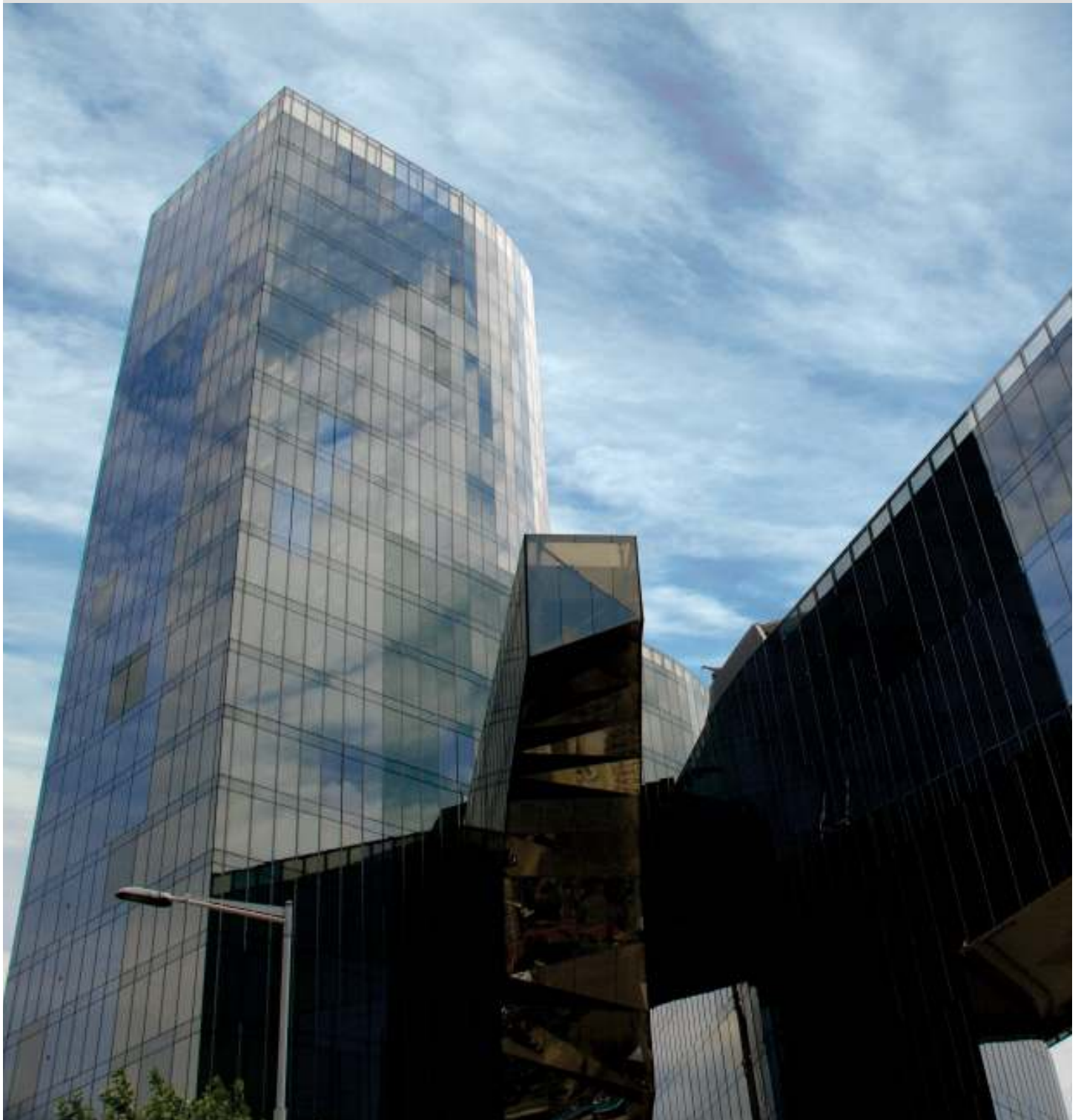




# REAL ESTATE MONITOR

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**3rd QUARTER, 2010**





# REAL ESTATE MONITOR

3rd QUARTER, 2010

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# REAL ESTATE MONITOR

3rd QUARTER, 2010

## Letter from the Chairman of the AEB Real Estate Committee

Dear real estate professionals,

Welcome to the Real Estate Committee Monitor for the 3rd quarter of 2010. There has been quite a bit of activity within the various working groups of the Committee over the past months, and I am pleased to be able to give you a brief update of these activities together some insight as to the current market activity, and some insight as to where things appear to be heading.

Olga Arkhangelskaya and the rest of the team from the "Finance and Investment" working group have been active in preparing for an upcoming event titled "Banks as owners of Real Estate Assets: Risks, Challenges and ways to move forward" which will take place on the 25 of November. It is not always easy to get banks to talk openly on this topic, but I am hopeful that those banks that are present will engage in constructive and open exchange helping to stimulate momentum that will contribute to getting some more liquidity into the real estate market. Tim Millard and the rest of the team from the "Industry sub-sectors" working group have also been active planning for a number of upcoming events, the most immediate one being titled "Green Office: Fancy trend, or a way out of the Crisis?" which will take place on 18 November. Green issues are definitely working their way up on the agenda of a number of market participants in Russia and this event promises to be interesting. I encourage you all to reach out to the AEB team and register to attend these events.

There has been a good level of activity in the other working groups and I would in particular like to thank Christophe Vicic and the rest of the "Membership and Operations" working group for their pro-activity focused on the preparation of this publication and the six monthly position paper which is due to be released shortly. Arnaud Dubois continues to work relentlessly promoting the activities of Real Estate Committee and the real estate sector in Russia as a whole, and Pavel Vishnyakov is working to mobilise the "Infrastructure" working group.

The real estate capital market was less active in Q3 when compared to the preceding quarter and down 21% on the corresponding period for 2009. Equity capital in the real estate market remains scarce and debt markets also remain very tight. Debt financing from international banks appears to be primarily limited to finalisation of existing pipeline activity, whilst there is some evidence of new lending activity by domestic banks in the area of development activity.

In the office sector a number of new assets have come on line, but despite this vacancy rates for quality A class accommodation continues to decline. The labor market continues to strengthen, the retail market is relatively buoyant and there are signs of some new activity in this sector. The warehouse sector remains stable, however the level of new development activity remains limited. In the hospitality sector there are signs of gradual increases in occupancy rates. Finally, in the residential sector there are real signs of positive momentum, with a number of market participants predicting a continued uptick in activity over the coming months.

With the uncertainty around the issue of the appointment of a new Mayor for the City of Moscow now behind us, all eyes are now focused on understanding what changes this new appointment will herald for the real estate sector in Russia. There are a multitude of challenges to be addressed including infrastructure, transportation, legal reform, and the permitting of development activity, all of which require significant focus to ensure that the real estate sector in Russia evolves at an appropriate pace. The AEB Real Estate Committee has a real and meaningful role to play in contributing to this process and encourage all of you to challenge yourselves to engage in this process in any way possible.

