Investors adjust to Russia's new normal

With its economy in the doldrums and international sanctions continuing to bite, Russia's real estate prospects don't look too healthy. Despite this, there are optimists who are seeing some upsides.

The oil price crash and western sanctions have put Russia's economy in dire straits. It contracted by 4.6% in the second quarter, the largest drop in six years, marking the country's first recession since the 2009 financial crisis. A quick recovery is unlikely.

CEE shopping centre owner and developer Atrium European Real Estate Limited has seven assets in Russia worth around €340m. Chief executive Josip Kardun "doesn't see the bottom yet". He cites an oligarch contact of his who says president Putin's adventures in Ukraine and Syria are proving costly, equivalent to Russia hosting seven Sochi Games, not just one.

Tom Devonshire-Griffin, managing director Russia and CIS at JLL, says: "Investment volumes for the last quarter were the lowest in a decade. So far this year volumes are down 35% on last year, which was low anyway. We think they will amount to $3bn by the end of the year."

"There are a lot of domestic investors in the market, the problem is sellers: if I were one I wouldn't sell in this market. If we don't have any major difficulties, we will keep some momentum. The volatility of the ruble, which can move 25% in a few weeks, makes it impossible to plan. Retailers have had such a shock with the currency falls since they are selling in rubles and buying in dollars – they can't pass on this cost to the customers."

The picture is pretty grim but investors and agents have adjusted to the new normal. "Relatively speaking, it's business as usual. We're busy with management, facilities business and renegotiating leases," says Devonshire-Griffin.

On the positive side, he says: "Rents have flattened, vacancy is starting to decrease and we are seeing net absorption of space, although I can't say yet that this is a trend."

Dmitry Mints, chairman O1 Properties, one of Moscow's largest investors and owners of Class A office property, has offered tenants rental flexibility (as have Moscow's shopping centre owners) and inducements to renew leases. Mints estimates O1 Properties has lost 20% of its rental income in a year, but does not expect the situation to worsen.

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Andreas Ridder, CBRE

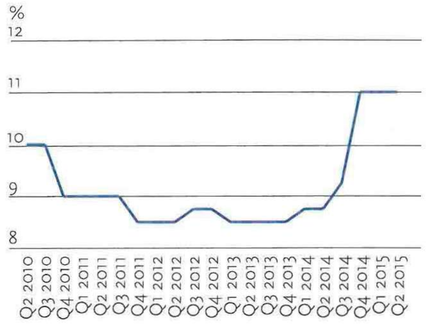
Andreas Ridder, CBRE CEE chairman, sees some positivity. "Investment volumes are about half what they should be, but this is still a surprisingly high amount," he says. "Hines is still buying in Moscow, some more international investors with US backing also, and the Chinese are looking."

And residential is booming: "Russians are asking: 'the ruble is worth less so what can we invest in?' and the answer is residential. There are conversions of development sites that were zoned as offices [which are] now going for housing use. Chinese institutional money is looking to invest in this."

He suggests that the West is realising that it has to accept it must deal with Putin as a player on the world stage, so there is a view that sanctions might be loosened, and this is prompting investors to look for good deals now in expectation of an eventual upturn.

Russian office yields

Yields have climbed above 10%



Source: Cushman & Wakefield

Rustam Aliev, a partner in law firm Goltsblat BLP's real estate and construction practice, estimates the office vacancy rate to be 35%, partially as a result of huge skyscrapers that have been built in new business district Moscow City. But vacancy is less of a problem in the retail and logistics sectors: retail development is becoming more focused on the regions and where retail expands, logistics development follows.

"Investment deals are still happening and even foreign investors are attracted by good-quality assets at a 10% yield," says Aliev. "There are two types of foreign players: international ones that have been in Moscow some time, such as Morgan Stanley, PPF and Hines, who know how the market works, have done recent deals and are preparing for others; and new ones, including Asian or Middle Eastern investors, who have tended to join forces with existing players.

"The Russian Direct Investment Fund may play a big part in this development as they have allocated some of their $10bn fund to real estate assets and also partnered with some of the key sovereign foreign funds. This fund has already partnered with The China Investment Corporation ($2bn) and Mubadala Fund ($2bn) of the Middle East. There has also been partnerships with the Korea Investment Corporation and a number of other sovereign foreign funds."

Recent deals include Hines Russia & Poland Fund, a Hines affiliate and PPF Real Estate Holding jointly acquiring Metropolis Office Buildings I and III in Moscow for around $300m in August. PPF plans a long-term partnership with Hines, and is exploring other opportunities in Russia.

Finnish property company Sponda has sold the Solnechniy II shopping centre and the Bakhrushina House office building in Moscow for around $46.6m to Horizon Properties, and retail group PMK bought 360,000 sq m of Moscow warehouses from BIN Group for $320m.

It will take a few more deals like this to convince other investors that Russia is worth moving into again.