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The tale of two crises

In its transition following the dissolution of the USSR Russia went through a number of crises, particularly in the early 1990s. However, the most relevant benchmark for the recent events is the 1998 crisis. In this report we compare the economic effects of 2008 and 1998 crises in Russia relevant to the commercial real estate market. We attempt to extract valuable insights from the past decade that can serve as a guide for market development in the new cycle.

One conclusion that can be drawn from history is that the market will be gradually restoring its balance via the absorption of vacant areas through growing demand. As a result, we will again see rental growth in the medium term.

Another important factor is the flight to quality, which is evident everywhere, from tenant requirements to construction technologies. The key lesson today is that the market maturity, low rental spreads among top, medium and low-quality projects and particularly, increased competition, will favour premium projects, concepts and services. The time when any project could – and in many cases did – work without careful planning, construction, leasing and management is over.

In its short transition period Russia went through a number of crises. However, the first few of them in the early 1990s were to a large extent the products of the transition itself. In other words, they were primarily caused by the transition from planned to market-based system. The new system hit its first roadblock in 1998. Since then, the Russian economy not only managed to avoid downturns but built a remarkable momentum, with GDP growth averaging around 7% per annum.

This marks the current stage as the trough of the second crisis in modern day Russia. A natural internal benchmark for recent events is the 1998 crisis. This report compares the key factors and events of the two crises and extracts valuable insights from the past decade.

Causes

The decline of **commodity prices** has been the key factor inflicting pain on the Russian economy. Although this is often overplayed in the press, the fact that about a quarter of the Russian GDP is produced by the oil and gas sectors underscores their significance. The declines of the Brent oil price to the average level of $12.7 per barrel in 1998 and from $145 to $34 in 2008 significantly reduced Russian export and budget revenues.

What was different this time is the speed of the reversal; with the oil price recovering towards $70-80 levels in just a few months after hitting the bottom (see the chart).

The deterioration of the Russian economic performance in 2008 was exacerbated by the military conflict in Georgia. This significantly altered expectations of local market participants, particularly among foreign companies. The **political risks** that the conflict highlighted lead to a quick demand contraction. The effect has been similar to that on local market players in 1998, when they lost confidence in the ruling elite after repeated failures to obtain parliamentary approval of the nominee for the Prime Minister position.

Another key factor, specific to the current crisis, is a severe **global recession**. The 1998 crisis came to Russia amid relatively good global economic performance, with the GDP of advanced economies growing 2.6% that year and 3.6% the next.[1] The comparable figures in 2008-09 were 0.6% and -3.4%, respectively, reflecting a strong external pressure on the Russian economy.

[1] International Monetary Fund, *World Economic Outlook Database*, April 2010.

Brent oil price, USD per barrel

Source: Bloomberg

Rouble devaluation

A common result of both crises was a significant devaluation of the rouble. However, the depth and speed of devaluation was very different. In the first occurrence the Russian currency lost 74% of its value vis-à-vis the U.S. dollar within twelve months. In fact, over 60% of the value was lost in the first two months.

In the second crisis the correction was delayed (only 7% was lost in the first two months), was smaller (35% at the peak) and the trend reversed quickly (to the level of 26% within a year). It is worth noting that after the 1998 correction the GDP returned to growth faster, in Q2 1999, while in 2008 it took almost a year.

Domestic finances

Although the last crisis did not allow the Russian economy to remain an island of stability in a global storm, the country's position is quite different today from that a decade earlier. One notable difference is the state of public finances. The Federal budget has been posting sizeable surpluses, around 4% of GDP on average since 2000 as opposed to constant deficits in and before 1998.[2] The surpluses allowed the Treasury to set aside significant reserves.

On the private side, consumers entered this crisis with low debt levels, and so did banks. The situation was somewhat troublesome in the non-financial corporate sector; however, even there it was far from alarming.

[2] The 1998 deficit was 3.3% of GDP vs. 4.1% surplus in 2008.

Inflation

Consumer inflation has been a constant problem for the Russian economy throughout its transition. The period between the crises was marked by notorious double-digit annual price growth. Temporary successes in taming it (for example, in 2006) were followed by missed targets.

Nevertheless, the current situation offers a sharp contrast to that in 1998, when at some point the headline inflation topped 100% (in February-August 1999). The most recent monthly reading (April) was at 6.1% YoY, and further improvement is expected in the short term.

On the other hand, high inflation after the 1998 crisis resulted in a quick discounting of liabilities and allowed domestic households and firms to emerge with much better balance sheets.

Consumers

Declining wages, growing unemployment and inflation have brought personal incomes down in the course of both crises. The differences, however, are three-fold. First, incomes were declining even before September 1998. On the contrary, until 2008 personal incomes were growing at around 12% per annum in real terms.

Second, the current decline is much lighter, with the lowest point reached in December 2008, when the average real disposable income was 11.6% down YoY; this contrasts with the December 1998 figure of -31%.