Yours truly

**Richard Gregson**



# REAL ESTATE MONITOR

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## Real Estate Committee New Structure



**Real Estate Committee**  
Richard Gregson  
Chairman

### Steering Committee

- Chairman
- Leaders from each Sub-Committee (Deputy Chairs)



#### **Membership and Operations:**

Christophe Vivic  
Chief Operating Officer  
Jones Lang LaSalle  
Russia & CIS



#### **Finance and investment:**

Olga Arkhangelskaya  
Ernst & Young  
Head of Real Estate  
Advisory Services



#### **Industry sub-sectors:**

- Office
- Residential
- Retail
- Industrial/warehouses
- Hotels

Tim Millard  
Managing Partner Russia and  
CIS Cushman & Wakefield



#### **External Affairs - Government relations & coordination with other associations:**

Arnaud Dubois  
IMAGIM Ltd  
Managing Director Partner  
Global Real Estate Solution



#### **Infrastructure:**

Pavel Vishnyakov  
OOO EC Harris Rus  
General Director



#### **AEB Committee**

Olga Silnitskaya  
Coordinator



## Past & Upcoming Events

### Past events

- 13.07.2010 Membership & Operations working group meeting
- 30.07.2010 Finance & Investment working group meeting
- 03.08.2010 Sub-sectors working group meeting
- 19.08.2010 Membership & Operations working group meeting
- 02.09.2010 Steering committee meeting & Sundowner
- 10.09.2010 Finance & Investment working group meeting
- 07.10.2010 General committee meeting & Sundowner
- 12.10.2010 Sub-sectors working group meeting
- 19.10.2010 Membership & Operations working group meeting
- 29.10.2010 Finance & Investment working group meeting
- 11.11.2010 Sub-sectors working group meeting

### Upcoming events

- 18.11.2010 Sub-sector working group event:  
**“Green office: fancy trend or way out of the crisis”**  
Venue: Cushman & Wakefield  
Ducat Place III, 6th Floor, Gasheka St. 6, Moscow
- 25.11.2010 Finance & Investment working group event:  
**“Banks as owners of Real Estate: risks, challenges and ways to move forward”**  
Venue: Ernst & Young - Sadovnicheskaya Nab.77, bld.1, Moscow
- 07.12.2010 Membership & Operations working group meeting  
Venue: PwC - Butyrsky Val, 10, Moscow
- 08.12.2010 **AEB 15<sup>th</sup> Anniversary Celebration**  
Venue: The Grand Ballroom of the Lotte Hotel Moscow
- 14.12.2010 Steering committee, general committee meetings & Sundowner  
Venue: Ernst & Young - Sadovnicheskaya Nab. 77, bld.1, Moscow



## Real Estate Quarterly Market Snapshot Review

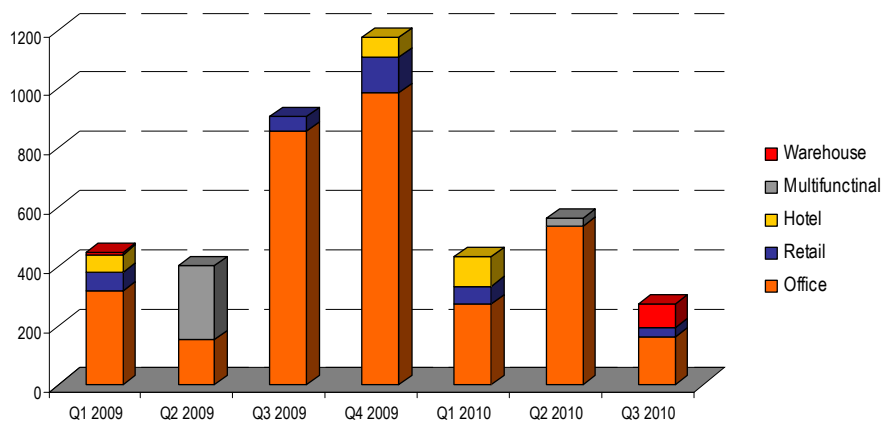
Although the rate at which Russian economy is recovering is slowing down, the next upcoming months are likely to bring back the general trend towards economic recovery, as Ministry of Economic Development reports. This trend is going to be supported by the growth of consumer demand, restoration of supplies, and the investment activity that expected towards the end of the year.

### CAPITAL MARKETS

The third quarter of 2010 was far less impressive than the second quarter in terms of investment activity: there was 51% less investment in commercial real estate than in the preceding reporting period. Thus, the total volume of investment in commercial real estate in Q1-Q3 2010 reached \$1.26 billion which is 21% less that the figure for the respective period of 2009.

The office segment that has historically been the most appealing for investors remains on top of the rating in terms of investment attraction: 76.5% of the total investment in 3 quarters of 2010.

Investment volume dynamics, Russia, \$ mln



One of the largest deals closed the 3<sup>rd</sup> quarter was the acquisition by Metallurgic Holding Evraz Group of the Western Gate business park (developed by Centurion Group). A number of large deals were announced in Q3 2010: Alfa Arbat Business Center that houses TNK-BP headquarters may be purchased by Transneft. RVM Capital managing company is currently in the process of acquisition of 2 buildings in Domnikov Business Center.

Much less deals were closed in the other segments of commercial real estate. The second transaction in the retail segment since the beginning of the year was closed in Q3. Russian developer company Moon-Invest sold its Format Shopping Center located in Mytishchi (Moscow region).

The share of acquisition deals by end users in the total volume of investment decreased compared to the three quarters of 2009 (when this share equaled 42%) and reached 30.7% as of Q1-3 2010.

International investors are very careful about coming back to the Russian market. In the first three quarters of 2010 only 11% of investment came from abroad (although this is still significantly higher than the previous year's figure – 2%).

No decrease of capitalization rate was reported in Q 2010 as compared to Q2 2010. For high quality office properties this figure currently equals 10.75-11.25%. The figures for high quality retail and warehouse properties have undergone no significant change and currently range between 11.5-12.5% and 13-13.5% accordingly.

