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*Adrian Keith Salter,  
Chairman of the AEB  
Real Estate Committee*

Firstly I would like to congratulate all you fellow Real Estate professionals who have worked so hard to maintain your business and service to our industry in Russia through 2009. It has been a very hard 12 months and finally we are beginning to see some light at the end of the crisis or correction, tunnel.

The AEB Real Estate committee also went through some changes in the way it approaches the task of coordinating our member's efforts and delivering to you the information you need make an informed decision when solving your Real Estate question. The formation of a new Steering Committee was the logical way for us to ensure that the right people, with the relevant experience oversee the work we do and I hope you will benefit from the expertise that is guiding our committee.

The introduction of a General overview of Real Estate Investments section in our quarterly monitor will enable you all to read and gain a clearer understanding of the macro economic factors that are pulling our industry into better times ahead. The statistics that are presented show a slow, but sure recovery of some of the more well established Developers working in Russia and as so many people knew, this process will only allow for survival of the fittest.

The AEB wishes to thank the contributors to this edition of the Real Estate Monitor:

- Cushman & Wakefield Stiles & Riabokobyenko • DTZ • Intermark Savills •
- Jones Lang LaSalle • Knight Frank • KPMG • Mayfair Properties • Praedium Oncor International
- Spectrum Group • SSCM • Sunbury Heights Group •

The following sections that present a market overview by our committee members backed up with averaged market statistics will enable you to understand what important transactions took place in the 4<sup>th</sup> quarter of last year in the Commercial, Retail, Warehousing, Residential and Leisure industry.

With clear signs of the Commercial market having reached the bottom of the curve and the supply now drastically cut, the demand that we see is absorbing the cream of what is available at very attractive prices.

The Retail sector is a tough one to call as the evidence on the street shows many spaces vacant and yet the sales of major outlets remain high. Are we witnessing a gradual decline of the small outlets as their international counterparts are able to maintain turnover and survive on a small margin, time will tell.

The warehousing market overview clearly highlights not only the gap between supply and demand in the regional cities, but the large deals that have been made at the end of last year, proving that some organizations still have big plans for business development in Moscow.

All the necessary data that one needs if you are making a residential deal is available as usual in our monitor and the decision between down town or country living is still one that raises the debate about the cities transportation infrastructure.

The final section of the monitor has articles from some of our members and it will enable you to tune up your understanding of the latest changes in the Russian legislation on mortgage financing and read a general update on the Construction sector to understand if now is a good time to begin your Real Estate development in Russia.

I wish you all happy reading and look forward to receiving your reactions via the usual AEB channels of communication.

For those of you who will also attend MIPIM this year may I take this opportunity to encourage you to coordinate with your fellow AEB REC members so we can all help to distribute the news that we present to you in the monitor!

Regards,



*Adrian Keith Salter,  
Chairman of the AEB Real Estate Committee*

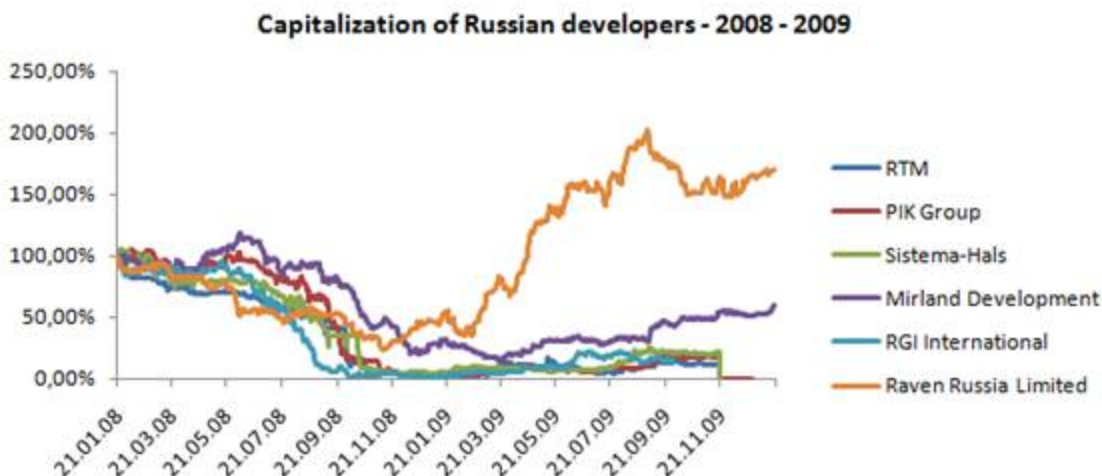
# GENERAL OVERVIEW OF REAL ESTATE INVESTMENTS

Firstly, the recent macro economic developments, i.e. the slowing of the GDP decrease, forecast of GDP consecutive growth over the next 3 years (4,5% in 2010 according to Fitch forecast as of 02-02-2010 and according to the forecasts of the RF government as of the end of Q4 2009 - 3,1% in 2010, 3% in 2011, 4,3% in 2012), amount of the liquidity in the market (decrease in MIBOR 2-7 days rate from nearly 17% since February 2009 to 5% as of 01-02-2010), decrease in the government bonds yield (from 11,4% as of 11-01-2009 to 7,1% as of 11-01-2010) have led to a significant improvement in the capital markets - growth of the stock market indices (RTS - 129%, MMVB - 137% from 01-01-2009 to 31-12-2009) and a revival of the debt capital markets.