The third difference is the length of the decline. After the 1998 crisis it took 18 months for incomes to begin the recovery compared with 12 months this time.

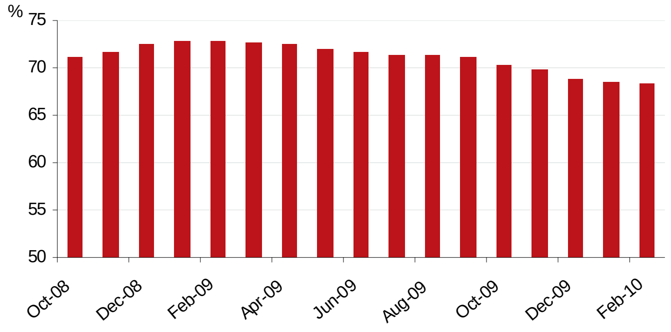
Another important factor is the reaction of consumers. During both crises consumption levels declined, with preferences shifting to cheaper products. However, this time there were savings from previous years to rely upon, and that is what consumers turned to at first to smooth their consumption. As a result, the propensity to spend increased initially. Although it adjusted later, retail sales began to show positive year-on-year figures in January 2010.

Lessons from 1998

Despite several differences, the 1998 crisis offers a useful guidance for future economic development. The post-1998 rebound came quite quickly, in Q2 1999, but was gradual at first, gaining speed only in 2000.

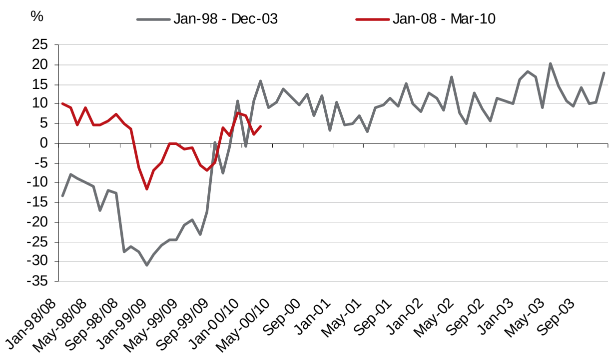
This time, the unused capacity and low base effects, which were big additional growth drivers a decade ago, are weak. Prolonged rouble devaluation has delayed the recovery. However, going forward the strength of the Russian consumer and of public finances, as well as lower inflation, will play a positive role. What is still amiss for a sustainable momentum is a strong rebound in investment activity. Recovering capital markets, including real estate financing, set the stage for improvement. However, claiming full victory is somewhat premature.

Propensity to spend in Russia



Source: Rosstat

Real disposable income growth in Russia



Source: Rosstat

Commercial real estate market

The real estate market, particularly the office segment, displayed quick reaction to the macroeconomic fluctuations. Office rents in Moscow began to decline almost in lock-step with GDP and then stabilized shortly after the economic growth returned to the positive territory (see the left chart below).

However, for the commercial real estate market the comparison with 1998 is more of a stretch. Even in Moscow there were few international quality buildings (Class A) in mid-1998: only seven office projects, five shopping centres and nine warehouses, with less than 200,000 sq m of space per segment. Even with Class B assets included, the difference between 1998 and 2008 is striking, as the right chart below illustrates.

Nevertheless, the events of the past decade offer valuable guidance on how the real estate market will likely be evolving after this crisis.

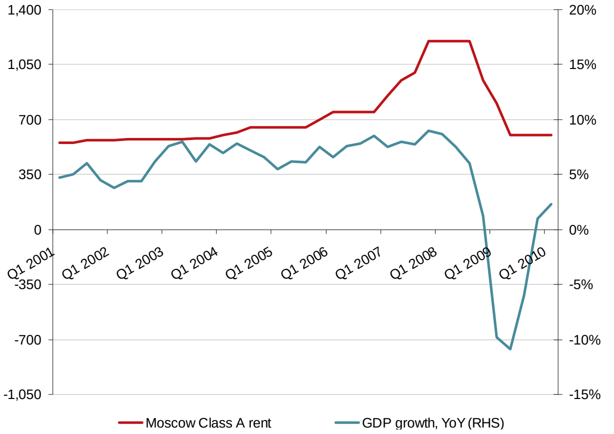
Looking forward

The first few years after the 1998 crisis rents in Moscow grew at a moderate pace. Prime office rent increased less than 2% per annum in 2000-2004. Interestingly enough, this has happened against the background of low vacancy rates reached by 2001.

The later stage of the previous cycle (2005-2008) brings us to the period of high rental growth on the back of strong economic performance. This acceleration is also likely to be repeated, although not necessarily to the same extent or speed. Currently high construction volumes will soon turn to a trickle, because very few new projects are being launched. As the vacant areas are absorbed by growing demand, the space deficit, particularly in higher quality segments, will again push the rents up and encourage new construction. In fact, rents for prime areas already began to increase in Moscow.