Source: Praedium Oncor International



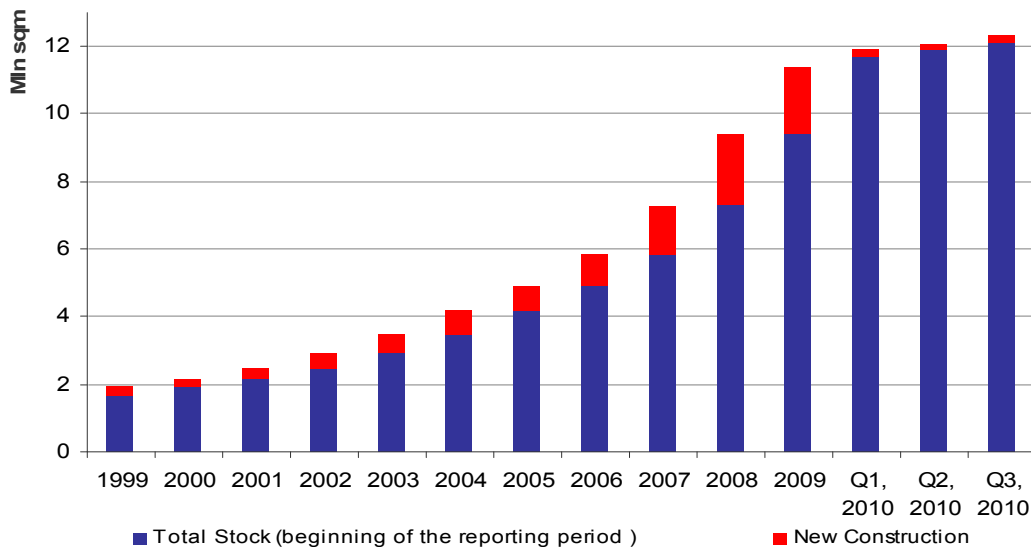
# REAL ESTATE MONITOR

3rd QUARTER, 2010

## Real Estate Quarterly Market Snapshot Review

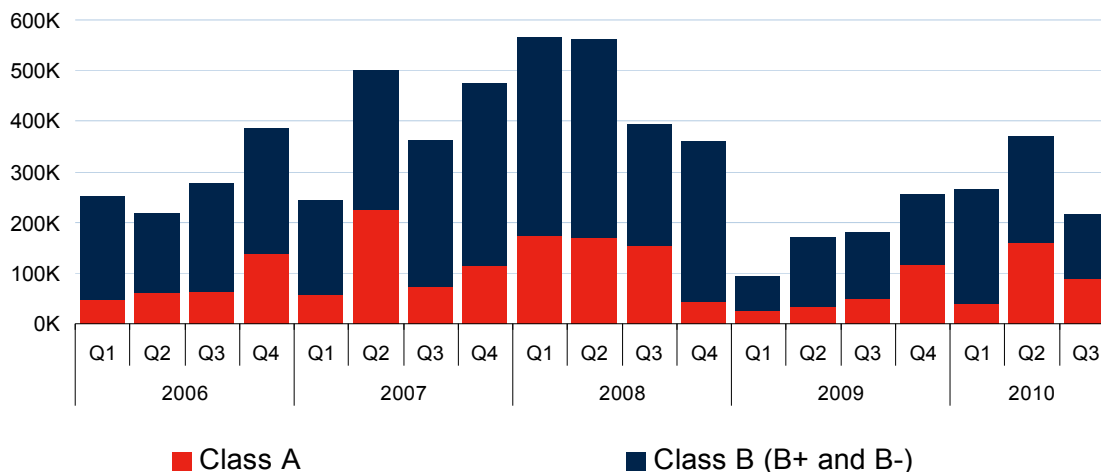
### OFFICE MARKET

Quality office supply went up in Q3 2010. Major projects completed in Q3 2010 are: Nagatino i-Land phase I part II (3 buildings totaling 78,245 sq m); AFI na Paveletskoy (83,000 sq m); Mirax Plaza Bldg D (21,190 sq m); and Helios City (20,000 sq m). Total amount of commissioned in Q3 office buildings is the greatest from the beginning of the year.



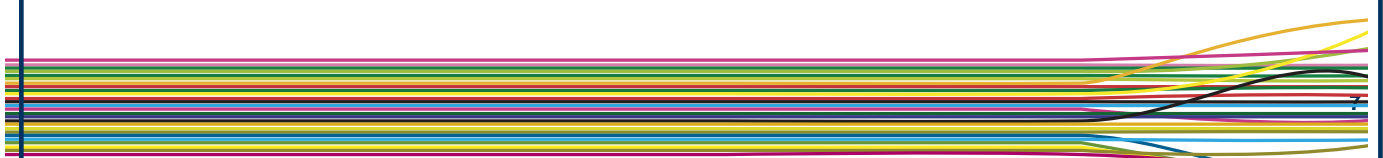
Modern office stock (Classes A, B+, B-) in Moscow has amounted to 12,37 mn sq m by the end of Q3.

### Take-up dynamics



Take-up for Q3 2010 accounted for 210,000 sq m.