Thus, the capitalization of major development companies increased dramatically in 2009 (see 1<sup>st</sup> chart below), though still not reaching the pre-crisis level (see 2<sup>nd</sup> chart below).

More banks, though from the top-tier, are now ready to lend to the credible borrowers at more reasonable interest rates.

These two facts determine a much better financial position of major developers, who are not the hostages of the financial crisis any more, and are not urged to sell at the crisis prices.



Secondly, the level of activity in the rent market has increased dramatically, while tenants are hunting for the best deals still at crisis prices. The sub-lease market, according to the leading consultants, has decreased by half in the 4th quarter 2009; thus, decreasing the available stock. This trend is set to continue and we agree with the leading consultants, that rent deal flow will continue to increase in 2010.

Thirdly, as noted, some best investment assets changed ownership in 2009, and it is logical to predict that new owners, having acquired the assets at the bargain prices, will be willing to hold till the prices recover to the pre-crisis level.

Fourthly, while the positive trends are visible both on the macro economic level and in the real estate market in particular, there is still a certain level of cautiousness among all investors regarding long-term perspectives.

Therefore, we believe, that the current situation is setting a scene for quite a new situation in the market - where there is a negotiating balance between the sellers and the buyers - availability of quality assets is gradually decreasing, while the buyers are still cautious, though willing to invest, as time is pressuring on the investment returns.

We believe that this trend will lead to the compression of the real estate yields, gradually over 2010.

Decline of the "country risk", as the government bond yields are decreasing, will contribute to the absolute value of such compression.

# MOSCOW COMMERCIAL RENTAL MARKET

## OFFICES

### Office Market overview in Q4 2009

In the end of Q3, some signs of stabilization appeared, which were proved in Q4. Within the Q4, rents were stable. At the moment, it is believed that in Q4, rents in the core reached their bottom.

By the end of the year 2,2 mln sqm of the office stock was vacant. The positive trend is the stabilization of vacancy rate dynamics, which begun in November. In December, the vacancy rate decreased by 1,8% because of the increased demand and the considerable reduction of new construction. Most likely, this trend will continue in 2010 and the vacancy rate might decrease by 3 to 5% by the end of the next year. Yet, the balance of the market is far away.

At the moment, Class A vacancy rate is 26%, Class B vacancy rate is 20%. Most of the vacancies are in the newly constructed buildings (delivered in 2008 and 2009), where the vacancy rate is about 43% (45% for Class A and 43% for Class B).

Although the demand is less than before, the take-up was supported by a number of large deals. In 2009, there were 16 deals 5,000 sq m +. The largest deals on the market, closed in Q4, were done by: Siemens (the purchase of in Legion II (Phase I), 22,495 sq m), Unilever (leased 21,222 sq m in Marr Plaza) and Sportmaster (leased 21,185 sq m in Aviator business center).

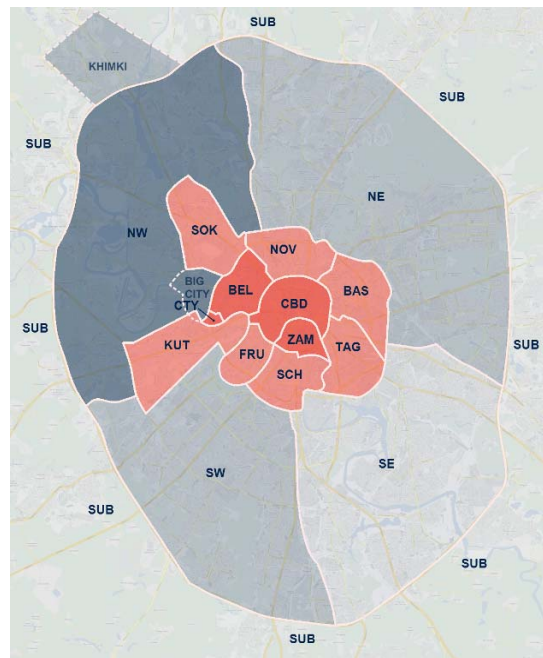
At the moment, the average prime Class A rental rate is US\$750 and average Class B rental rate is US\$350, verifying from \$300 to \$900 (per sqm per annum, base asking rental rate without VAT and OPEX).

