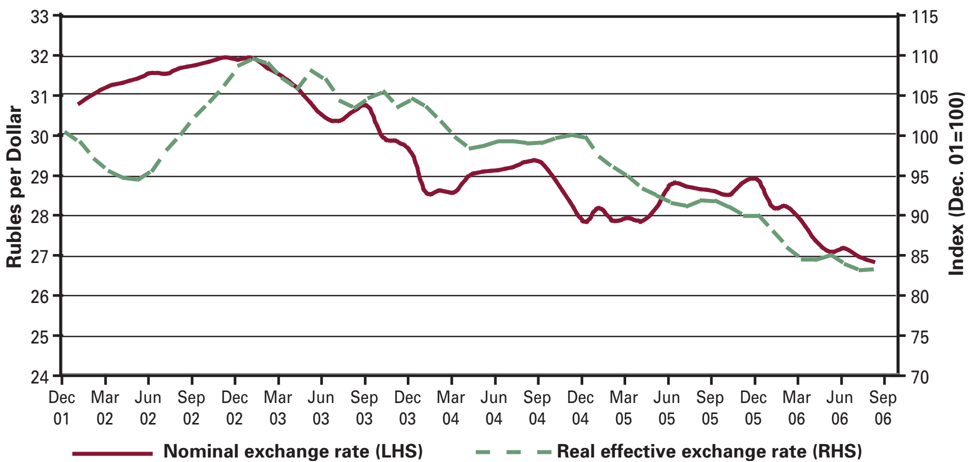
AN ECONOMY IN TRANSITION

Russia is experiencing a transition from growth driven by unusually favorable conditions in the external economic environment to growth increasingly dependent on domestic demand. Both positive and negative factors are at work here. On the positive side, a doubling of real wages since 1999, increased public pensions, a low propensity to save, improved access to credit and negative real interest rates have supported an acceleration in consumption growth over the past two or three years. The expansion of the financial services industry should ensure this continues.

On the negative side, an appreciation of the ruble of 65 percent from 1999 to 2005, according to the Economist Intelligence Unit (EIU), has eroded the manufacturing sector's competitiveness (Figure 1). Also, an analysis of the sectoral composition of economic growth suggests that capacity constraints are emerging in several key sub-sectors, especially natural resource extraction and transportation. This reflects a consistent and long-term under-investment, both in absolute terms (18 percent of GDP over the past five years) and relative to other emerging markets. The growth rate of service sectors is rising, and construction activity remains buoyant, reinforcing economic growth via domestic demand.

The contributions of the external sector and domestic demand to economic growth are becoming more balanced, but

Figure 1: Ruble exchange rate appreciation



Source: Central Bank of the Russian Federation

it is important not to underestimate Russia's dependence on oil and gas exports. Official data shows the oil and gas sector form only 9 percent of GDP, but World Bank estimates from 2004, which adjust for transfer pricing, indicate that oil and gas accounted for as much as 20 percent to 25 percent of GDP. Given the rise in commodity prices since the World Bank's report came out, oil and gas are now an even higher share. Also, oil, fuel and gas constituted about two-thirds of export revenues in 2005. To the extent that high oil prices have stabilized the economy and contributed to a rapid recovery in investment, it could be said that Russia's economy depends even more on volatile international commodities markets than before the ruble crisis in 1998.

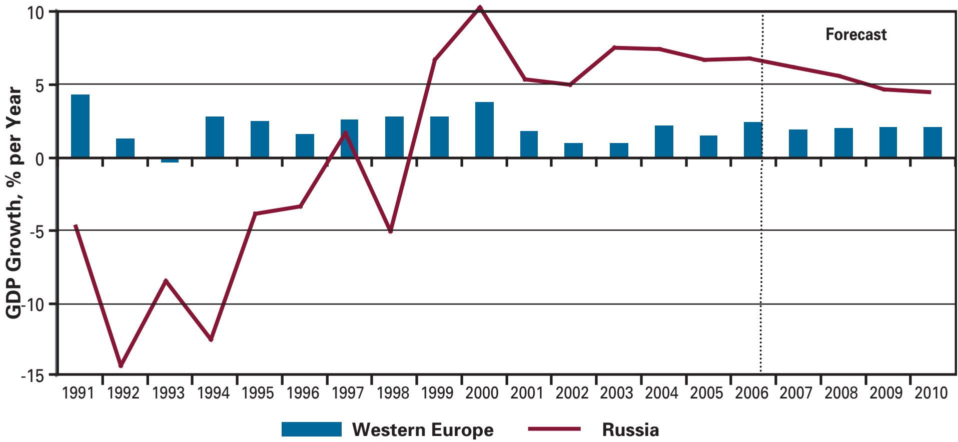
TOWARD SUSTAINED PERFORMANCE

Economic growth is expected to moderate slightly over the short term as high oil prices and increases in fixed investment offset sluggish output growth in capacity-constrained sectors and the impacts of a further appreciation of the ruble. Real GDP growth is expected to average about 6 percent this year and next (Figure 2). Over this time, government finances will likely remain robust, and the risks to liquidity in the corporate sector and banking system are limited.

Over the medium term, growth is expected to moderate further; EIU anticipates that Russia's economy will grow at an average annual rate of 5.2 percent in the next five years. The nature of the growth, however, will depend much on whether private-sector investment can be raised enough to address increasingly evident capacity constraints and severe sectoral and regional imbalances. Indeed, greater diversification of economic activity across business sectors and regions is among the key challenges facing the economy.