Source: Colliers International, Cushman & Wakefield



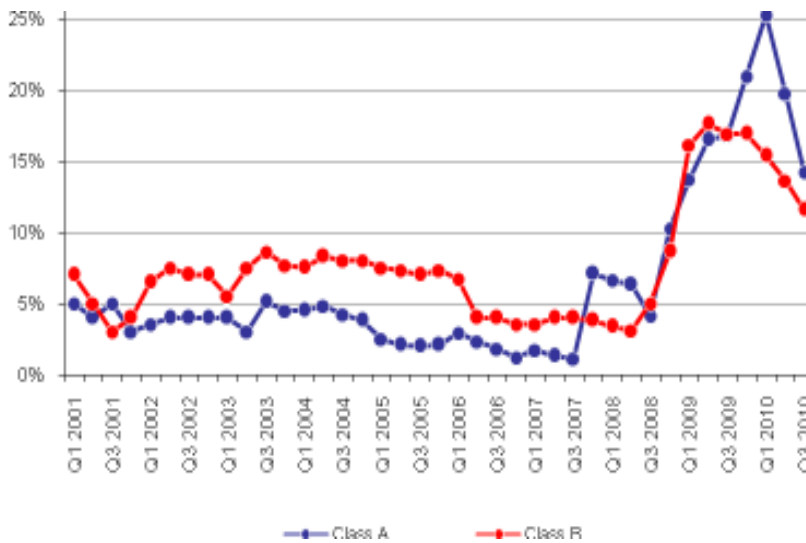


# REAL ESTATE MONITOR

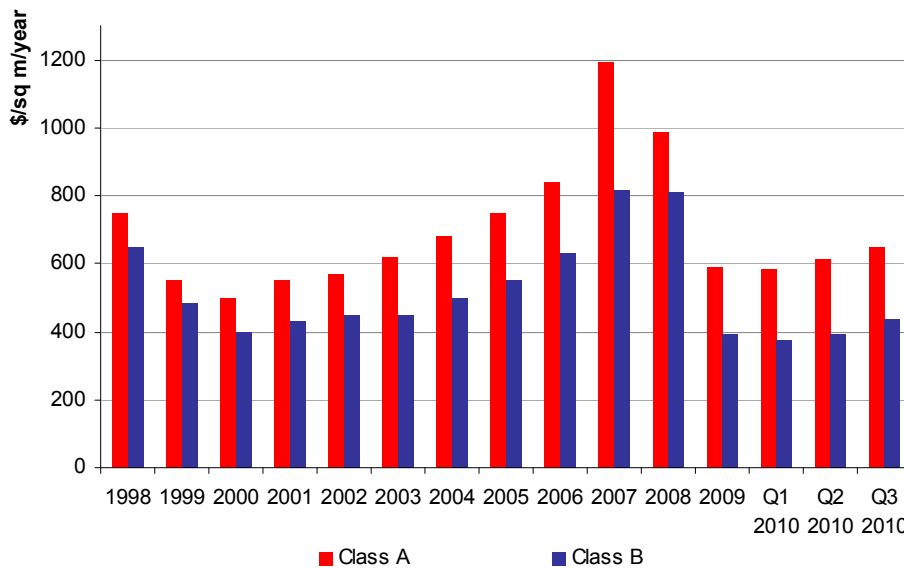
3rd QUARTER, 2010

## Real Estate Quarterly Market Snapshot Review

Vacancy level is equal to 1,48 mn sq m in Q3 2010. The average vacancy rate in Moscow office buildings is 11,99% (for Class A offices – 14,19% and for Class B offices – 11,59%). Thus, according to graph below vacancy rate has been decreasing during two quarters for Class A and during three quarters for Class B.



Rental rates increased in the Q3, and by the end of quarter base rental rate has been equal to \$649 per sq m in Class A office buildings and \$439 per sq m in Class B office buildings.



Source: Colliers International, Cushman & Wakefield



## Real Estate Quarterly Market Snapshot Review

### RETAIL

Improving labor market and income growth rates being in the positive zone translated into retail sales growth of 6.7% YoY in July and 6.5% YoY in August, extending the positive trend seen in H1. This has affected the retailers' demand, both Russian and foreign retailers are ready to expand their chains.

#### Shopping centers

Although large volumes of shopping centre premises (139,200 sq m) have entered the Moscow market in Q3, the vacancy rate has not increased. In fact the vacancy rate in Moscow declined to 7% in Q3 2010. This was a result of continued decline of vacant areas in existing shopping centres, including recently opened SCs. In particular it is worth mentioning that new shopping centres are opening with higher occupancy level, at 80-90% compared to 60-70% during the crisis. As the retailer demand has improved, we do not expect massive SC openings in this and the following year to have negative effect on the vacancy rate.

The vacancy rate in existing Moscow shopping centres has declined to minimal level. As the retailer demand has improved, we do not expect massive SC openings in this and the following year to have negative effect on the vacancy rate. Additionally, vacancy rate increase is constrained by the probable postponement of some shopping centres' openings. On the back of higher demand and lower vacancy rate, the rents have started to recover. Although prime rental rates in Moscow remained unchanged at USD4000 per square meter in Q3 2010, the average rents increased 10-30% from the crisis level depending on the tenant.

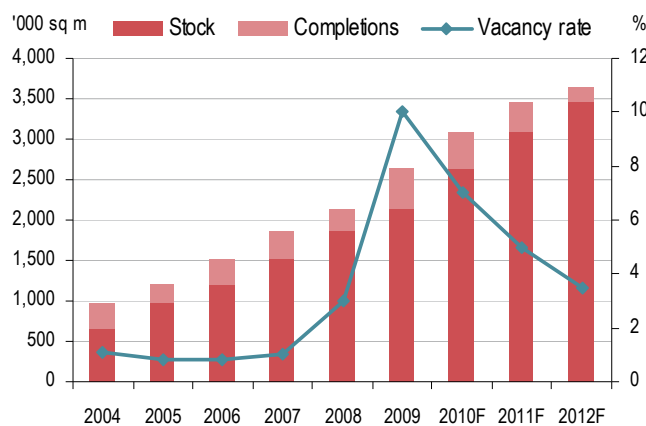
#### Q3 2010 SC rents and yields

Indicator		Moscow		St. Petersburg	
		min	max	min	max
Prime SC base rent*	USD/sq m/year	2,700	4,000	1,300	2,000
Average SC base rent	USD/sq m/year	500	1,350		
Prime street retail base rent	USD/sq m/year	3,500	4,000		
Prime SC yield	%	10.0	10.5	12.0	12.5
Vacancy rate	%	7.0		8.0	

\* Represents the net rent that could be expected for a notional prime position shop situated in the best shopping centre.

Source: Jones Lang LaSalle

#### Moscow market balance



Source: Jones Lang LaSalle

#### Moscow project pipeline

Name	Announced year of opening	GLA, sq m
Gagarinsky	2010	70,000
Tsvetnoy	2010	22,000
Severnoe Siyanie	2010	12,250
Parus	2010	17,150
Favorit Centre	2010	24,000
Kaleidoskop	2010	35,000
Mall of Russia	2010	114,000
GoodZone	2011	70,000
Rechnoy phase II	2011	40,000
River Mall	2011	85,000
Fashion House Outlet Centre	2011	26,765
Outlet Village at Belaya Dacha	2011	38,000
Tverskaya Zastava	2012	37,000

Source: Jones Lang LaSalle



## Real Estate Quarterly Market Snapshot Review

### Street retail

Rental rates for the street-retail premises went down to 30-40% during the sharpest phase of the crisis (H1 2009). They fall down for more than 50-60% for some of the top premises, that are located on the first row of the central business streets, where rates before crisis exceeded \$15 thousands/m<sup>2</sup>/year.

The resumption of the street-retail market was outlined already in the second half of 2009: rental rates in some segments have started to grow. The rental rates for the premises, located in bedroom community, have now returned to pre-crisis indicators. At the same time top premises, located on the central streets, have been considerably overestimated before crisis, are still leased for 30-50% cheaply, than during the pre-crisis period.

Aggregate volume of street–retail space on central retail corridors, thousands of sq m	410
Share of vacant space, %	1,8-7,0%
Aggregate volume of street–retail space on main retail streets, thousands of sq m	150
Share of vacant space, %	1-7,8%
Base rental rates, \$ per sq m per annum*	
Central retail corridors	1300-5300**
Main retail streets	700-2200**
Space on 1st floors of residential homes in bedroom communities	500-1200**

1.\*Excluding operating expenses and VAT (18%)

2.\*\*Rates for stores with areas around 200 sq m

Source: Knight Frank Research, 2010

### Moscow prime street retail rents, Q3 2010

	Minimum	Maximum
Tverskaya Street	3,000	4,000
1 Tverskaya-Yamskaya Street	1,200	2,500
Novy Arbat	1,500	2,500
Kuznetsky Most	1,500	3,500
Kutuzovsky Prospect	2,000	3,500
Leninsky Prospect	700	3,000
Prospekt Mira	700	2,000
Sadovoe Koltso	1,500	3,000
Krasnaya Presnya	1,000	2,200
Stoleshnikov Lane		5,000
Petrovka Street	1,000	3,500
Patriarshie Prudy	2,000	2,500
Ostozhenka Street		2,700

Rents are given for a single unit of 100 sq m GLA located on the ground floor of a high street premises.

