



JONES LANG  
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Q2 2010

## Russian economic and investment market commentary



## Russian economy

The Russian economy continued to recover in Q2 2010 with the majority of macroeconomic indicators showing improvement. The Economy Ministry has estimated GDP expanded 4.2% YoY in H1 2010. Industrial production increased 10.2% YoY in H1 2010.

Real wages growth slowed to 5.5% YoY in June from 7.0% YoY in May because of a weaker low-base effect in June, resulting in H1 growth of 4.4% YoY. Real disposable income growth moderated to 1.4% YoY in June from 2.8% YoY in May and ended H1 with 4.8% YoY growth. Despite the strong real wages number, real disposable income growth continued to moderate, as a result of actual declines in social benefits and other types of personal income. On a positive note, unemployment fell to 6.8% in June from 8.6% in March.

Rising incomes translated into retail sales growth of 5.1% YoY in Q2, extending the positive trend seen in the previous quarter. Improving consumer confidence and easier access to consumer loans continued to drive non-food sales, which expanded 4.8% YoY in Q2 compared with a decline of 0.8% in Q1. Food sales growth slightly improved to 5.5% YoY in Q2 vs. 4.1% YoY in Q1.

Consumer inflation continued to moderate to 5.8% YoY in June from 6.5% YoY in March and from 8.8% at the end of 2009. This should provide additional support to a consumer sector recovery, as well as providing a more controlled environment for investment.

On the back of a weakening euro, the rouble depreciated slightly in Q2, from 29.36 to 31.27 per USD. Relatively high oil prices, averaging over USD75 per barrel in Q2, maintained strong terms of trade position. However, the current account surplus will likely begin declining in the near future, as oil prices have stabilised, while imports will continue increasing as consumer demand recovers. Although this will ease the pressure on the rouble somewhat, high currency inflows will still remain the key factor determining the local FX market environment. Therefore, the rouble will likely continue taking back ground lost during its recent depreciation.

The Central Bank of Russia continued to provide support to the economy by cutting the refinancing rate to 7.75%, and the minimum one day REPO rate to 5%. This, plus lower inflation, should make financing more affordable for commercial banks. Although bank financing is still limited, large institutions, such as Sberbank and VTB, continue to open new credit lines to developers.

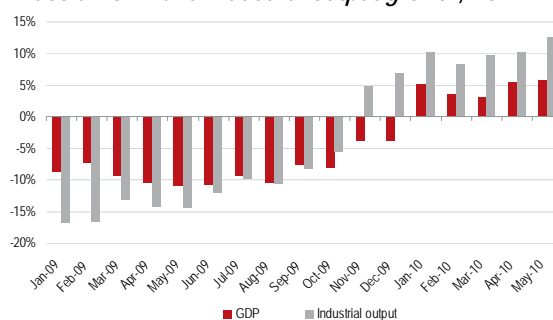
We expect further improvement in economic performance, with the consumer sector and industrial output leading the recovery.

### Key macroeconomic indicators

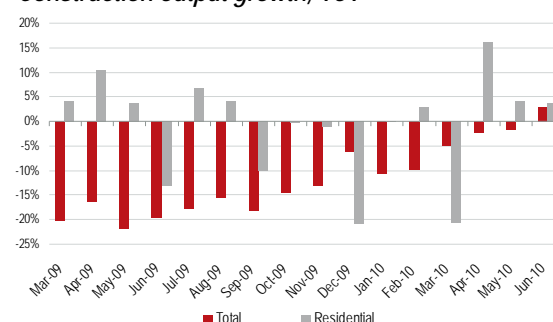
|  | 2008  | 2009  | 2010F |
|--|-------|-------|-------|
| Nominal GDP (USD bn)                   | 1,679 | 1,217 | 1,462 |
| Real GDP growth (%)                    | 6.2   | -7.9  | 4.5   |
| Unemployment (% end-year)              | 7.7   | 8.2   | 7.5   |
| CPI (%)                                | 13.3  | 8.8   | 7.0   |
| Exchange rate (RUB/USD, end-year)      | 29.38 | 30.24 | 29.0  |
| Real wage growth (% YoY)               | 9.7   | -2.8  | 4.0   |
| Retail trade turnover (USD bn)         | 558   | 458   | 508   |
| Real retail sales growth (% YoY)       | 13.0  | -4.9  | 4.4   |
| Urals oil price (USD/barrel, end-year) | 36.5  | 76.7  | 78.3  |
| FDI into Russia (USD bn)               | 70.3  | 38.7  | 45.0  |
| International Reserves (USD bn)        | 426.3 | 439.5 | 485.0 |