Industrial output is highly dependent on heavy industries. Metallurgy, fuels and energy formed more than 35 percent of industrial output last year; light industry was less than 5 percent. The manufacture of consumer and high-tech goods contributes little to the economy. The source of output is also highly skewed by size of enterprise. EIU estimates that small and medium-size enterprises account for just 10 percent to 15 percent of Russian GDP, compared with about 50 percent in more advanced emerging economies and in developed markets. EIU attributes this to small business expansion being repressed by burdensome taxation, regulations, and the anticompetitive practices of larger enterprises, often by exploiting ties with local bureaucracy.

Figure 2: Russian GDP prospects relative to Western Europe



Source: EIU

Geographic specialization and the promotion of specific industries within regions during the Soviet era created economic distortions. For example, several large cities in the Arctic Circle are not sustainable without government support. Also, Soviet planners' belief in the benefits of scale resulted in a small number of enterprises (sometimes as few as one) forming the basis of the entire local economy of a city or region, making the closure of a bankrupt enterprise a politically sensitive issue. To the extent that size attracts diversity, larger cities have tended to deal with the economic transition better than smaller ones.

This specialization has also contributed to severe regional income inequality, which the economic recovery since 1999 has exacerbated. According to a United Nations report, in 1991 the average income of the top decile was 7.8 times higher than that of the bottom decile. By 2001, this ratio had risen to forty. Due in part to a large decline in the portion of the population living below the official poverty line (from about one-third in 2000 to less than 16 percent at the end of 2005), this ratio has fallen greatly in the past few years but remains well above the 1991 level.

Similar differences are seen in regional GDP (Table I). The city of Moscow produces almost one-fifth of Russia's total GDP. The Moscow region accounts for a further 4 percent, as does the city of St. Petersburg. These regions and Tyumen (a main oil production area) create about 40 percent of Russia's output, with the rest coming from eighty-four other regions. Labor immobility from poor transport systems and hous-

ing shortages in larger cities contributes to these regional disparities.

According to the Center for Living Standards (part of the Russian Ministry of Health and Social Development), only 10 percent of Russia has reached middle-class or higher status. The average national monthly salary at the end of 2005 was about $300 ($600 in Moscow), according to EIU. However, given the projected rises in real wages and GDP per capita over the next five years (35 percent and 30 percent, respectively), there is great scope for a rapid expansion of the middle class. A strengthening middle class will increase consumer demand and stimulate growth in industry. A more powerful middle class might also strengthen institutions critical for the development of market economies, such as independent courts and democratic elections.

Inflation, now at 9.6 percent, is a threat to medium-term growth (Figure 3). The government continues to target exchange rate stability relative to dollars and euros: the mix is 60 percent dollars and 40 percent euros. Due to stronger domestic demand, the dollar value of imports rose 25 percent in 2005, but the current account surplus hit a record (12 percent of GDP) due to rising prices of Russian exports. This foreign currency reserve accumulation contributed to a rapid rise of the money supply (37 percent at the end of 2005), which is fuelling domestic demand, supporting inflation, and raising policy interest rates and the real effective exchange rate.

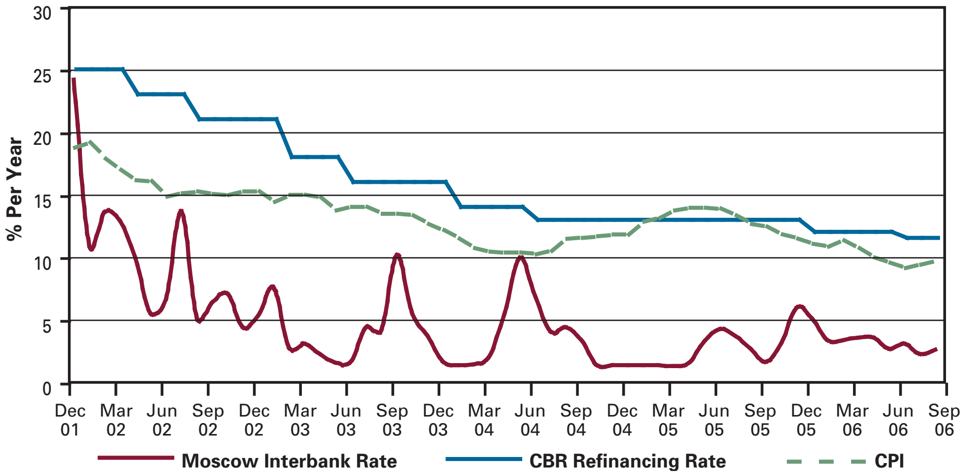
The Russian Central Bank allowed a modest nominal appreciation of the ruble in the early part of 2006, with a view to relieving inflationary pressure. The authorities have also introduced several measures to reduce inflation, such as regulating price increases of public utilities, restricting wage growth, limiting borrowing by state-owned companies, and reducing government expenditures. But these measures have proven ineffective. The failure to adapt exchange rate policy remains among the key risks to Russian price stability.