Rents (USD/sq.m/year) are quoted excluding operational expenses and VAT

Source: Jones Lang LaSalle



## Real Estate Quarterly Market Snapshot Review

### WAREHOUSES

In Q3 2010 the general situation in the market of warehouse properties remained rather stable. Tenants demonstrated a comparatively lower activity than in Q1 and Q2; however there were more tenant inquiries for larger surfaces.

The rate of new construction remains unprecedentedly low: according to preliminary estimations, only 285,000 sq m are likely to be actually delivered. The volume of new construction in 2010 is going to be record-low since the beginning of shaping of the Russian warehouse property market.

However, it is important to note that in Q3 2010 many developers announced their plans to construct new properties that are to be carried out before the end of 2011-beginning of 2012. This tendency is the first sign of recovering developer activity in the warehouse segment and also a reason to believe that the projects that have been put on hold due to the recession will be resumed and completed in the next 1-2 years.

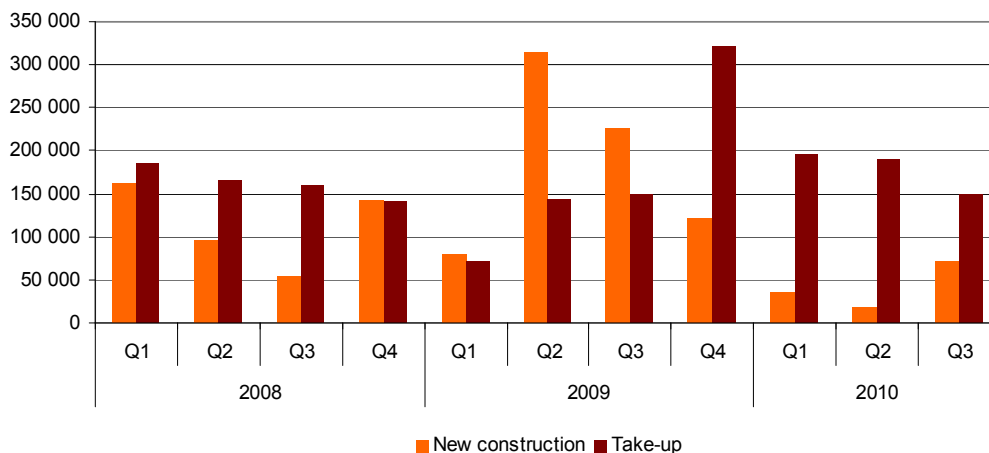
In Q3 2010 there was a number of lease deals for high quality warehouse space, one of largest being the acquisition of 32,500 sq m of warehouse space in A-Terminal logistic complex by Arkonada wholesale trade company (Class A property, 5 years term). Besides, in summer 2010 TNT Express and CJSC Intercomplex signed a lease deal for 5 years in Troitse-Lykovo warehouse complex. The tenant leased 10,885 sq m of warehouse and office space.

Large warehouse lease deals in Q3 2010 were not limited to Moscow region. Warehouse space tenants were visibly interested in the large regional cities of Russia: Saint-Petersburg, Yekaterinburg, Novosibirsk etc.

Real estate developers also show significant interest in the regions of Russia. Mirland Development Corporation intends to build a Class A logistic complex of over 150,000 sq m in Saratov Region. A German logistic company called SIF&B is planning to invest over 1 billion euro in a project of industrial and logistic park in Kaluga region.

Throughout the last 4 quarters starting from Q4 2009 the total amount of warehouse space leased is considerably larger than the space in properties under construction. Therefore, the vacancy rate is dropping sharply.

**New construction and take-up of the quality warehouse space, 2008-2010, sq.m**



Source: Praedium Oncor International

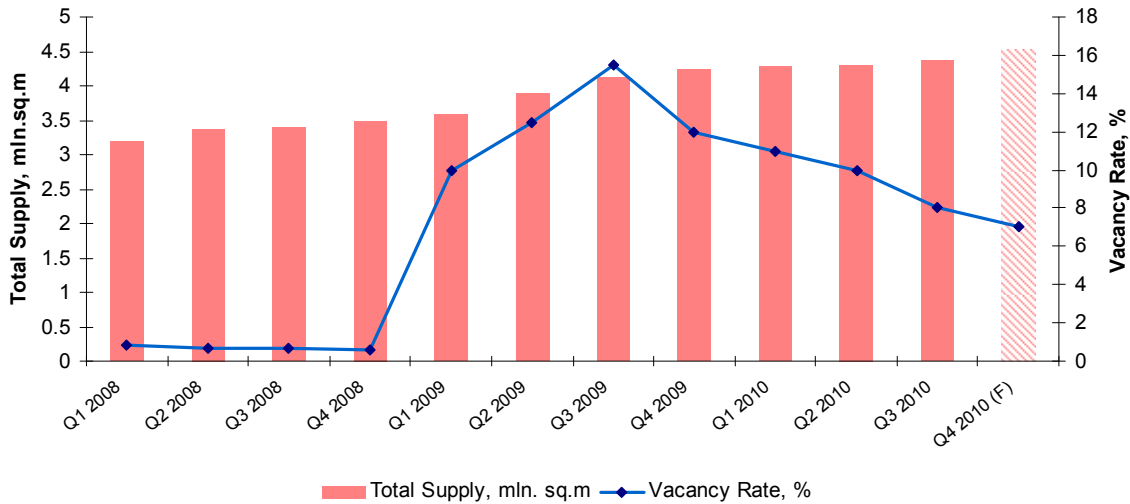


# REAL ESTATE MONITOR

3rd QUARTER, 2010

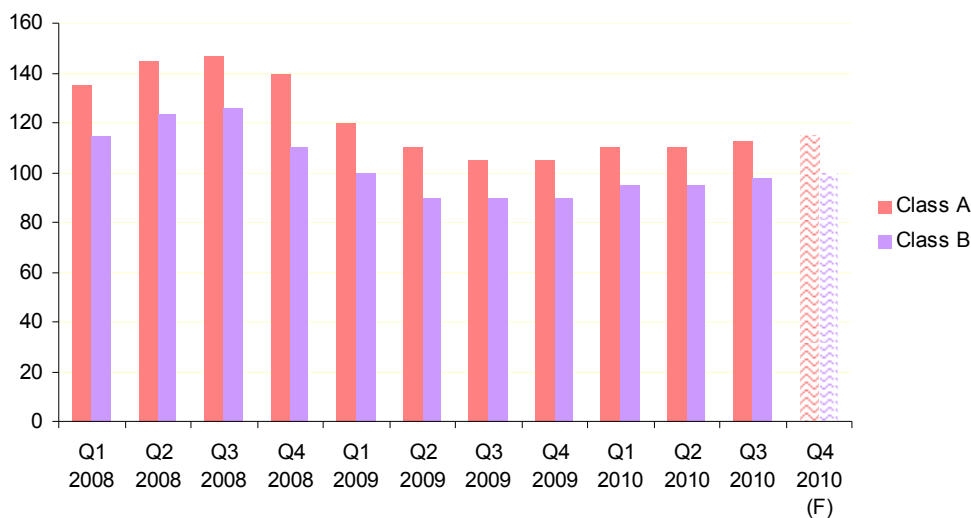
## Real Estate Quarterly Market Snapshot Review

Dynamics of new supply and vacancy rate in quality warehouse complexes



As of the end of Q3 2010 the average rental rates reached \$110-115/sq m/year (triple net) for Class A warehouse properties and \$95-100/sq m/year for Class B properties. Thus, average rental rates have grown by 7-8% throughout the three quarters of 2010. A further growth is expected towards the end of the year. It is estimated that the total growth in rental rates for 2010 may reach 9-11%.