*Information provided by Cushman & Wakefield Stiles & Riabokobylko*

### MOSCOW OFFICE SUBMARKETS

SOK – Sokol  
NOV – Novoslobodskiy  
CBD – Central Business District  
ZAM - Zamoskvorechye  
SCH – Schabolovskiy  
FRU – Frunzenskiy  
BEL – Belorusskiy  
TAG – Taganskiy  
BAS – Basmanniy  
CTY – Moscow City

OTA – Other trade areas incl.:  
SE – South-East  
SW – South West  
NE – North East  
NW – North West



**Average rents \* per sq.m. by market segment and location:**

Market rents	CBD	ZAM	BEL	NOV	BAS	TAG	SCH	FRU	SOK	KUT	NW	NE	SE	SW
Office Class A	680-900	570-800	500-700	500-700	500-800	500-800	650-800	550-700	500-700	500-800	500-700	400-600	400-600	500-570
Office Class B	500-700	400-500	450	400-500	450-600	600	450-550	450-550	500	500	400	300-400	300-400	300-400

\*All rates indicated in the table are in US dollars, excluding VAT and operational expenses

Supply vs. Demand	Total supply of vacant space (sq m)	Total demand for office space (sq m)	Vacancy Rate %
Office Class A	1 900 000	130 000	26%
Office Class B	500 000	110 000	20%

Planned vs. actual delivery of office space	Planned delivery of office space (sq m)	Actual delivery of office space (sq m)
Office Class A	300 000	13 000
Office Class B		68 000

Operational expenses	Min	Max
Office Class A	60	110
Office Class B		

**Information provided by Cushman & Wakefield Stiles & Riabokobylko, DTZ, Jones Lang LaSalle, Knight Frank, Praedium**

# Retail

## Retail Market overview in Q4 2009

Last year was marked by record-high SC completions in Moscow, at 494,000 sq m. Two large openings happened in Q4 2009 – Zolotoi Vavilon Rostokino (170,000 sq m GLA) and Gorod II (110,000 sq m). The projects were launched with occupancy levels of around 40% and 60% respectively. Above 70% of projects at final construction stages announced for H2 postponed their openings due to weaker tenant demand and, as a result, problems with leasing premises.

In Q4 2009, the average vacancy rate in Moscow approached 10%. It increased by 3 p.p. compared to the previous quarter due to large completion volumes and weakening demand. We expect further growth of the vacancy rate in 2010 due to large completions of the shopping centres delayed from the previous year.

Rental rates for the majority of tenants in Moscow shopping centres and street retail remained stable in Q4 2009. Despite increasing vacancies and earlier rental corrections, Moscow SC prime rents remain one of the highest in Europe at 3800 USD/sq m/year.

*Information provided by Jones Lang LaSalle*

Profile	Area (sq m)	Min rent	Max rent
		(USD / sq m / year)	(USD /sq m / year)
Hypermarket	>5,000	100	140
White & Brown	>2,500	190	300
	<2,500	410	550
Sporting goods	>3,000	120	250
	1,200-3,000	180	300
	<1,200	240	400
Cinema	>2,500	100	150
Entertainment	1,500-7,000	100	120
Perfume and cosmetics	300-500	1,200	1,800
	<300	1,500	2,200
Goods for children	>1,500	180	220
	<300	600	1,200
Household goods	1,000-5,000	100	130
DIY	8,000 – 15,000	120	150
Food courts	40 - 90	1,000	2,000
Restaurants	250 – 600	400	600
	<250	300	750
Fashion and apparel	40-200	800	3,000
	200-1000	500	800
	>1000	% or turnover	400

Supply vs. Demand	Total supply of vacant space, (sq m)	Total demand for retail space	Vacancy Rate %
Retail*	262,800	n/a	10%

Planned vs. actual delivery of retail space	Planned delivery of retail space (sq m)	Actual delivery of retail space (sq m)
Retail*	1,240,000 (f 2009)	494,000 (f 2009)

*Information provided by Cushman & Wakefield Stiles & Riabokobylko, DTZ, Jones Lang LaSalle, Knight Frank, Praedium*

# WAREHOUSE FACILITIES

## Warehouse Market overview in Q4 2009

In the 4th quarter of 2009, the rental rates remained stable, which allowed many companies finalize their negotiations processes and close lease deals; thus, making it the busiest quarter of 2009. It was also the time when we again saw large deals on the market – such as Eldorado leasing 67,000 sq.m. of space at PNK Chekhov, 45,000 sq.m. M-Video lease deal at PNK Chekhov with outsourcing of logistics operations to a 3PL provider – as well as the deals that were totally new for Russia, such as first-in-class long-term lease of a 13,000 sq.m. deep-freeze storage facility at Agroterminal by the Dutch logistics provider Partner Logistics. We saw first sales' deals both in warehousing and land segments, which was also due to stable economic environment in the country. Deferred demand is back on the market, and executives have completed budgeting processes for 2010, which will result in even more deals to come in the first half of 2010.

Companies continued paying a lot of attention to outsourcing in the logistics segment, and 3<sup>rd</sup> party logistics became a great solution for such companies as Bonduelle, Sprandi (Moscow), Auchan (Novosibirsk), with even more deals to come next year.

However, speculative construction of quality warehouse projects was halted all across Russia. In 2009, over 785,000 sq.m. have been delivered in Moscow region alone; however, in 2010, we expect to see approximately 550,000 sq.m. completed with no large-scale projects (over 50,000 sq.m.) announced for 2011 to 2012 due to expensive financing and high vacancy rates (compared to pre-crisis values of 0.5%). If consumption remains at the levels of 2009, we may face deficiency of quality proposals in the Moscow region by the end of the year, which will result in growth of rental rates.