Table I: Gross regional product per capita (percent of national average)

Top Five	%	Bottom Five	%
Tyumen Region	410	Republic of Adygeiya	38
Moscow City	235	Ivanovo Region	36
Krasnoyarsk Republic	138	Republic of Daghestan	35
Republic of Tatarstan	132	Republic of Tyva	30
Republic of Sakha (Yakutia)	121	Republic of Ingushetia	21

Source: U.N. Human Development Report for the Russian Federation, 2005

Figure 3: Inflation and interest rates



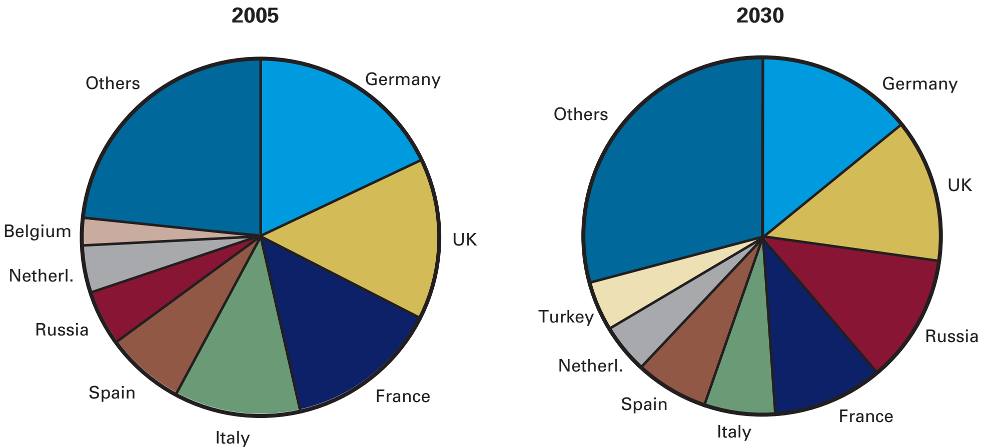
Sources: Bloomberg; Central Bank of the Russian Federation

Although the longer-term outlook for the Russian economy is highly uncertain, growth would have significant ramifications. Russia is now the world's fifteenth-largest economy. EIU forecasts average annual real growth over the next twenty-five years of 3.2 percent, which would raise GDP from about $790 billion to roughly $5,900 billion in 2030, making Russia the seventh largest economy, and the third largest in Europe, ahead of France, Italy and Spain (Figure 4). In this scenario, growth is very much front-loaded, with the first five years of the twenty-five-year horizon seeing average annual growth of about 5.2 percent, and the last five years about 2.8 percent. This front-loading reflects Russia's demographic profile, especially in terms of a declining and aging population.

A DEMOGRAPHIC CRISIS

Over the first half of this decade, Russia's population fell by 3.3 million to 143.2 million according to the U.N. The decline would have been greater but for net immigration, mostly due to the return of ethnic Russians from other former Soviet republics. Population contraction is expected to continue: the latest U.N. estimates predict a 22 percent decline in population (to 112 million) by 2050. The transition process has aggravated the already poor demographic outlook. While death rates have been rising since the 1960s (from a deteriorating health care system, stress and environmental degradation), death rates and infant mortality rates rose rapidly in the 1990s, while birth rates remained low.

Figure 4: European GDP by country, 2005 and 2030



Source: EIU

The fall in population was accompanied by a decline in life expectancy. Total Russian life expectancy at birth has fallen from just under seventy years in 1970 to about sixty-five years now, largely due to the deterioration in male life expectancy, which at fifty-eight years, nine months is now comparable with that of the 1950s. Recent data suggests that this decline has stopped. Nevertheless, the Russian population is aging rapidly (as in most higher-income industrialized economies), straining the pension system. Currently, 13.8 percent of the population is over sixty-five, and this is expected to rise to about 20 percent by 2030. The current pay-as-you-go system cannot cope with these demographic trends. However, the reform of the pension system is at an early stage.

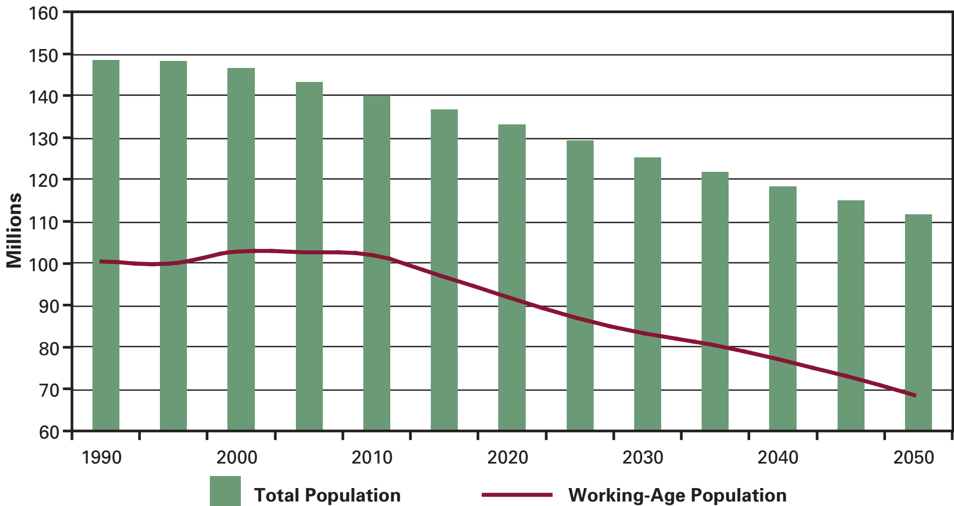
Declining and aging populations do not bode well for the size of the working-age population, which is the key driver of secular or structural occupier demand (especially for office space). The working-age population peaked in 2000 and is likely to fall by more than one-third by 2050 (Figure 5). The Russian government estimates that an annual flow of about one million working-age migrants is needed to mitigate the effects of an aging and declining population from 2007. Against this background, labor supply is certain to become an ever-greater constraint on economic growth.

