



JONES LANG
LASALLE®

Real value in a changing world

on.point

Q2 2009

Russian economic and investment market commentary



Russian economy

The Russian economy continued to decelerate in Q2, although stabilization signs appeared towards the end. The GDP is estimated to have declined by 10.9% YoY in H1 2009, worsening the Q1 correction of 9.8%. Weakening demand across the majority of sectors and a drop in investment activity (-18.2% YoY in H1) have been the major factors. However, according to the Economy Ministry estimates, the down cycle is ending, with the GDP growth estimated at +0.1% in June (in seasonally adjusted terms).

Industrial production was down by 14.8% YoY in H1. Construction fared even worse at -19.3% YoY; residential construction performed well until May, but posted 13% YoY decline in June. Retail sales continued to decelerate in Q2 and ended the quarter 5.6% down YoY.

The recent months were characterized by the first signs of an improving situation in the labour market. The unemployment rate eased to 8.3% in June, compared with 9.2% in March. However, personal incomes extended the negative trend: real wages declined by 2.8% YoY in H1 2009, although real disposable income remained flat.

The rouble has strengthened further since the devaluation in January-February but has been quite volatile in recent weeks. In the large part this has been due to EUR/USD swings, sometimes supplemented by oil price fluctuations. The Bank of Russia continues to step in regularly to curtail sharp swings, although the recent volatility seems to reflect a more hands-off approach.

Oil prices increased during Q2 from USD60 to above USD70 per barrel. Although this has provided additional support to the economy, oil prices remain the biggest external risk, and periodic swings serve as a reminder that the situation can quickly change either way.

Inflation eased to 12% YoY at the end of June, helping to curtail the impact of lower consumer incomes. This has triggered reductions in the key interest rate from 13% to 11.5% for the first time since 2007. We believe the effect of this adjustment will be rather muted, as neither consumers nor capital markets rely heavily on this instrument.

The government announced several initiatives to combat the effects of the crisis on the economy. Although some programs will not be implemented in full, the federal budget is projected to show a deficit of some 8% of GDP this year and 6.5% in 2010. The government plans to cover most of the shortfall via borrowing, which will boost the treasury debt volume on the market.

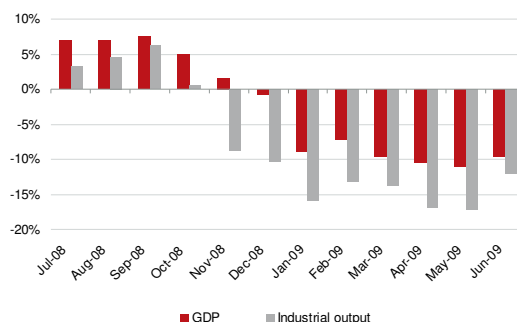
Recent news, whether in Russia or abroad, seem to offer some alternatives to the pessimism of the beginning of the year. However, the consensus view still puts the start of the global stabilization several months into the future. In the meantime, the development of the real estate investment market will remain limited by the lack of financing.

Key macroeconomic indicators

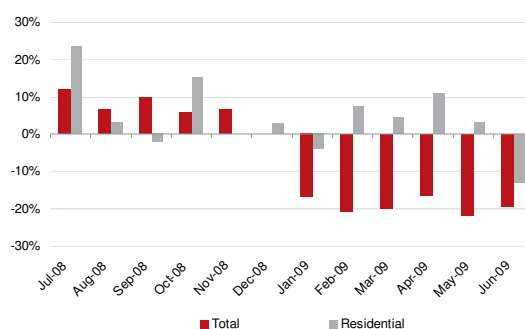
	2008	2009F
Nominal GDP (USD bn)	1,673	1,293
Real GDP growth (%)	6.2	-8.0
Unemployment (% end-year)	7.7	9.0
CPI (%)	13.3	11.5
Exchange rate (RUB/USD, end-year)	29.38	33.05
Real wage growth (% YoY)	11.4	-4.0
Retail trade turnover (USD bn)	558	419
Real retail sales growth (% YoY)	13.0	-6.5
Urals oil price (USD/barrel, end-year)	91.7	60.0
FDI into Russia (USD bn)	70.3	35.0

Source: Rosstat, Economy Ministry, Bank of Russia, Bloomberg, Jones Lang LaSalle

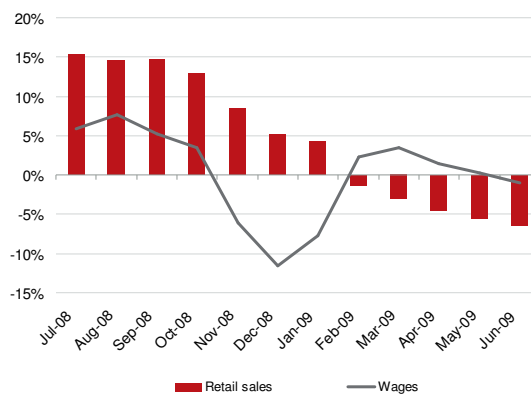
Russian GDP and industrial output growth, YoY



Construction output growth, YoY



Real wage and retail sales growth, YoY



RUB/USD exchange rate and oil price



Commercial real estate investment market

The slowing of the investment activity in Russia continued in Q2 2009, posting a 94% decline YoY. Limited financing and continuing price and rental corrections remain the biggest obstacles for investors, keeping lot sizes and transaction volumes down.

The market is now characterized by the dominance of local investors, while foreign investor activity remains low. Increased yields in more transparent and less risky Western European markets and lower risk tolerance of investors are the two key factors behind this. As a result, foreign investments accounted for only 4% of the total in H1 2009 vs. 72% in 2008.