Source: Rosstat, Economy Ministry, Central Bank of Russia, Bloomberg, Jones Lang LaSalle

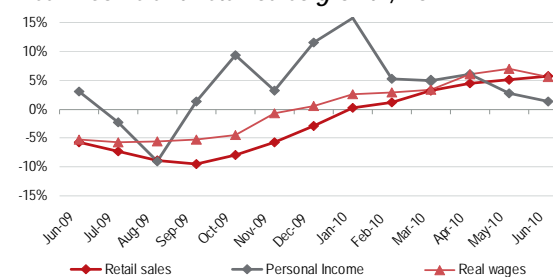
Russian GDP and industrial output growth, YoY



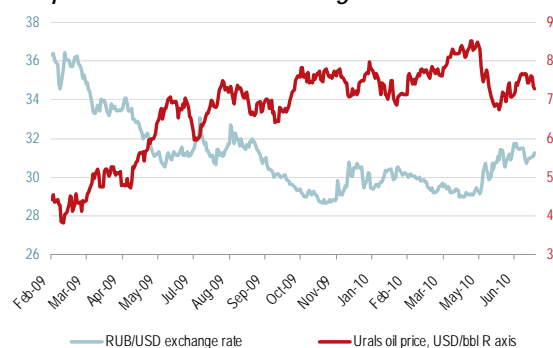
Construction output growth, YoY



Real income and retail sales growth, YoY



Oil price and RUB/USD exchange rate



## Real estate investment market

In Q2 2010 investment activity continued to pick up in Russia, with deal volume up 65% YoY, to USD903 mn. We expect a further recovery in H2 2010, as there are several deals currently at the due diligence stage. We expect the annual investment volume to reach USD4 bn.

Market activity was characterised by the dominance of Russian-funded investors (71% of the total in H1 2010), while foreign investment remained low. However, interest from the latter has increased significantly (we discuss this topic in more detail in the last section of this report).

Developers and investors remained focused on the two perceived less risky and more mature Moscow and St. Petersburg markets in H1, with 57% of deals completed in Moscow, 35% in St. Petersburg and only 8% in other regional cities.

The residential market continues to attract the bulk of investments, accounting for 40% of all transactions completed in H1 2010. Several major purchases have been made by the government for use as social housing, whilst most other deals were development projects.

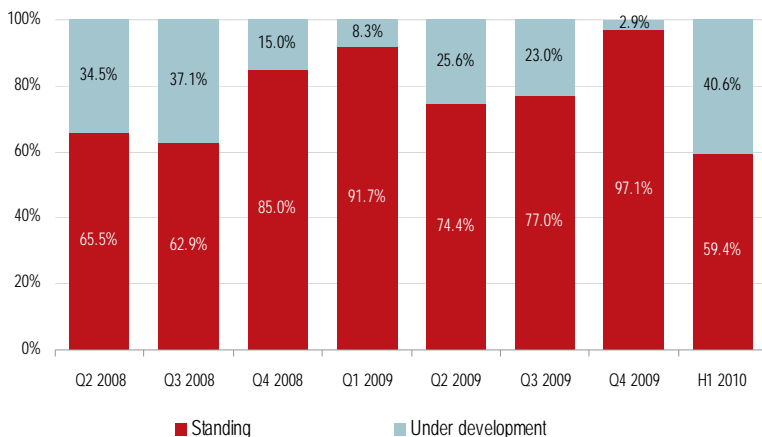
Moreover, activity increased in the office segment in Q2 2010, to 59% of the total investment volume from 12% in Q1. Many corporate players view current pricing as the market's bottom and are buying space for owner occupation, fixing rental rates.