Dynamics of Rental Rates for International Quality Warehouse Space, \$/sq.m per year



Source: Praedium Oncor International



## Real Estate Quarterly Market Snapshot Review

### HOSPITALITY

The first three quarters of 2010 showed an overall 3% increase in hotel occupancy across all market segments. Both Dollar and Ruble ADR (average daily rate) continued decreasing and amounted to 6% and 12% respectively. Thus a slight average 2% increase of RevPAR (revenue per available room), set in Dollars, was observed on a YTD basis. Average Ruble RevPAR dropped by 7%. Such price variance may be explained by the currency exchange rate fluctuations: by the end of the first nine months of 2010 US Dollar weakened by 6% against Russian Ruble. Thus when Ruble rates decrease, Dollar rates may still show growth.

A two-way demand shift may be observed: on one hand, hotel clients aiming to lower expenses switch to more economical lodging, on the other hand, luxury and upscale hotels became more affordable due to prices reduction. Thus there is a visible demand increase in midscale and upscale hotel segments.

The upscale segment indicated the best results reaching the highest Dollar RevPAR rise of 7% (\$162). Such increase was reached by a 3% occupancy rise and stable dollar pricing policy. The Ruble rates decreased by 9% (9 214 RUR). The Ruble RevPAR declined only by 3% and amounted to 4 793 RUR.

Business hotels remained practically at the same level, showing a 3% RevPAR increase (\$134), which was composed of 3% occupancy rise balanced by a 2% Dollar ADR decline. ADR, set in Rubles, diminished by 11% in line with 7% decrease in Ruble RevPAR (3 959 RUR).

In midscale segment a 6% RevPAR increase may be noticed by the end of 3Q2010 (\$91). The occupancy grew by 5% and a 5% decrease in Dollar ADR may be observed. Rates set Rubles declined by 14%, which was the most significant drop across all the segments. Nevertheless Ruble RevPAR decline stopped at 3% (2 706 RUR).

An absolute gap in RevPAR between the segments continues to shorten. The variation between the midscale and upscale segments decreased to 71 US Dollars. The difference in RevPAR between upscale and business hotels shortened to 28 US Dollars.

Only one 4-star hotel, SK Royal on Dmitrovskoye Highway, just outside the MKAD, entered the market during the 3rd quarter of 2010. We assume that gradual increase of existing hotel supply and resumption of postponed construction works on hotel projects may be expected. In line with the reduction of entering barriers to the market during the crisis and post crisis period there is a visible expansion of operator presence.

### Hotels, opened in Moscow in 2010

Name	Room number	Address	Class
Lotte Hotel	304	Novinsky Bul., 8-10	5 stars
Garden Ring (Sadovoye Koltso)	85	Mira Pr-t, estate 14, Bldg. 2	4 stars
Renaissance Moscow Monarkh Center Hotel	366	Leningradsky Pr-t, 31, Bldg 2,3	4 stars
Radisson Royal Hotel (former Ukraina)	507	Kutuzovskiy Pr-t, 2/1, Bldg. 1	5 stars
Katerina Park (former Evrolux)	260	Kirovogradskaya Ul., 11	3 stars
Hotel within SK Royal mixed use complex	170	MKAD/Dmitrovskoye Sh., 163A	4 stars

Source: Ernst & Young



# REAL ESTATE MONITOR

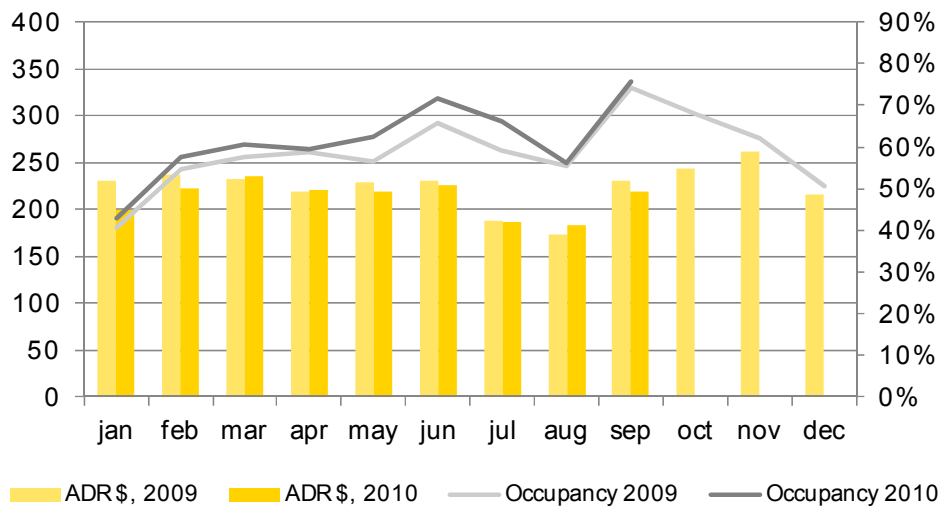
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## Real Estate Quarterly Market Snapshot Review

Future hotels, planned for opening in 2010

Name	Room number	Address	Class
Courtyard Moscow Paveletskaya (Mixed-use complex Vivaldi)	170	Kozhevni Cheskaya Ul., 8/ 4	4 stars
Radisson Belorusskaya	264	Yamskoe Pole 3-ya Ul., 26	4 stars
Azimut in Danilovskaya Manufaktura mixed use complex	134	Varshavskoye Sh. 9, Bldg. 1B,	3 stars