There are significant regional differences in the demographic outlook. Depopulation is less severe in urban areas, due to in-migration. Russia's urban population is expected to fall by about 6 percent

over the next twenty-five years, versus a decline of roughly 30 percent in rural areas. Many cities are already seeing population declines, but the prognosis for Russia's two largest cities, Moscow and St. Petersburg, is more positive: both are likely to experience population increases over the next ten years (3.5 percent for Moscow and 1.5 percent for St. Petersburg) and more modest growth thereafter, according to U.N. estimates.

To maintain high levels of economic growth over the long term, Russia must address several major long-term challenges. There are severe environmental problems. Key concerns are water pollution, air pollution from industrial emissions and energy generation, increased waste generation (including nuclear waste), and soil contamination and land degradation leading to falling agricultural productivity. These issues require very large, long-term government investment. Transportation network quality is one of the main determinants of long-term economic prosperity. Russia's transportation infrastructure, which remains largely state-owned, has deteriorated greatly in the past twenty years as a result of sustained under-investment. The promotion of small and medium-size enterprises is crucial for more balanced and diversified growth. Improved business and governance standards and greater corporate transparency are among the key reforms needed. Creating conditions where entrepreneurial activity is appropriately rewarded may help alleviate the current brain drain.

Figure 5: Russia's national demographic profile



Source: UNPD

The reform of the judiciary, law enforcement agencies and local/regional governance is also required to improve the investment environment, reduce bureaucratic corruption and raise private-sector investment. While the law now allows for the private ownership and free trade of commercial land, progress on improving the security of property rights is essential, not least in terms of promoting private-sector investment and the development of private credit markets. Finally, greater integration into the global economy, through Russia's accession to the WTO (expected in 2007) should help accelerate reform.

THE INVESTMENT ENVIRONMENT

Russia's export revenues contributed to record trade and current account surpluses, and record foreign reserves. The economy, while facing a challenging development agenda, has limited capacity to absorb large surplus revenues and reserves. The government has tried to sterilize the inflow by amassing a stabilization fund. Formed in January 2004, the fund is critical to macro stability and has helped prevent even more rapid exchange rate appreciation; still in its infancy, it will likely reach three trillion rubles ($115 billion) by the end of 2006. No longer just an insurance policy protecting the federal budget against changes in world oil prices, it is now an important component of national wealth. Even if oil prices fell sharply, the fund is already sufficient to ensure a balanced budget for several years. If, as is more likely, oil prices stay high, the fund will offer a partial solution to several current development challenges Russia faces.

The fund also is important in preventing a repeat of the 1998 government default and in repaying Russia's foreign currency debt. In January 2006, Russia repaid the debt owed to the IMF, while in August it paid off its Soviet-era debts to the Paris Club. Russia's budget and tax policy for 2007 aims to bring foreign debt from 9 percent of GDP as of late 2006 to 8.3 percent in late 2007, and to 7.5 percent in late 2009. Internal debt is likely to exceed foreign liabilities as early as 2008.

These policies have supported a strengthening of Russia's sovereign rating. Moody's was the first major rating agency to raise Russia to investment grade in 2003, while Fitch and S&P did so in 2004. Now Fitch and S&P rate Russia two notches above investment grade, following upgrades over the summer. Moody's rates Russia one notch above investment grade but is expected to raise its rating. All three agencies continue to stress the remaining political

and institutional risks, especially in the run-up to parliamentary and presidential elections at the end of January 2007 and spring 2008, respectively.

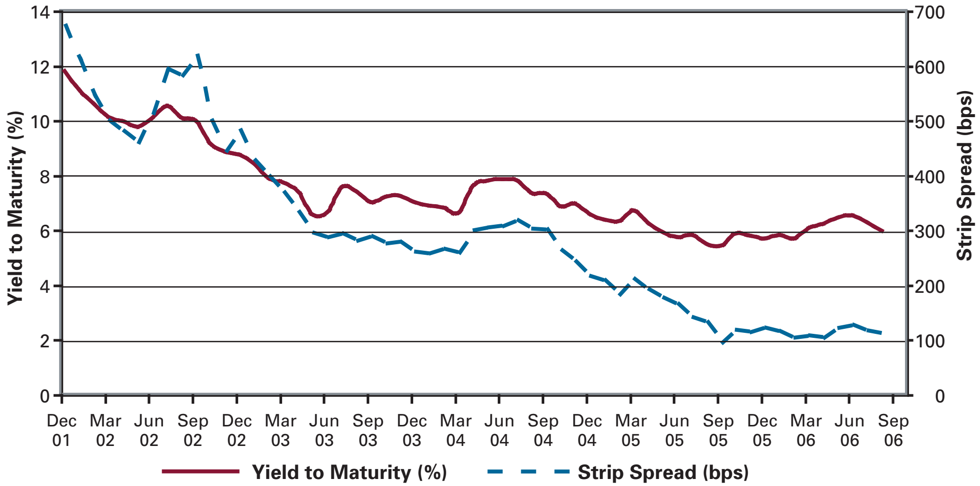
Higher ratings have raised investor confidence. A large rise in FDI has occurred in recent years, despite lingering political uncertainty, exacerbated by the Yukos affair and the expansion of state intervention in strategically important companies or industries. FDI inflows grew by 40 percent in 2005, reaching $14.6 billion, supported by the recent improvements in the business climate and economic outlook. Equity markets, now an important source of finance for large companies, have seen a rise in valuations and trading volumes. Russia's principal equity market index—RTS—rose by 85 percent in 2005 and by 55 percent in the first four months of 2006 (Figure 6). The sharp corrections in May and June were in line with trends in emerging equity markets, sparked by a broader risk aversion among investors, and led to the postponement of several IPOs. Having fallen by one-third from early May's peak, the market has since recovered to within 10 percent of this high.