Banks and other lenders, still predominantly government affiliated, continue to provide debt financing and restructuring or are extending loans to existing borrowers. For example, Sberbank has approved a RUB1.23 bn credit line to RBI, a development company, to construct a multifunctional complex in St. Petersburg and provided a seven year loan of RUB450 mn to Mayak Invest to build the Jam Mall shopping and entertainment centre in Kirov. Foreign banks are also active, although they are mainly focusing on income producing assets for refinancing. For example, the loan of Eurohypo to Forum Properties on Aurora Business Park was completed in 2010.

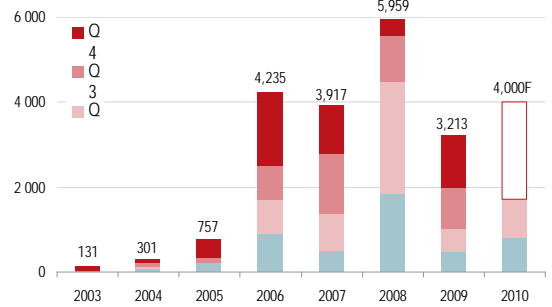
As a result of compressing yields and rental stability, investor interest in projects currently under development is returning, accounting for 41% of the deals completed in H1 2010 compared with 17% for the same period in 2009.

Yields declined 25-50 basis points (BPS) in Q2 and in addition to dropping 50-100 BPS in Q1 reflect increasing investor interest. We expect this to translate into more deals in the remainder of the year. The overall economic recovery and improved liquidity environment will lead to a further increase of investment into real estate, particularly larger lot sizes.

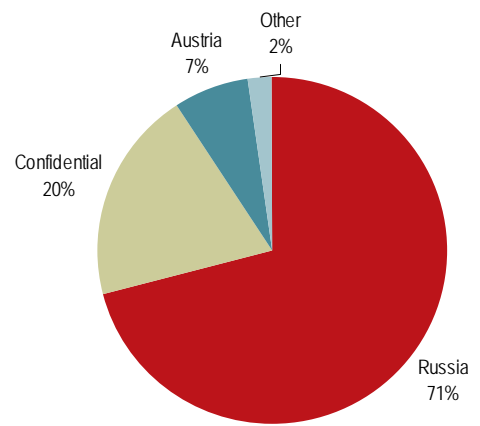
### Investment breakdown by type



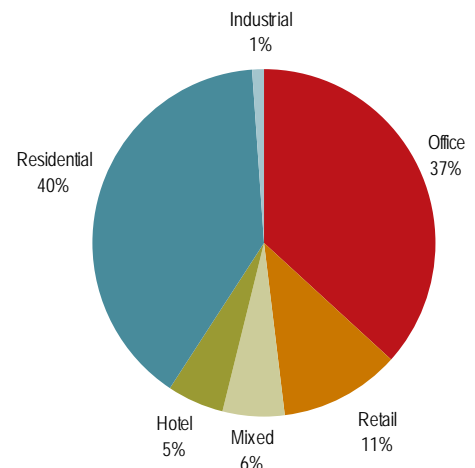
### Investment volume dynamics, USD mn\*



### Investment by investor origin, H1 2010



### Investment by sector, H1 2010



\* Investment deals, excluding corporate acquisitions, land purchases, JVs, direct residential sales to end-users.

## Yields and rates

In Russia, after a decline in Q1, risks remained almost flat with only marginal increase of credit default swap (CDS). Russia's five-year CDS spread has increased 50 BPS since the end of Q1 2010.

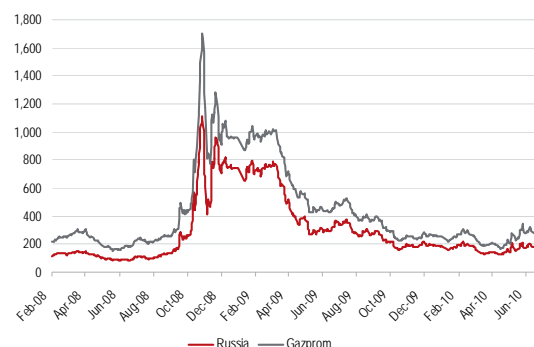
The local credit market is recovering after experiencing a significant contraction since the end of 2008. In June, the average rouble lending rate was down 2.4 percentage points to 11.3% in May from the end of 2009. Although commercial real estate lending remained scarce, debt financing for prime investment projects became more accessible.