Regions have been struck worst, with vacancy rates roaring as high as 50% in some cities (quality stock exists in the cities with a population of over 1 mln people, such as Novosibirsk, Ekaterinburg, Rostov, Kazan, Samara, Ufa, Chelyabinsk, Perm) and rentals going significantly down. There is currently no average rental rate available for regional projects, as each client's request is being considered on the case-by-case basis, rates are usually being provided in rubles for the first 1-2 years, and special terms are being proposed. Unfortunately, many cities won't recover during the next two years.

*Information provided by Knight Frank*

Market rents	Inside MKAD	Less than 30 km from MKAD (till Betonka (A107))	More than 30 km from MKAD	Kaluga*
Logistics	120-140	90 - 110	90 - 100	90 - 100

\* Kaluga is considered as the unique example of remote business location

*Information provided by Cushman & Wakefield Stiles & Riabokobylko, DTZ, Jones Lang LaSalle, Knight Frank, Praedium*

# TYPICAL ELEMENTS OF OFFICE RENTAL CONTRACTS

Office	
Lease Term	Class A, Class B+: 3-5 years Class B- 1 year
Time of rental payment	Monthly in advance
Possibility of rent increase / Rent reviews	7-10% annually for Class A and Class B office buildings.
Notice period	Class A, Class B+: 6 months, Class B- 1 month
Safety deposit	Class A: 1 - 3 months, Class B+ and B: 1 month

Retail	
Lease Term	11 months without registration and up to 15 years for anchor stores in shopping centres. 3-5 years most common.
Time of rental payment	Monthly in advance
Possibility of rent increase	3-5% annually for Shopping Centers, 7-10% annually for Street Retail.
Notice period	3-6 Months
Safety deposit	1-3 Months most common 1 month

Warehouse	
Lease Term	Class A: 1 -2 years (instead of 5-7 years leasing contracts) Class B: 1-2 years Class C: 11 months (allows for not registering the lease) Lease time reduction (only for 1-2 years instead of 5-7 years) allows to avoid fixed rental rates lasted long time period. NOTE! Sublease is now been widely used. 3PL providers, who have long term lease and lack of clients, now offer vacant warehouse spaces for sublease. In this case, rental rate period can be for 6 months and above.
	Class A – monthly in advance Class B,C - rents are paid monthly in advance
Possibility of rent increase	Subject to the lease agreement. Operating expenses are more likely to increase.
Notice period	Individual approach in most cases
Safety deposit	Class A- 1-3 months rent, sometimes-bank guarantee Class B- 1-3 months rent deposit

*Information provided by Cushman & Wakefield Stiles & Riabokobylko, DTZ, Jones Lang LaSalle, Praedium*

# MOSCOW RESIDENTIAL MARKET

## Residential Property Market overview in Q4 2009

The fourth quarter of 2009 was marked by stabilization in all segments of the Real Estate market. At the residential real estate market, a trend towards slackening of the rates of price reduction has emerged, and the end of September was marked by 15% increase in rental rates, compared to the crisis. And in the fourth quarter, also, there was a little increase of price level: 5-10%.

Depending on the district, square footage and interior of the apartment, offering price varies between US\$2,300 and US\$13,000.

The budget and the demand in the fourth quarter remained at the level of the third quarter. Rating of the districts also has not changed during the fourth quarter: Golden mile district (Ostozhenka, Prechistenka) is still of top demand, as well as Patriarshy ponds, Chistye ponds and Krasnaya Presnya.

Many of the tenants converted their rental prices into rubles and prefer having them fixed in the contract, without affiliation to the CB RF exchange rate.

by MAYFAIR Properties

## Rental prices

### Average rent prices in USD per month by market segment and location:

Market rents (class, average size)		Top popular areas (Kropotkinskaya, Arbat, Patriarshye, Tverskaya, Tretyakovskaya, Chistye Prudy)	Inside Garden Ring (excluding top popular areas), Frunzenskaya, Taganskaya, Kursk,aya, Novoslobodskaya	North West, near Anglo- American school or Airport	South West, near embassies and the schools
Apartment Class A	Studio/up to 60 sq. m.	2800 – 4000	1300 – 2000	1200 – 1500	1200 - 1500
	1 bedroom/ upto 70 sq. m.	3000 - 4000	1400 – 2500	1300 – 2000	1300 – 2000
	1 bedroom/up to 80-125 sq. m.	4200 – 6000	1500 - 2800	1500 - 2800	1500 - 2800
	2 bedrooms/ upto 120 sq. m.	5000 – 6000	2000 - 3500	2000 - 3500	2000 - 3500
	2 bedrooms/ up to 130-170 sq. m.	6000 – 9000	2500-4000	2500-4000	2500 - 4000
	3 bedrooms up to 160 meters	8000 – 13000	3000- 5500	3500- 5000	3500- 5500
	3 bedrooms/ up to 170-220 sq. m.	8000 – 16000	5000 – 8000	4500 – 8000	5000 – 8000
	3-4 bedrooms 220 sq. m and up	12000 – 22000	7000 – 12000	5000 – 10000	7000-13000