Increasing investor confidence has also raised international demand for Russian bonds. In common with many other emerging markets, Russia's sovereign yield spread over U.S. Treasuries has compressed rapidly over the past few years (Figure 7). However, this repricing has been particularly acute for Russia, due to a fall in the probability investors attach to the government defaulting on foreign currency debt amid the massive accumulation of for-

Figure 6: Russian equity market performance

Source: Bloomberg

Figure 7: Russian government bond yield and spreads over U.S. Treasuries



Source: JP MorganChase

eign reserves and the prudent management of these reserves in the Stabilization Fund. At the start of 2006, the hard currency spread stood at 118 bps, versus 478 bps three years earlier. While market volatility in May and June resulted in a widening spread, Russian government bond spreads are now as tight as ever (circa 100 bps). While this has clear benefits in terms of the cost to the government of raising long-term debt finance, it is also having a positive impact on the liquidity and pricing of the small market for ruble-denominated bonds. As the government seeks to substitute domestic for foreign debt, the increased market size and liquidity will continue to help the corporate credit market in terms of companies' ability to meet their funding requirements through domestic bonds.

Unlike Central and Eastern European markets, Russia's private equity landscape is characterized by an abundance of local capital from wealthy individuals and cash-rich businesses seeking to invest in noncore business activities, and a limited presence of international private equity fund managers. The European Bank for Reconstruction and Development (EBRD) notes that the provision of private equity capital from institutional investors remains volatile, highly cyclical, and hampered by a lack of corporate management skills, ownership disputes and regulatory uncertainties. However, improvements in the business climate and economic outlook are contributing to more international private equity investors seeking to penetrate the market.

After the 1998 collapse, bank lending has been slow. Banks still finance only about 10 percent of private sector investment, compared with 50 percent in developed markets. Corporate lending continues to be hampered by a lack of transparency in the corporate sector, a legal framework that favors borrowers over lenders, a lack of capital and the dominant position of a small number of banks.

Reform in the financial-services sector, and phasing out the special privileges of a few banks should lead to a rapid expansion of private debt markets. Unlike elsewhere in Central and Eastern Europe, where foreign banks have driven the modernization of the banking sector, Russia has had little penetration by foreign banks. The barriers to entry remain formidable, but the past few years have seen some international banks open offices in Moscow and St. Petersburg to serve their international clients. While the opening of the banking sector to foreign competition remains a subject of negotiation in Russia's upcoming accession to the WTO, ongoing liberalization should encourage further foreign entrants over the short to medium term. This should lead to increased flexibility of loan terms on offer and to more attractive pricing.

According to EIU, some improvement in the overall business environment has occurred over the past few years. EIU's business environment rankings show that since 2001, Russia's score has risen from 5.0 to 5.6 (out of 10). Some progress has taken place on deregulation and a reduction of administrative barriers to business (such as licensing, registration, inspections, land use and taxation). Positive changes have also occurred in some of the institutions enforcing corporate governance laws and regulation. Progress, however, is slow, and the enforcement of contracts and property rights remains uneven. Corruption, which is difficult to measure, appears to have risen in recent years, according to surveys by Transparency International, EBRD and the World Bank.

THE REAL ESTATE MARKET

The improving investment environment is one factor that has put Russia's real estate market on international investors' radar screens over the last few years. Most investors are pursuing opportunistic strategies, engaging in development activity, partnering with local operators (either via joint ventures or the acquisition of controlling interests), but investors increasingly seek to acquire existing and leased buildings. Demand is driven by a growing number of institutional-investor-backed private equity funds and public vehicles (most notably listed on London's AIM) with Russian or Eastern European strategies. To-date,

investor demand has focused almost entirely on Moscow and, to a much lesser extent, on St. Petersburg. While these cities dominate in terms of population, levels of business activity and the volume of investment-grade stock, eleven other Russian cities with populations of over one million might offer more adventurous investors opportunities over the longer term, especially in the retail and residential sectors (Table II). However, exit risk/liquidity in these second-tier cities is completely unproven.

Table II: Russia's largest cities

	Population (millions)	Distance from Moscow (km)
Moscow	10,406,578	-
St. Petersburg	4,601,000	630
Novosibirsk	1,405,569	2,819
Jekaterinburg	1,304,251	1,420
Niznij Novgorod	1,297,550	488
Samara	1,151,681	867
Omsk	1,142,773	2,243
Kazan'	1,110,022	724
Cel'abinsk	1,095,053	1,500
Rostov-na-Donu	1,057,958	957
Ufa	1,036,026	1,169
Volgograd	1,032,938	909

Source: www.citypopulation.de/Russia.html

Unlike the real estate markets of many other Central and Eastern European cities, Moscow and St. Petersburg have abundant local capital from wealthy individuals and large enterprises seeking to diversify away from core business activity. When opportunistic investors entered Central European markets in the mid-1990s, their capital filled a void and played an important role in the modernization of stock. The lack of local capital also made for a less competitive acquisition environment. In Russia, competition for projects/investments between local and foreign investors is fierce. Moreover, the rigorous due diligence procedures that international investors undertake in this highly immature and opaque market hinder them relative to local investors.