Financing through bond placement continued to be popular in Russia: Q2 2010 corporate bond issues volumes exceeded Q1 2010 levels by RUB98 bn. Developers used this financial instrument – e.g., LSR Group placed a RUB1.5 bn exchange bond issue in June.

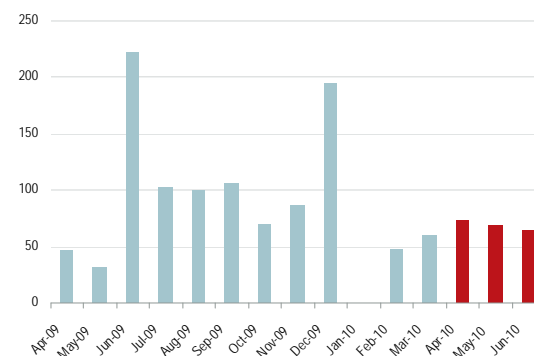
Increased investor interest caused further compression of Moscow prime real estate yields in Q2 2010. Yields declined 50 BPS for both offices and shopping centres to 10% and 11% respectively. Warehouse yields compressed 25 BPS to 12.25%. Prime yields in St. Petersburg remained the same as in Q1, ending Q2 at 12% for offices, 12.5% for shopping centres and 13.5% for warehouses.

Russian real estate equities underperformed the overall market in Q2, dropping around 26% vs. 15% for the overall market. Market capitalisation of all real estate companies remains below their net asset values.