<b>Apartment Class B</b>	Studio/up to 60 sq. m.	2000 – 3000	1700 – 3000	1200 – 2500	1200 - 2500
	1 bedroom/ up to 70 sq. m.	2000 – 3500	1700 – 3500	1500 – 3000	1200 - 3000
	1bedroom/up to 80-125 sq. m.	2500 – 4000	2000 – 4000	1500 – 3000	1500 - 3000
	2 bedrooms/ up to 120 sq. m.	3500- 5000	3000 – 5000	3000 – 4500	3000-4500
	2 bedrooms/ up to 130-170 sq. m.	4000-6000	4000 – 6000	3500-5500	3000-5000
	3 bedrooms up to 160 sq. m	5000 – 8000	5000 – 7500	4500 – 7500	4000 - 7000
	3 bedrooms/ up to 175-220 sq. m.	6000 - 8500	5500 – 8000	5000 – 7500	5000 - 7500
	3-4 bedrooms 220 sq. m and up	9000 – 12000	7000 – 11000	7000 – 9000	7000 - 10000
<b>Apartment Class C</b>	Studio/up to 60 sq. m.	1700	1500	1000	1000
	1 bedroom/ up to 70 sq. m.	2000	1500	1400	1400
	1bedroom/up to 80-125 sq. m.	2700	2300	2000	2000
	2 bedrooms/ up to 120 sq. m.	3500	3300	2500	2500
	2 bedrooms/ up to 130-170 sq. m.	5000	4000	3300	3300
	3 bedrooms up to 160 sq. m	5500	4800	4000	4000
	3 bedrooms/ up to 170-220 sq. m.	-	-	-	-
	3 bedrooms/ 220 sq. m. and more	-	-	-	-

***Information provided by Mayfair Properties and IntermarkSavills***

**Apartments**

**Class A** – apartments in new buildings with underground garages and 24-hour security.

The building is decked out with high-quality decorative materials, natural granite and marble. The building is designed following a certain architectural style.

Advanced engineering systems, 24-hour security, parking facilities, property maintenance services, children’s playground, additional special facilities for tenants like tennis court, swimming pool, restaurant, etc.

**Class B** - apartments in all types of buildings except the new ones renovated within the last 1-2 years to the highest Western standard using premium quality materials. Premium western renovation, designer interiors: advanced engineering systems, security systems, parking facilities and property maintenance services.

**Class C** – apartments in all types of buildings except the new ones, renovated 3 or more years ago: western renovation, semi-western renovation.

Usually, realtors classify apartments not by class but by the type of renovation performed in apartments and the type of building the apartment located in. To describe residential real estate market one has to learn the Moscow real estate glossary, which identifies the type of building in Moscow, as well as the type of renovation styles found on the market.

## COUNTRY PROPERTIES

### Cottage Rental Market- up to 50 km from MKAD

Cottages, price per sq. m	Rublevskoye, Novorizhskoye	Mozhayskoye, Kaluzhskoye, Kievskoye	Dmitrovskoye, Piatnitskoye
Compounds	300-1000	150-700	100-600

*Information provided by Mayfair Properties*

## REGIONAL MARKET OVERVIEW

Market rents	ST. PETERSBURG	YEKATERIN BURG	KRASNOYARSK	ROSTOV-ON-DON	KRASNODAR
Office Class A	400 - 500	600	460	300	300 - 400
Office Class B	300 - 400	400 - 500	350 - 400	280	n/a
Retail	900 - 1600	850 - 1500	n/a	600 - 1100	n/a
Warehouse	80 - 110	70 - 120	n/a	50 - 120	80 - 120

## Hotel Market overview in Q4 2009

The hotel market is quite a different class in comparison to other real estate objects. Rather than trading with average rents per sq. m and fitting into classifications such as A, B & C, they can be benchmarked in performance by average daily rate / average annual occupancy and RevPAR (revenue per available room). In addition, there is no global hotel classification system and the traditionally used 3 star / 4 star and 5 star rating does not always tell the full story.

### Moscow

According to the latest available data from the Department for Moscow Hotel Industry Coordination, as of January 1, 2009, there were approximately 246 hotels with 52,095 guest rooms in Moscow. From this, only 24 (over 6,200 rooms) are so-called 'internationally branded' properties. We expect this number of branded hotels to increase significantly in the coming years.

Hotel operating data is of course confidential to each property and not all properties are willing to share such information. As such, we cluster hotels according to our own view of their positioning in the market – for example;

- Luxury includes hotels such as Ritz Carlton and Park Hyatt
- Upper Upscale includes Swissotel and Marriott Aurora
- Upscale includes Marriott Grand and the Hilton
- Upper Midscale has Holiday Inn Lesnaya and Marriott Courtyard
- Midscale includes Park Inn Sadu and Holiday Inn Vinogradova

We are then able to benchmark the performance of a cluster of hotels against previous years to identify trading trends and to make forecasts. Of course within each cluster, there are stronger and weaker performers based upon location, brand, quality, facilities and general trading and operational abilities.

