City Still Hot Property

Across the board, the Moscow real estate market is on the up. Significant developments in the retail and office markets mean that the city has moved out of the shadow of '98 and into new territory. However, it is still struggling to compete with Eastern Europe, where investors perceive less risk.

In the last four months the Moscow real estate market has continued booming in line with favorable economic news and improving business conditions. "Since June, some previously planned developments have been committed and started, and planning for additional new developments has started in each of the major market types: warehouse, retail, office and hotel," said Gerald Gaige, partner at Ernst & Young and head of its real estate advisory services and business valuation group.

Tamara Kushwaha, senior director of the investments group at Stiles & Riabokobylko, agreed, but said that "the office sector is more mature than the industrial and retail sectors." She noted that the office sector in particular is transforming from a pure leasing market to a market where entire buildings can be bought and sold. "Our current portfolio, for example, consists of three office buildings with ground-floor McDonald's restaurants for sale exclusively by us on behalf of ZAO Moscow McDonald's," Kushwaha said.

The retail side is also undergoing rapid development now, with IKEA opening its first Mega Mall project and with Mega II already underway. "Retail developers are becoming much more sophisticated about the quality, design, layout and planning of what they build in Moscow," Kushwaha said.

COURTESY OF STILES & RIABOKOBYLKO

▲ Tamara Kushwaha

"So if there is a significant and sustained decline of oil prices it will definitely retard the development of the real estate market," he said. But he said that to have a major negative effect on the property market, "the reduction in oil prices would have to be significant and to last for two years or more. The longer the current situation holds, the more insulated the real estate markets will become from

handle project finance. The cost of project/debt financing in Russia is high, from

13 percent to 15 percent, and even more if the risk is higher. In Russia, there are no LTVs (long-term vehicles), which means there are less ability and less opportunities in Russia to refinance, so loan-valuation ratios are better in Eastern Europe than in Russia," he said.

Another problem is that under present investment contracts, the title to property is only transferred when all the conditions under the contracts are fulfilled. In other words, even after an investment contract has been signed, the assets cannot be pledged, making it impossible to use them as collateral.

And in contrast to Eastern Europe, Russia did not allow foreign investors onto its real estate markets at an early stage. "On the one hand, Eastern Europe has a large number of high-quality products on the secondary market, many of which however have been bought by foreign investors such as German and Austrian pension funds and the like. On the other hand, there are few foreign investors in Russia, but the downside is that Russian constructions tend to be of lower quality because local investors were less exposed to the expertise of world class developers and architects," Myshkin said.

"The current cap rates compression leads to the situation when investment properties in Moscow become less attractive to international investors due to the fact that the cost of refinancing is still extremely high (around 8 percent to 9 percent), which makes the leveraged yields comparable to those in Eastern Europe, while the country risks are perceived to be still higher in Russia than in the countries soon to become EU members," Myshkin said.

by Ian Pryde

"The rate of building first-class big-box retail and new storefront retail has been phenomenal since the 1998 crisis, but there is still huge scope for growth."

The warehouse market is likely to remain a built-to-suit market, according to Kushwaha. "The market for warehouses is directly related to production and retailing and was underdeveloped in the past," she said, "but we now find this market attractive and are currently advising key investors in this area. Several major global players are coming to Moscow to invest this year and next."

Rental Rates May Decrease

Gaige said that the undisputed potential for expansion, however, does not mean that yields will continue rising: "While the positive trends are expected to continue, there is a chance that in the medium term, office and warehouse projects could level off or even decline if substantial amounts of planned supply are actually completed and then come onto the market. The biggest unknown right now is the impact of the first few 'Moscow-City' office skyscrapers."

Kushwaha also said that rentals could begin a slow downward movement in the retail sector to accommodate the trial and error that retailers must make to find their pricing in this market. "But this is a positive trend because retail rentals have been too high in the past, and that has made it hard for retailers to expand or roll out," she said.

While at first glance it might look as if Moscow's current property boom is disturbingly similar to that on the eve of the August 1998 crash, most experts point to significant differences. Gaige said there is indeed a significant connection with the high oil prices in recent years and that Russia has obviously benefited greatly from them.

"The biggest unknown right now is the impact of the first few 'Moscow-City' office skyscrapers."

changes in the oil pricing market," Gaige said.

Kushwaha agrees, arguing that many involved in Moscow's real estate market now believe that a huge amount of work needs to be done in building and rebuilding properties, expanding businesses of all kinds and taking advantage of the huge retailing potential and the opportunities in the service sector. "After 10 years, the local population now has a handle on capitalism, while the foreign advisors based here have a better understanding of how Moscow and Russia and the Russians work. The combination of these two groups coming together at a time of good luck on the Russian oil front has resulted in an impressive optimism, energy and pace in business here in Moscow," Kushwaha said.

It is a combination of this optimism and the currently unattractive yields in Western Europe that has stimulated considerable interest in Russian property by foreign institutional investors.

"Russia's real estate market is still in the embryonic stage, even compared with Eastern Europe, so there is a lack of institutional buildings which are suitable for real estate funds — for example pension funds," said Oleg Myshkin, director of Colliers International.

"Russia suffers from a lack of project finance," Myshkin said. "While the banking system has excessive liquidity, it is still not equipped for lending and therefore cannot