Average market ADR (\$) and occupancy dynamics, 2010 vs. 2009



Source: Ernst & Young



## Real Estate Quarterly Market Snapshot Review

### THE ELITE REAL ESTATE RENTAL MARKET DURING Q3 2010: COMPLETE RECOVERY NOW NEAR

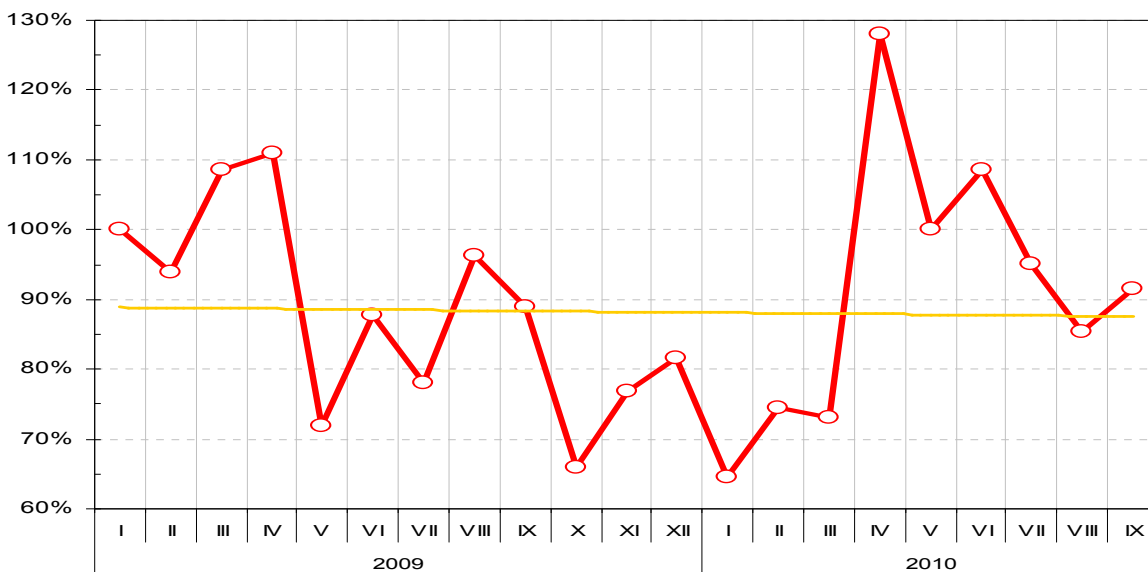
During the nine months since the start of this year we have observed a gradual growth in rent rates and an increase in potential tenants budgets. However, an analysis of closed transactions during this period shows that the major share in demand remains within a price range of up to 4,000 USD, indicating that the effective demand remains low.

However there are grounds to believe, that in the near future the current situation will undergo drastic changes. During the third quarter due to the unfavorable weather and environmental conditions activity on the rental market decreased. However, overall the demand structure for elite apartments has changed little over the past year. Most of the tenants (67%) are still foreigners employed by large companies and embassies; and 30% are Russians.

As most of tenants (60%) have families, demand is growing accordingly for three- and four-room apartments (30% and 25% respectively). An interesting growth trend in demand for two-room apartments resulting from an increasing share of potential tenants under thirty was observed during the report period.

The results from the first three quarters of the year show a geographic demand structure where the largest portion is within such districts as: Arbat-Kropotkinskaya (15%), Tverskaya-Kremlin (12%), Leningradsky Avenue (11%), and Zamoskvorechye (10%): about 48% of all requests are for real estate within these districts. Analysts recorded a slight decrease in interest in Patriarshiye Prudy area.

**Development of demand on Moscow high-budget residential property rental Market, Jan 2009 – 100%**



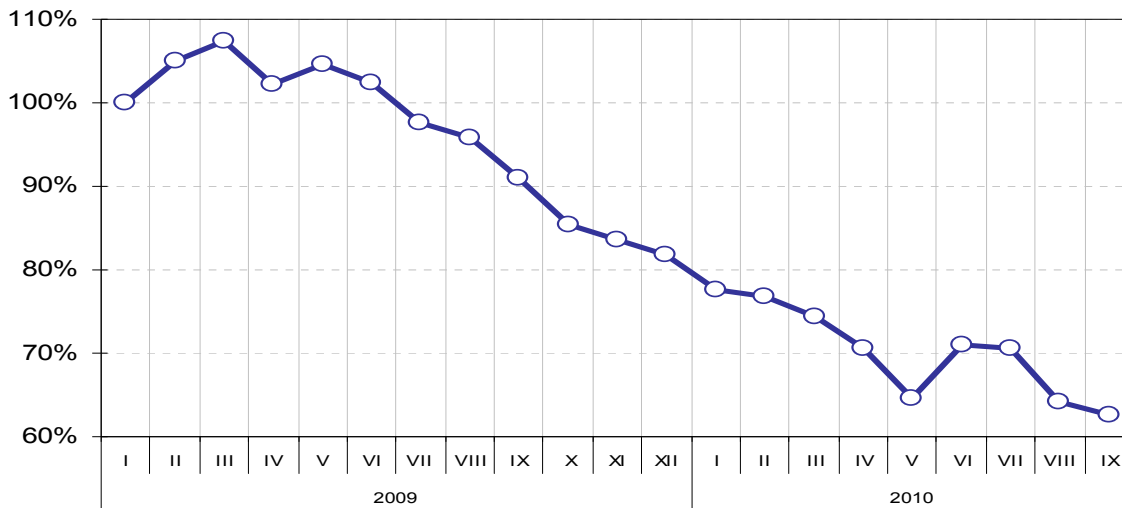
On the whole, one can say that today there are clear indicators that show a near future active growth in demand. As for the supply, the situation is quite the opposite. According to IntermarkSavills' consolidated estimates, the amount of high budget real estate supply at the end of the third quarter of 2010 was 24% lower than at the end of December 2009. In June 2010 the quantity of free supply increased (by 10% as compared to May 2010). This was partially caused by tenants moving to country properties for the summertime and by owners bringing projects back to the market. However, the quantity of supply continued to shrink, and by the end of September 2010 the quantity of apartments offered for rent was 11% less than at the end of the second quarter of 2010.

Source: IntermarkSavills



## Real Estate Quarterly Market Snapshot Review

Development of supply on Moscow high-budget residential property rental Market, Jan 2009-100%



By and large, there is still an acute shortage of high quality, high class comfort residential property.

The geographic structure did not change during the three quarters of 2010, and the leaders remained the same: Arbat-Kropotkinskaya (17%), Leningradsky Avenue (10%), Tverskaya-Kremlin (10%), and Leninsky Avenue (11%). There is still a shortage in the supply in such districts in high demand as Patriarshiye Prudy and Zamoskvorechye as there was in the previous year.

The room demand structure in high budget apartments is still primarily for three-room (39%) and four-room (28%) apartments which is equal to the potential demand for them. At the same time, due to the limited number on the elite rent market the most compact apartments disappear from the market quickest, especially during periods when the paying capacity of tenants is low: the share of such apartments has reduced by 5% since the beginning of 2010. The share of five-room and multi-room apartments grew by 2% as compared to the end of 2009, though significantly lagged behind retrospective demand.

What about rental rates for elite residential property under these circumstances? At the end of September the weighted average budget of supply and the unit rent rate in high budget residential property amounted to 6,528 USD per apartment per month and 584 USD per sq.m. per year. However, it was still less than the pre-crisis level and 16% higher than the same indicator at the end of the same period of 2009 (in Q3 2009 it was 5,613 USD per apartment per month).