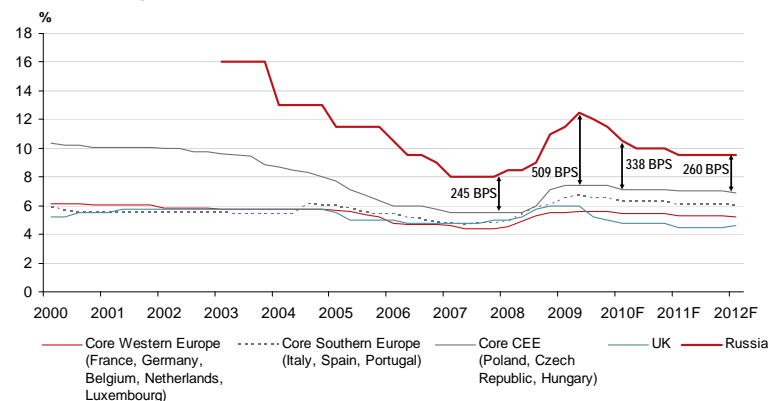
Russia and Gazprom five-year CDS yields



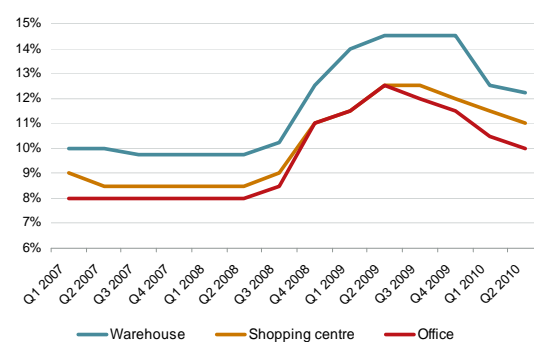
Corporate bond placements, RUB bn



Office prime yield European benchmarks



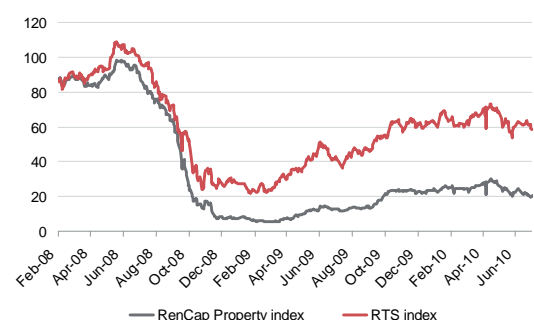
Prime yield dynamics in Moscow



Key CRE investment indicators

|                                       | Q3 2009 | Q4 2009 | Q1 2010 | Q2 2010 |
|---------------------------------------|---------|---------|---------|---------|
| <b>Moscow prime yields, %</b>         |         |         |         |         |
| Office                                | 12.0    | 11.5    | 10.5    | 10.0    |
| Retail                                | 12.5    | 12.0    | 11.5    | 11.0    |
| Warehouse                             | 14.5    | 14.5    | 12.5    | 12.25   |
| <b>St. Petersburg prime yields, %</b> |         |         |         |         |
| Office                                | 13.5    | 13.5    | 12.0    | 12.0    |
| Retail                                | 13.5    | 13.5    | 12.5    | 12.5    |
| Warehouse                             | 15.5    | 15.5    | 13.5    | 13.5    |
| <b>Equity market growth, %</b>        |         |         |         |         |
| RTS Index                             | 27.1    | 15.2    | 8.9     | -14.8   |
| RenCap Property Index                 | 69.4    | 14.7    | 10.8    | -25.7   |

Renaissance Capital Property Index vs. RTS Index



Source: CBR, Bloomberg, RTS, Renaissance Capital, Jones Lang LaSalle

## Return of international capital

The first half of 2010 was marked by a revival of international real estate investment funds activity. The market has already seen deals that include an international capital component – for example Bakhrushin House business centre was purchased by UFG Asset Management, Capital Plaza BC – by an international fund with VTB Capital participation. Moreover, several other funds announced their investment plans (see the table below) and are actively evaluating new investment opportunities.

A flight to quality is still driving the market. Newly-opened funds are ready to invest in smaller offices, well-located mid-size retail schemes and residential real estate, as long as the offered property is high quality. Although many assets are available on the market, only a few meet the funds' high quality requirements for location, quality of the building, tenants and legal structure. Clear evidence of positive market sentiment is investor interest to development assets, which has started to occur recently.

Additionally, credit markets have begun to show signs of improvement. In 2009 banks would not considered financing new loans, however, large Russian banks are now more willing to finance new construction projects, as long as future revenue from the asset is proved to be sustainable, and there is clear availability of developer equity. At the same time, because of the changed demand structure for commercial real estate, many developers are now reconsidering their projects' concepts to ensure profitability and to obtain bank financing. As financing become more affordable and available for development projects and to refinance standing assets in H2, we expect investment activity to accelerate.

### Recently announced real estate investment funds

| Fund Name   | Fund Manager  | Source of capital        | Fund volume                                      |
|---|---|--------------------------|--|
| UFG Real Estate II                                | UFG Asset Management  | Global                   | USD90 mn   |
| VTBC-DB Real Estate Partners I                    | VTB Capital and Ashmore                                       | Finland, Russia          | EUR100 mn  |
| The Barwa Gazprombank Russia/CIS Real Estate Fund | The First Investor, Barwa Real Estate Company and Gazprombank | Qatar, Russia            | USD150 mn  |
| Perspektiva                                       | Fleming Family & Partners Ltd                                 | Global                   | RUB1 bn (USD33 mn)                               |
| Storm Real-Estate Fund AS                         | Storm Capital Management Ltd.                                 | Norway                   | USD51.7 mn                                       |
| The Jensen Russian Real Estate Fund II, L.P.      | Jensen Group  | Europe and North America | USD89 mn   |
| Heitman European Property Partners IV             | Heitman   | Global                   | EUR400 mn (EUR100 mn to be invested into Russia) |
| Morgan Stanley Real Estate Fund VII               | Morgan Stanley  | Global                   | USD4.7 bn (to be invested globally)              |
| Two funds   | Accent Real Estate Investment Managers                        | Russia                   | USD200 mn  |
| Renova Sroy Group (two private REITs)             | Strategy Management Company                                   | Russia                   | RUB300 mn (USD10 mn) - 1 <sup>st</sup> fund      |

Source: Open sources, Jones Lang LaSalle



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