The high propensity for corporations to own rather than lease adds to the competitiveness of the acquisition environment confronting the international investor. Strata ownership, where occupiers own the floors/units they occupy and a share of the common space, is common. Thus, investment assets tend to have a higher portion of international tenants (who prefer leasing) than is common in most other European markets. Due to years of underinvestment, the existing stock of real estate fails to meet the needs of tenants. Most is class C, and much is obsolete by Western standards. The shortage of prime space has led to strong rental growth in the past few years, which has raised occupation costs to among the highest in Europe.

The privatization of the construction sector in the early 1990s, increasing security of property rights and improvements in the institutional framework that allow risk to be appropriately rewarded, plus

the acute lack of modern space, have led to very high levels of construction activity over the past few years. The development pipeline across the three main commercial property sectors is substantial and growing. Anecdotal evidence suggests that construction costs have risen by 25 percent in the past twelve months as a result of capacity constraints (shortages of skilled labor and experienced management) and increases in material prices, especially steel. This is contributing to longer construction times and lowering completion rates.

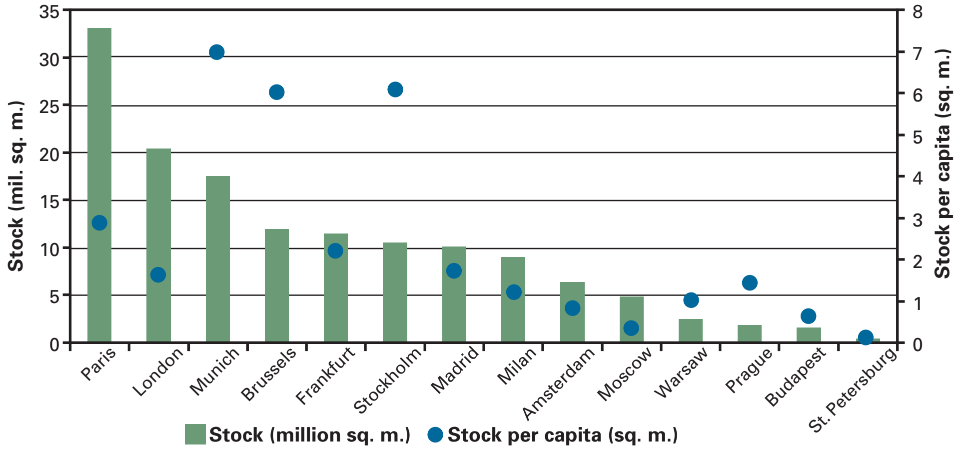
Market transparency is improving. Most major international property agents/consultants have established large offices in Moscow and are providing increasingly detailed analysis of the market. However, the number of transactions involving brokers remains small, and pricing remains opaque, particularly outside the capital. Anecdotal evidence suggests that in the absence of adequate comparables, several brokers did not reduce valuation yields during 2005, despite evidence of an increase in investor demand.

MOSCOW

Moscow, with a metropolitan area population of 14.5 million, is larger than any city in the European Union. Once the center of the Soviet empire, the Russian capital is leading the country's transition to a more service-based economy. The occupier base contains a large government sector and associated organizations, headquarter buildings for larger industrial and financial-sector corporations and smaller service-sector businesses. The city has seen rapid growth in the past few years, in population and economic activity, while the transport infrastructure is under increasing pressure. Road network improvements are under way (most notably, adding another ring road to the existing four), but it will be years before they are completed.

Moscow still has a shortage of modern office space. At mid-2006, the stock of grades A and B was 4.9 million square meters, according to Knight Frank (Figure 8). While larger than the stock in Warsaw, Prague and Budapest, this is small compared with Western European cities, especially given Moscow's population. Demand for modern office space is very high. Gross take-up is running at more than one million square meters per year, both from expansion and the need to upgrade from poorer quality stock. Moreover, with low availability, latent demand for space is significant. Unemployment in the city is lower than the national average (about 7 percent),

Figure 8: Stock and stock per capita



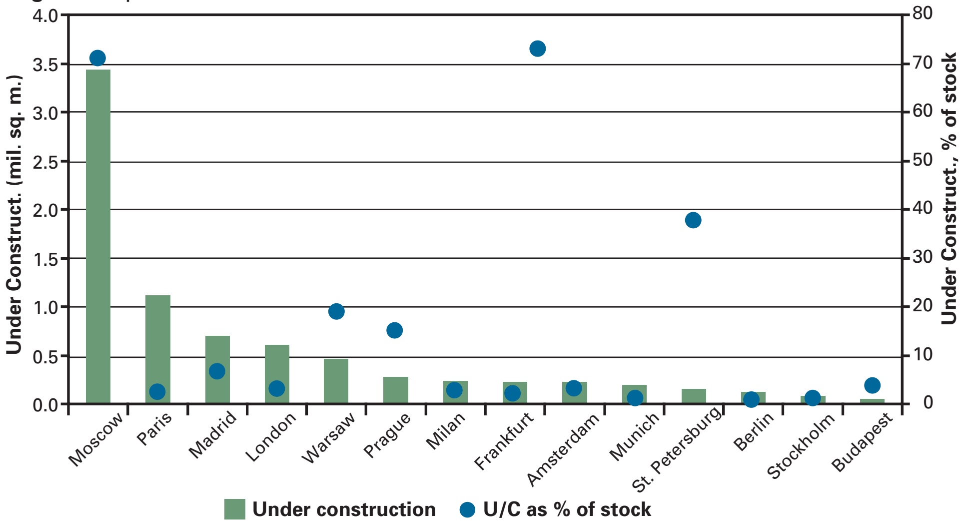
Sources: Cushman & Wakefield; Knight Frank; Prudential Real Estate Investors

and the participation rate is high. Nevertheless, significant scope for growth in office-based employment remains due to a relatively high level of underemployment in the city.