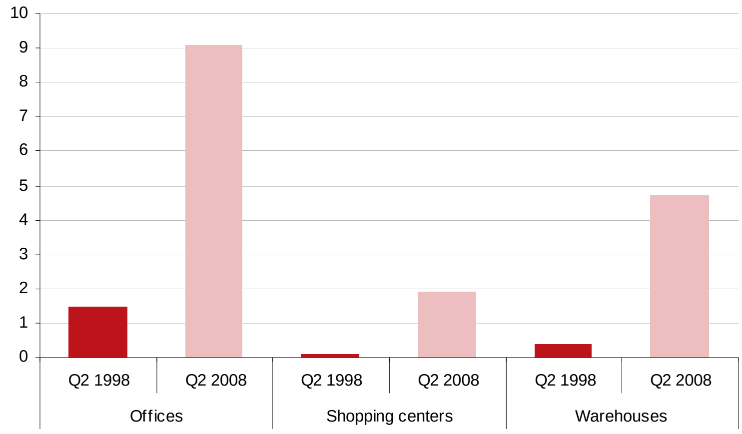
In the previous cycle, it took two years for the Moscow office vacancy rate to return to pre-1998 crisis levels. This time, it will likely take longer due to high new supply at the end of the previous cycle and more moderate economic performance expected in the medium term.

Moscow office market reaction to economic trends



Source: Rosstat, Jones Lang LaSalle

Modern real estate stock in Moscow, mn sq m



Source: Jones Lang LaSalle

Among the commercial real estate segments, we see advantages in **retail** directly and in **warehouses** indirectly due to support from appreciating currency, growing incomes and resistant consumers. The warehouse segment will also benefit from the current supply-demand balance, from being the least developed segment and the one with shortest construction cycles. It will not be surprising if vacancy rates in Moscow warehouses return to single digit levels in a few months (from 14.3% currently). This, in turn, will encourage some developers to resume construction.

For the Moscow **office** market, which is still facing large new completion volumes, it will likely take longer to pass through the initial recovery phase of the new cycle. However, there is little doubt that currently vacant space – which is equivalent to less than three times the 2009 take-up – will begin to shrink as the new construction decelerates sharply.

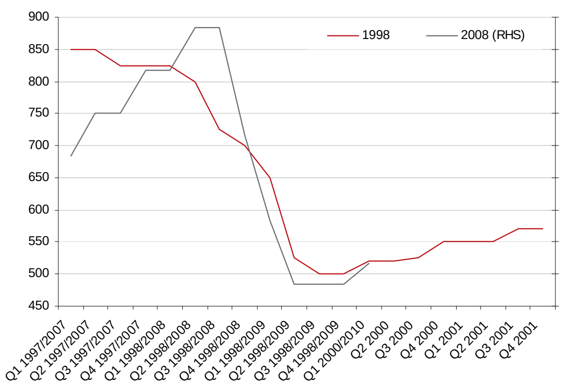
Looking beyond the numbers, one clear feature of the on-going recovery is the flight to quality, which is evident everywhere, from tenant requirements to construction technologies. The key lesson today, in our view, is that the market maturity, low rental spreads and particularly, increased competition, favour premium projects, concepts and services.

The time when any project could – and in many cases did – work without careful planning, construction, leasing and management is over. Therefore, within each real estate segment the performance of high quality projects will differ from medium- and low-quality ones, offering a premium on quality via higher rents and prices.

Short lags in the real estate sectors in Russia require constant monitoring of the macroeconomic performance by market players. Currently macro indicators point towards a new growth phase. However, sizeable risks remain. The highest danger lies on the external side, mainly with the price of oil. Internally, the biggest risks are the business sentiment, which is needed to extend and deepen the first signs of the investment growth. Another critical factor is the consumer sentiment. Fortunately, it has been quite robust in the face of growing unemployment and declining incomes.

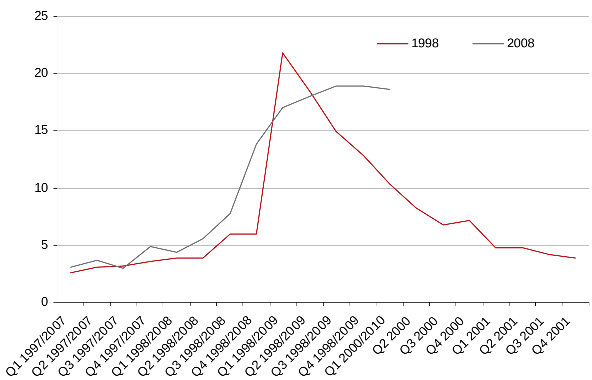
We are currently in the beginning of a new cycle. This time, the growth phase will be slower and more competitive. Learning the lessons of the last decade and focusing on quality will help market players take the most advantage of the new cycle.

Moscow prime office rent, USD/sq m/year



Source: Jones Lang LaSalle

Moscow office vacancy rate, %



Source: Jones Lang LaSalle

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