At the end of 2009, we received the following results for the year as compared to 2008;

### Hotel Trading Performance YTD, December 2009 vs. December 2008

Segment	December YTD 2009 vs. December YTD 2008					
	Occupancy %		ADR, RUR		RevPAR, RUR	
	2009	2008	2009	2008	2009	2008
Luxury	57	62	12,803	15,770	7,318	9,880
Upper Upscale	65	70	9,939	12,959	6,435	9,126
Upscale	62	64	6,590	8,783	4,062	5,617
Upper Midscale	67	70	4,930	6,754	3,323	4,708
<b>Percentage change from December 2008, %</b>						
Luxury	-8.1		-18.9		-26.0	
Upper Upscale	-7.2		-23.4		-29.5	
Upscale	-3.2		-25.0		-27.7	
Upper Midscale	-4.3		-27.1		-29.5	

*Information provided by DTZ*

BEITEN BURKHARDT

**Latest changes in Russian legislation  
on mortgage**

Elena Sapegina, BEITEN BURKHARDT

A pledge of real estate (mortgage) has been and remains one of the most effective and called for types of pledge in the area of financing major investment projects. However, to date, when banks and other financial institutions encountered significant volumes of defaults on previously granted credit and loans, the impossibility to expeditiously foreclose and realize mortgaged real estate property and rights thereto, led to a sharp liquidity shortage in the market.

In order to correct the existing situation and simplify the use of a pledge, including mortgage of real estate, at the beginning of 2009, Russia carried out reforms of the legislation on pledge. The amendments to the legislation on pledge were introduced by the Federal Law, "On Introducing Amendments into Certain Legislative Acts of the Russian Federation in connection with Developing the Procedure for Foreclosing Pledged Property" No. 306-FZ dated December 30, 2008 (hereinafter the "**Law on Introducing Amendments**"). The Law on Introducing Amendments entered into force on January 11, 2009 and is applicable to pledge legal relations emerging after the said date.

The reforms of the Russian legislation on pledge are of a comprehensive nature; the amendments and addenda affect both general provisions on pledge and special regulations on pledge of movable and immovable property, legislation on notarization, state registration of rights to real estate, and legislation on insolvency in terms of the rights of lien creditors at the various stages of bankruptcy of a debtor. The objectives of the introduced amendments are to simplify and accelerate the procedure for satisfying creditors' claims using pledged property.

Furthermore, in mid 2009, certain amendments were made to the Federal Law, "On Mortgage (Pledge of Real Estate)" No. 102-FZ dated July 16, 1998 (hereinafter the "**Law on Mortgage**"). These amendments were introduced by Federal Law No. 166-FZ dated July 17, 2009 and entered into force on August 2, 2009.

This article examines the most important amendments and addenda introduced into the Law on Mortgage during 2009.

**Revision of the grounds for refusing to foreclose pledged property**

Pursuant to the general rule, pledged property may not be foreclosed if the debtor's violation of the obligation secured by the pledge is extremely insignificant and the amount of the pledgee's claim is clearly disproportionate to the value of the pledged property.

The amendments made to the Law on Mortgage concretize the said rule, stipulating that pledged real estate (rights thereto) may not be foreclosed when the following conditions are simultaneously met:

- the amount of the unperformed obligation is less than 5% of the valuation of the subject of mortgage under the mortgage agreement;
- the period of delay in performing the obligation secured by the mortgage is less than 3 months.

In such cases, the subject of mortgage may be foreclosed after the amount of debt and the period of delay exceed the stated limits. Moreover, in the case of foreclosure on the pledged property through a

judicial procedure, the Law on Mortgage grants the right to prove in the judicial proceedings that the violation committed by the debtor in other situations is extremely insignificant and that the amount of the pledgee's claim is clearly disproportionate to the value of the pledged property. However, in the case of foreclosure of the subject of mortgage through an extrajudicial procedure, that the aforementioned amount of debt and period of delay have been exceeded is a sufficient ground for the pledgee to take a decision to satisfy its claims against the debtor using the subject of mortgage.

The Law on Mortgage has also been supplemented with a provision stating that if the debtor violates the terms for making periodic payments more than 3 times within 12 months, the pledged property may be foreclosed even if each delay is insignificant, unless the parties to the mortgage agreement have stipulated otherwise.

### **Simplification of the extrajudicial procedure for foreclosing pledged property**

The previously valid version of the Law on Mortgage established that the judicial procedure for foreclosing pledged property was the main procedure. The possibilities for satisfying a pledgee's claims using pledged property without addressing a court were substantially limited, namely: pledged property could be foreclosed extra judicially only on the basis of a notarized agreement between the pledgee and the pledger, entered into after the grounds for foreclosing the subject of mortgage emerge (for example, after the debtor violated the term for repaying credit, failed to pay interest, etc.).

For the purposes of simplifying the procedure for satisfying a pledgee's claims, the new version of the Law on Mortgage has expanded the possibilities for the parties to a mortgage agreement to apply the extrajudicial procedure. Now the parties may agree upon the extrajudicial foreclosure procedure at any time regardless of violation of the obligation secured by the mortgage, including at the stage of entering into the mortgage agreement or by entering into a respective agreement subsequently. The requirement to have an agreement on extrajudicial foreclosure notarized has been repealed. However, it is now mandatory to have the pledger's notarized consent to extrajudicial foreclosure of the pledged property. Such consent may be given prior to entering into the mortgage agreement.

### **Revision of the procedure for realizing pledged property**

The introduction of the aforementioned additional possibilities to enter into an agreement on extrajudicial foreclosure of pledged property has also led to an increased number of alternatives for realizing foreclosed property.