In mid-2006, vacant space amounted to less than 4 percent of stock. This, combined with strong demand, has resulted in rapid rental growth in the past few years. Prime rents stand at $700 to $800 per square meter per year, making office space in Moscow more expensive than any other city in Europe, except London and Paris. While space close to the Kremlin and in the CBD tends to command a premium, the premium is relatively small, even compared with noncentral locations. This may stem from the travel time and costs of working in the city center, especially given the very congested transport infrastructure, but it may be a function of scarcity.

Rising rents and prices are two factors that have contributed to a very high level of construction activity (Figure 9). At the end of 2Q06, 3.4 million square meters of office space was under construction. The completion of this space will increase the existing stock of modern office space in the city by 70 percent. Despite capacity constraints (skilled labor shortages and a lack of good quality construction companies), the pace of new construction continues to rise. Construction times are growing, while inspections of premises by the State Commission face greater delays, and time frames for commissioning are consistently deferred to later dates.

Figure 9: Space under construction

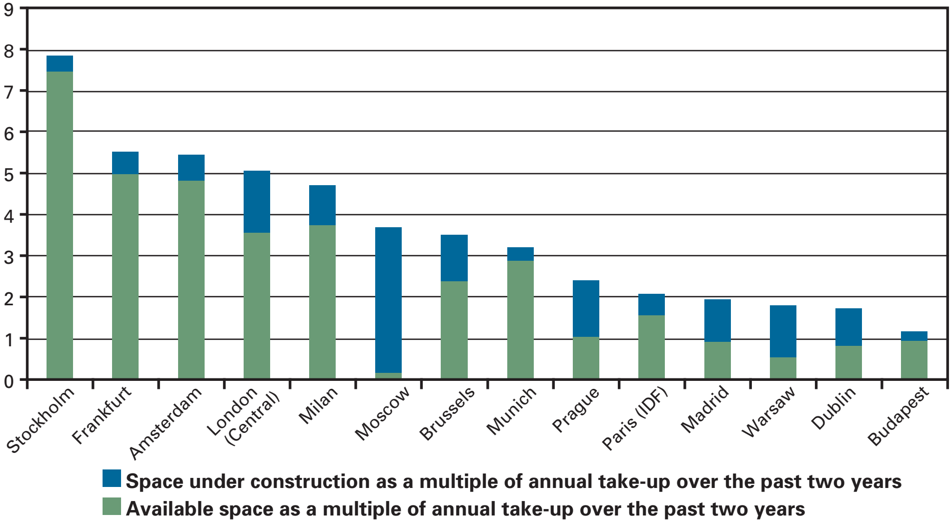


Sources: Cushman & Wakefield; Knight Frank; Prudential Real Estate Investors

According to Knight Frank, the Moscow authorities intend to reduce the pace of construction of nonresidential premises in the city center, with a view to intensifying construction at the MIBC Moscow-City site—a huge development along the Moscow River, three miles southwest of the Kremlin, which the authorities hope will become the country's main financial district. Some evidence suggests that the market might be able to absorb this new space if take-up continues at current levels. Adding the volume of available space to that under construction and comparing it with recent take-up levels, Moscow's situation is not extreme. At about 3.5, the ratio of space vacant and under construction to annualized take-up over the past two years is much lower than in the Frankfurt and Amsterdam markets, although higher than Madrid and Paris (Figure 10).

Nevertheless, the development pipeline is the biggest risk to the stability of Moscow's office market. The level of latent demand for space is unknown, but a risk of oversupply exists. This situation is similar to that in Warsaw, Prague and Budapest from the mid-1990s onward, which resulted in rental declines of 50 percent or more in subsequent years. A simple cross-sectional rental model suggests that a stabilized rental level reached when the Moscow office market enters a more mature phase might be about $450 per square meter for prime space. This new supply is likely to more severely affect

Figure 10: Space under construction or vacant as a multiple of annual take-up



Sources: Cushman & Wakefield; Knight Frank; Prudential Real Estate Investors

class-B space (in terms of rental levels and tenant quality) and should lead to greater discrimination by location. It should also speed submarket formation, leading to greater differentiation of the occupier base in these submarkets.

Sale prices in Moscow are rising rapidly. The price per square meter of class-A offices is $4,000 to $7,000, while the price per square meter of class-B offices is $3,500 to $4,500, according to Knight Frank. Agents are quoting prime office yields of sub-9 percent, down from 13 percent a year ago, but the transaction evidence to support these levels remains thin. These levels are a 300-bps premium over Warsaw and Prague, but it is not clear that this is sufficient to compensate investors for the additional risks and illiquidity. At current finance costs (circa 350 bps over U.S. LIBOR), little potential for positive income leverage exists for prime offices.

Other sectors offer international investors more defensive opportunities. The Moscow region is likely to become one of Russia's largest logistics centers. The stock of modern industrial space amounts to less than three million square meters. Growing demand for international-standard warehousing and logistics management, combined with increasing interest in the sector from institutional investors (domestic and international), has contributed to several potential large-scale logistics and industrial park projects in the development pipeline. Local authorities are also encouraging large international industrial developers to tender for the creation of Special Economic Zones

designated for industrial use. The volume of modern industrial space under construction (now 430,000 square meters) is set to grow rapidly.