The average budget of an apartment requested by tenants during the third quarter of 2010 amounted to 5,440 USD per apartment per month which was 4% higher than the same indicator at the end of the third quarter of 2009 (5,230 USD). However, during the summer months there was a sharp decline in the budgets requested. After that sharp decline prices started to grow again in September.

Therefore, during the entire year a slow, but stable positive correction of rent rates and budgets was seen, which is a sure sign of gradual recovery within the rental market.

It seems that this budding growth in demand and the reducing supply will lead to prices returning to pre-crisis level and growing further.

Source: IntermarkSavills



## Hot Topic

### **RESTRUCTURING OF TROUBLED DEBT: REAL ESTATE ASSETS TRAPPED IN BANKING INSTITUTIONS**

#### **Problem**

As a result of the financial crisis, many companies have been unable to service their debt, causing a large number of real estate properties to end up on the banks' balance sheets. The banks assume control over the real estate properties themselves or take shares in companies that have real estate assets. Contrary to the market expectations, this accumulated mass of real estate has not been offered up for sale at distressed prices; consequently, the often-forecasted market crash has not yet materialized.

The common practice observed on the market today is an attempt by both the banks and the borrowers to avoid any definite resolution of the real estate problem: banks prefer to restructure debt, rather than having to force borrowers to sell collateral properties at large discount; borrowers argue that prices will soon recover to pre-crisis level, enabling prompt loan repayment. Inaction of the banks is driven both by optimistic expectations and the underlying concern over capital decrease from losses due to sales, tax effects, and potential worsening of other regulated parameters. As a consequence, very few properties make it to the market; vast majority of real estate remains idle on the balances of the banks and their affiliated structures.

The underlying reason for this situation is clear: as long as there is hope for market recovery, and there is no pressing need to act, banks would prefer to wait for the real estate prices to rise. Unfortunately, there are a number of risks hidden within the seemingly safe status quo. It may be reasonable to expect price recovery for high quality real estate properties that are capable of generating a stable income stream. Many real estate assets, however, are simply not liquid, and their price may not recover even in the mid- to long-run scenarios. In that case, every month of holding onto such asset brings the bank a loss in the amount of income that could have been earned on the money tied down in the asset.

Some banks do have a degree of understanding of strategy for 'good' real estate assets (i.e. marketable objects in favorable locations); yet even they struggle with 'bad' assets, e.g. agricultural lands, industrial buildings, frozen development projects. On their part, consultants also tend not to be interested in helping find solutions for such low-potential assets. Lack of alternative solutions forces the banks to simply keep these real estate properties on their balances, rather than having to sell at negligible prices.

One of the ideas that market participants have been looking at involves getting rid of dead-weight real estate by bundling bad assets with the good ones. Highly diverse nature of real estate properties would make it very difficult to create a portfolio attractive enough for an expanding company or a real estate fund, yet it seems one of the very few ways for banks to raise money from non-liquid assets.

Another serious problem occurs with respect to construction projects: in the cases when the bank continues financing projects that no longer fit the market. It is very likely that once such project is completed, the value of the real estate property will be substantially less than the incurred development costs. In that case, the bank would be wise to stop financing construction until such time as the project concept is reviewed and its market potential is confirmed (which may be achieved, for example, by signing preliminary lease agreements between the developer and key potential tenants or buyers).

As ownership period increases, the banks are also faced with the problem of ensuring their real estate assets remain in working condition. Engaging a professional facility management company means the bank has to incur additional costs, which may look particularly undesirable for properties with low or zero income stream. Yet saving on operational expenses may accelerate depreciation and, thus lower the asset value even further.

*Source: Ernst & Young*



# REAL ESTATE MONITOR

3rd QUARTER, 2010

## Hot Topic

### Recommendation

It is only possible to find solutions for problems that have been detected. The longer critical issues remain hidden, the greater will be the associated risks. Therefore, banks should strive to have a clear picture of its real estate portfolio at all times. In order to achieve that, bank can perform (on its own or by engaging external experts) an integrated due diligence of real estate properties, both those held on the balance, and those offered up as collateral for potential problem loans.

Based on the results, the strategy for each such property, or, at minimum, groups of similar properties, should be determined; strategies may include continuation of ownership, development, sale, discontinuing financing, etc. Specific actions to be undertaken within the due diligence process should be tailored to individual characteristics of each portfolio, and may include the following:

Tool	Allows to
Legal due diligence of the property rights, as well as permits and encumbrances of the development projects	<ul style="list-style-type: none"> <li>•Check the title to real estate assets</li> <li>•Minimize the legal risks</li> <li>•Ensure the legitimacy of development project</li> </ul>
Appraisal of the market value of the property and forecast of the market value at the commissioning date	<ul style="list-style-type: none"> <li>•Monitor dynamics of the market value and choose the right moment for transaction</li> <li>•Compare investment budget and value of the completed project to assess the feasibility of further investments</li> </ul>
Technical due diligence (both for completed projects, and for buildings under construction)	<ul style="list-style-type: none"> <li>•Assess quality and current conditions of the property</li> <li>•Check the progress of the construction</li> </ul>
Commercial analysis of the terms of rental agreements	<ul style="list-style-type: none"> <li>•Discover the opportunity to increase revenues from operating properties</li> </ul>
Highest and best use analysis	<ul style="list-style-type: none"> <li>•Choose the development option that leads to the greatest value of the asset</li> </ul>
Feasibility study, sensitivity analysis	<ul style="list-style-type: none"> <li>•Assess the potential of the development project and level of associated risks</li> </ul>

Based on the developed strategies, potential for-sale portfolios should first be formed and then ownership structure should be adjusted. It is important to create legal structures that will allow for disposition of properties in desired combinations with minimum tax effects and legal risks. Liquidity of assets can be significantly increased by the proper legal structuring in accordance with the real estate market best practices (Russian/foreign SPV's, holdings and sub-holdings).

For properties which the bank has decided to keep, it is important to consider ongoing management issues. One of the options would be to engage a professional project monitoring company for the projects under construction and a facility management company for operational properties. Obtaining regular cost, time, budget and risk reports from independent observers will keep the bank up to date on the ongoing processes, and enable the responsible personnel to make informed decisions. Another option would be to contract an asset management company in order to delegate a large portion of decision-making and free up some of the bank's internal resources. In either case, offering portfolios instead of individual buildings may help negotiate favorable terms with these subcontractors.

Source: Ernst & Young



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## Contact details

**Olga Silnitskaya**

AEB Real Estate Committee Coordinator

[os@aebrus.ru](mailto:os@aebrus.ru)

+7 (495) 234 27 64 (ext.120)

Association of European Businesses

16/3 Krasnoproletarskaya street, Moscow, 127473

[www.aebrus.ru](http://www.aebrus.ru)

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