The Law on Mortgage grants a pledger and a pledgee the right to stipulate in the given agreement a condition for the pledgee to acquire the pledged property for itself or for third parties with the pledgee's claims against the debtor being offset against the purchase price. This provision also remains in the new version of the Law on Mortgage. Considering that an agreement on applying the extrajudicial procedure may now be entered into at any time, and not only after the obligation secured by the pledge is violated, the parties to a mortgage agreement are also able to establish the said means of realizing the pledged property at any stage of the mutual relations, including at the stage of entering into the mortgage agreement. It should be mentioned that this method of realization, as before, is not applicable to land plots that are a subject of mortgage.

The Law on Mortgage has also been supplemented with provisions that regulate in detail the procedure for realizing property at open auctions. In particular, requirements are now established for the content of and terms for publishing notifications on conducting auctions, cases where an appraiser must be

engaged to determine the starting sales price of the subject of mortgage, and the procedure for remunerating the auction organizer.

### **Executive endorsement of a notary**

The Law on Introducing Amendments has instituted a new provision stating that if a pledger fails to perform an agreement on extrajudicial foreclosure of pledged property, the pledgee's rights may now be enforced on the basis of an executive endorsement of a notary (previously only upon a court decision). Thus, a notary's execution of an executive endorsement on a mortgage agreement or deed (if the pledgee's rights are certified by a deed) is a sufficient ground for the pledgee to apply to a court bailiff for the purposes of transferring the pledged property to the pledgee for foreclosing it.

However, it should be noted that when executing an executive endorsement the notary must notify the pledger accordingly and grant the pledger 7 days to raise objections. The executive endorsement is executed by the notary only given incontrovertibility of the pledgee's claim; in other words, when based on the submitted documents, as well as the pledger's objections, the notary does not perceive the existence of a dispute between the parties to the mortgage agreement.

### **Impact of the amendments on valid mortgage agreements**

The Law on Introducing Amendments is applicable to legal relations emerging after January 11, 2009, i.e. after the date of its entry into force. Moreover, the parties to already concluded mortgage agreements may at any time enter into an additional agreement on extrajudicial foreclosure of pledged property, having executed in advance the pledger's notarized consent to apply such procedure.

### **Mortgage of commercial real estate acquired using borrowed funds**

Additional amendments introduced into the Law on Mortgage in mid 2009 regulated issues of mortgaging commercial real estate acquired using borrowed funds. In accordance with these amendments, a building or structure and the land plot on which the building or structure is located, as well as nonresidential premises fully or partially purchased using loan funds from a bank or funds from a target loan granted for acquiring them by another legal entity, are considered pledged to the said bank or legal entity. The mortgage in favor of these parties is registered automatically (by operation of law), simultaneously with the registration of the borrower's title to the acquired building, structure or nonresidential premises and the title or lease right to the land plot on which the building or structure is located.

Previously, this procedure of registration of a mortgage by operation of law to a bank or other party that granted a loan for purchasing real estate applied only to cases of acquiring land plots and residential premises. However, in the case of purchasing commercial real estate (buildings, structures and nonresidential premises), establishing a mortgage in favor of a bank or other lender was possible only on the basis of a mortgage agreement, which could be entered into only after the borrower's title to the acquired real estate was registered. In such cases there was always a certain time span between the granting of the credit or loan and the conclusion of the mortgage agreement when claims of the bank or other lender could not be secured by the mortgage of the respective real estate. The amendments made to the Law on Mortgage have eliminated the described flaw, thereby, protecting the interests of banks and other legal entities granting target loans for acquiring commercial real estate.

## Conclusion

The amendments introduced into the Law on Mortgage in many ways broaden parties' rights to satisfy creditors' claims using pledged property without addressing a court. Parties are now able to establish the fastest and simplest means of foreclosing and realizing pledged property, providing for transfer of the subject of mortgage directly to the pledgee, without addressing a court, as early as at the stage of entering into the mortgage agreement. The interests of banks and other lenders granting loan funds for acquiring commercial real estate are now protected by a mortgage, which emerges by operation of law simultaneously with the state registration of the borrower's title to the acquired real estate. It is expected that these measures as a whole will allow for reducing credit risks of banks and other lenders, decreasing the expenses and terms for enforcing liens, and consequently, for improving credit conditions. Nonetheless, a certain amount of time will be needed in order for practice to take shape as regards application of the new legislative provisions by both participants of pledge relations and judicial authorities.



## **An update on the construction sector in Russia – Crisis year 3**

Mark Smith, Managing Director, Sunbury Heights Group

As we enter the beginning of the third year of the global financial downturn, many are speaking of a slow recovery in the construction and real estate market. As the speculative boom that began the crisis concerned sub-prime real estate in the US, it is only natural that this sector should have borne the brunt of the correction. Construction companies and the wide variety of suppliers of goods and services serving them, have shed staff, lost momentum and, with a few exceptions, had to turn to external financing to enable them to continue at all.

In Russia, the boom in demand for commercial real estate during the years of the boom – roughly 2003 to 2008, struggled to keep pace with supply, prompting sky-high rents and the positioning of Moscow as the most expensive place on earth to do business. Large planned developments such as Moscow City and the conceptual planning of out of town business parks aimed to soak up the demand, while maintaining developed market rents and high yields for investors.