The retail sector is seeing a dramatic transformation. Several years of rapidly rising real wage growth and improved access to credit have led to real consumption growth of over 10 percent in the past few years. The retail sector is evolving rapidly to meet the demands of a growing middle class with increasing disposable income. The sector has seen several mergers and acquisitions over the past 12 months, and a number of retailers have—or are preparing for—IPOs.

Developers continue to announce large-scale shopping center projects in the Moscow region. Many of the new centers completed in Moscow over the past five years have been poorly designed or built. The next few years will see the development of better-conceived and constructed shopping centers and an improvement in existing projects as they expand. Construction is planned or under way on several high-profile schemes, and demand is high from both retailers and investors.

ST. PETERSBURG

St. Petersburg is Russia's second-largest city and the eighth-largest in Europe, with a metropolitan area population of 5.5 million. Europe has influenced this city more than Moscow, partly due to the presence of a port (the largest in northwest Russia), and the use of European architects in the 18th century. Despite the city's size and importance, the real estate market is very small. The stock of modern office space amounted to just 0.4 million square meters, and only a fraction of this would be considered class A by Western European standards. Although the existing stock of office space is highly centralized, with most development now occurring outside the center, the market will likely become highly decentralized over the next decade.

The industrial and retail sectors are equally immature. The stock of modern industrial facilities amounts to half a million square meters, according to Jones Lang LaSalle, a figure that is especially low given the importance of the port. The industrial stock is expected to double over the next two to three years, with much of the new space located around the new ring road. Vacancy is now very limited (less than 1 percent), with demand for space increasingly driven by retailers. Amid rising real incomes and greater consumer sophistication, the city has seen a rapid growth in shopping area development. About 10 percent of all Russia's modern shopping centers are in St. Petersburg, and with construction activity increasing, this share will rise.

Throughout Russia, rising wealth levels are affecting the residential sector. Years of underinvestment have resulted in severe housing shortages, particularly in larger cities, and the quality of existing stock is poor. With housing being one of the four national priority projects, government investment in the sector is expected to rise significantly. Much of this support is likely to focus on affordable housing for lower-income groups. The Federal Agency for Construction aims to double the volume of new housing nationally to about 80 million square meters by 2010. Rising income and better access to credit markets, however, is increasing demand for better quality housing. *The Economist* estimates that less than 8 percent of residential purchases are now financed with a mortgage. As the mortgage market matures, the level of private ownership is expected to rise rapidly, which should raise the demand for better quality housing and increase the level of private ownership, which is now very low.

POTENTIAL CHALLENGES FOR INVESTORS

While Russia offers real estate investors a diverse and growing set of opportunities, significant barriers to entry exist for international investors. An abundance of local capital (largely private) can execute much more quickly than institutional investors undertaking thorough due diligence. This makes for an aggressive acquisition environment and competitive pricing. Differing perceptions of risk between local and international investors can result in international investors being less competitive. This difficulty ensures that a reliable local presence in these markets is essential.

There remains significant counterparty risk: the investment market remains nascent and highly opaque, very few deals are professionally marketed, and relatively few professional vendors are in the market now. The institutional framework necessary to support foreign investment is immature. Uncertainty remains as to the security of property rights in some regions, the judicial system continues to undergo reform, and political and regulatory risks remain significant. Corruption is still evident in the bureaucracy, and recent events show that Russia is far from a mature democracy. Tax legislation relating to real estate investment changes often. This lack of stability creates difficulties for structuring acquisitions. Local capital markets are underdeveloped. Foreign banks have been slow to penetrate the market. Credit margins remain wide, and loan terms on offer are often inflexible, with banks typically enforcing aggressive amortization schedules. With debt priced relative to U.S. LIBOR at a credit spread of 300 to 350 bps for plain vanilla transactions, the potential for posi-

tive leverage is limited for prime assets. As a result, the optimal capital structure for an asset deal will often differ substantially from similar opportunities in other European markets. Real estate market risks are also higher. For example, the market remains highly opaque, exit liquidity is unproven, building quality is typically lower than in more mature markets, there are some questions as to the affordability of rents at current levels, and there is a risk that the long-run sustainable level of rents will be significantly below current levels.

These factors raise the burden of due diligence. Nevertheless, Russia offers a yield premium over Western Europe of 400 to 600 bps. In a low-yielding global investment environment, this premium looks attractive, and for well-structured, well-conceived deals, this could be sufficient to compensate investors adequately for the additional risks of this market.

CONCLUSION

Large increases in Russia's foreign reserves, generated by high oil and gas prices, have provided a great boost to growth. Prudent management of these reserves by the government through a stabilization fund has improved the medium-term economic outlook and has had a positive impact on the investment environment in Russia. Also, the reserves provide the Russian government with the opportunity and resources to address some of the longer-term, deep-rooted structural problems the country faces.

Moscow is Europe's most dynamic real estate market, with both construction and take-up activity exceeding levels in all other markets. The local economy is leading the country's transition to a more diversified economic structure. A construction boom is under way, generating rapid growth in the volume of investment-grade real estate. While the barriers to entry for foreign investors are large, the institutional framework needed for a substantial, liquid investment market to emerge in which foreign investors can actively compete is evolving quickly. Foreign investment remains focused on development opportunities executed through joint-venture relationships with experienced and reliable local partners, but demand for standing investments is increasing. Moscow could become a strategically important investment market for institutional investors seeking European real estate exposure.