As the crash hit, demand dried up. Completed but unleased space lay empty, unfinished commercial developments were frozen and boom driven business park concepts were shelved. Rents in Moscow City – mooted as the city's premier business destination fell by over 40% and the business park idea never got farther than Krylatsky Hills.

The effect on general contractors, architects, engineers and the entire construction ecosystem was devastating. During the 12 months of 2009, Moscow based general contractors reduced their workforces by an average of 70%, foreign construction squads (from China, Mongolia, Kazakhstan) wandered back home, real estate agents slashed their foreign workforce as international corporate demand disappeared and the industry, since then, has languished in a state of hibernation.

How has this affected construction material and labour costs? How have developer, investor and tenant construction procurement strategies met the challenges of the new environment? This is what this article aims to set out.

To analyse how the downturn has directly affected the cost of construction materials we first need to define the indirect and direct consequences of the downturn. An indirect consequence of the downturn is the fall in the price of some basic raw materials, such as oil, which was in turn caused by a general fall off in the demand for industrial and finished products. An indirect consequence of course is that a fall in prices prompts a fall in salaries, which reduces living standards and buying power across all sectors, impacting all sides of the economy. Direct consequences include the reduction in general demand, the

increased price consciousness of buyers and associated variation in procurement practices they put in place as a direct result.

In boom times, price increases are prompted by simple supply/demand issues, where raw material relative scarcity plays the dominant role (as with oil), and by demand-induced profiteering (this word is being used in a non-pejorative sense). Construction service companies (real estate agents, architects, design engineers, general contractors, etc) increase prices due to one of three factors: either as a result of an associated increase in labour costs, the ability to charge more for their services given an increase in demand or as a result of a lack of competition. They work with a relatively limitless supply of labour able to perform their tasks. During the boom years, I would argue that this form of profit-based construction inflation was the main driver of construction cost increases. While labour costs increased in line with general inflation, the increase in construction service costs in Russia amounted to between 4-18% per annum, between 2003 and 2008.

Construction materials continued their increase through the early months of the crisis up until May 2009, buoyed by the lagging effects of the previous high oil price and high existing stock levels. The levels of the decline in the second half of 2009 brought the year's numbers in many cases below those of full year 2008. From that month on, they posted month by month falls. Year-on-year figures for a basket of base construction materials are given below.

*Rub.*

<b>№</b>	<b>Name of materials</b>	<b>2008</b>	<b>2009</b>	<b>2010</b>
1	Concrete M250 B20 (m3)	3,950.00	3,300.00	2,800.00
2	Armature D25 (t)	35,300.00	28,900.00	23,700.00
3	Mortar M200 (m3)	3,550.00	2,970.00	2,600.00
4	Brick (pc)	8.70	7.40	6.52
5	Plasterboard sheets of 12 mm (m2)	95.70	96.50	94.70
6	Construction sand (m3)	570.00	480.00	250.00
7	Paint (5L)	124.80	127.30	136.70
8	Laminate 32 class	490.42	589.30	620.00
9	Carpets (roll) m2	370.00	370.00	370.00
10	Ceramic tiles	540.00	525.00	490.00

Developers and end-users took full advantage of the crisis to wring maximum value from the construction process. Battered by falling demand themselves, they reengineered their construction procurement plans in order to reduce overall costs. While developers became more likely to use cheap labour sources, both they and end-users focussed on design and build contractors as the answer to their cost-related problems. Sometimes, these decisions achieved their aims, although sometimes they were short sighted and resulted in higher longer term costs and a lack of cost certainty.

A design and build contract is often cheaper as the contractor provides discounted design as a loss-leader for the more lucrative construction engagement. There is also some saving in time, as well, and rather than tendering for architects, design engineers and then general contractors, only one tender is necessary.

However, design and build advocates often ignore the perils of signing up to a particular construction estimate before the design has been completed. Cost certainty in this regard falls drastically and claims often escalate during the working design process and during the construction phase itself. In Moscow, where final construction costs, without trained QS control, are often 40% more than the original contracted figure, this risk is real and apparent.

The sophistication of contractual means to employ a design and build contractor while safeguarding budget is not something that has been universally apparent. FIDC fixed price contracts and retendering

procedures once the design has been completed certainly serve the purpose, but remove the advantages of a D&B contract in any case.

But what of the future? It is our belief that construction volumes will not recover to their former volume in Russia for 3-5 years. The recession in Europe will serve to keep general volumes low across the continent and despite strong Chinese growth, risks remain high that unemployment and sluggish demand for products and services across all sectors will persist. In Russia, due to the continuing reliance of the economy on raw materials' sales, volatility will remain high signalling a continuation of the construction bear market.

The complexion of real estate stock locally will tend to favour mixed-use developments and those suitable for change-of-use. Green field developments are likely to suffer as renovations take the place of new build.

Having said all that, we think it unlikely that construction or labour material prices will fall any further. Existing material stocking is at a historically low level and the desperation of many in the sector to gain engagements purely to keep staff employed will serve to keep prices low for many months. Due to recent cost-cutting, it is our view that the scope for further decreases is limited.