There is more activity under the surface, taking the form of negotiations between vendors and purchasers, borrowers and lenders, but only a few closed deals. We note lower discount expectations among investors, observing only a few distressed assets brought into the open market, particularly those of high quality. Banks and other lenders prefer restructuring and extending loans to developers or developing repossessed properties themselves.

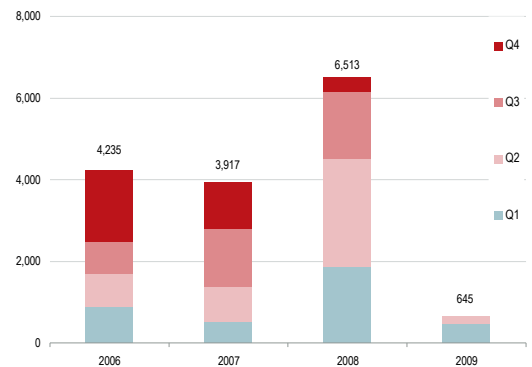
Q2 2009 saw a growing number of lawsuits initiated by banks seeking to collect loan repayments against developers and retailers. Alfa-Bank, VTB and Sberbank were the most often mentioned entities.

On the seller side, more assets are offered for sale, but price expectations do not show significant corrections. Nevertheless, there are signs that the gap in price expectations among vendors and buyers is shrinking, and we expect this to boost the investment activity in H2 2009.

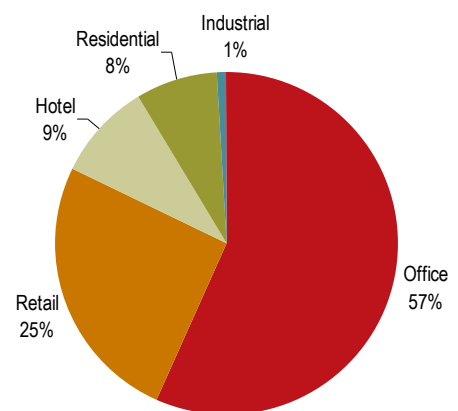
Projects under development became unpopular, accounting for 7.8% of all deals in H1 2009 vs. 50-60% in 2007-2008. Weaker tenant demand in the medium term perspective, lower risk tolerance and the lack of project financing favour standing income producing assets.

Risk adjustment also takes place across Russian cities: developers and investors prefer to deal in seemingly less risky and more mature Moscow and St. Petersburg markets. We are observing a shift away from Russian regional investment markets since H2 2008, although the retail markets there have still remained relatively buoyant.

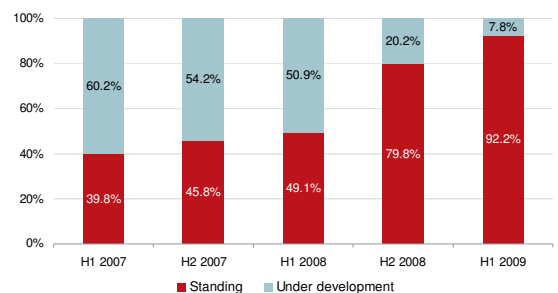
Investment volume dynamics, USD mn*



Investment volumes by sector, H1 2009



Investment destination dynamics



* Investment deals, excluding corporate acquisitions, land and residential acquisitions, JVs.

Source: Jones Lang LaSalle

Yields and rates

The global financial crisis initially elevated country risks, particularly for emerging markets. However, the recent months were characterized by declining bond yields.

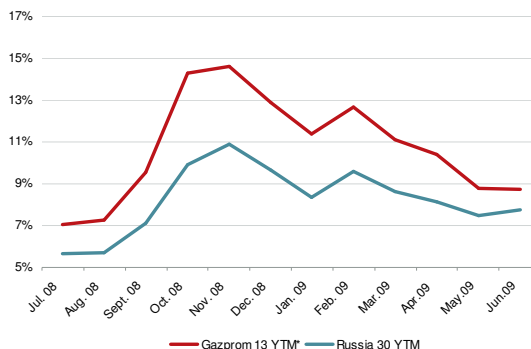
Within Russia, Q2 2009 brought signs of stability to the credit markets, reflected in a slight decline of the average bank lending rate, to 15.4% in June from 16.0% in March. Sovereign Eurobonds have performed in a similar way. However, it is still too early to speak about a credit market recovery. Commercial real estate lending remains scarce, although debt financing for prime projects still exists.

As bank loans became prohibitively expensive, financing through bond placement gained popularity in Russia: Q2 2009 corporate bond issues have exceeded pre-crisis levels.

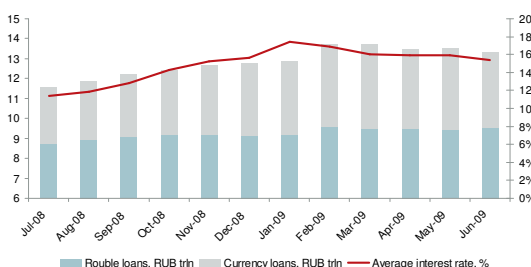
Real estate yields continued moving up in Q2 2009 and are now above 2005 levels. Prime yields in Moscow have ended Q2 at 12.5% for shopping centres and offices (+100 b.p. QoQ) and 14.5% for warehouses (+50 b.p.).

Russian real estate equities performed in line with the overall equity market, gaining 40-50% in Q2 2009. However, market capitalization of most real estate companies remains below the value of their assets.

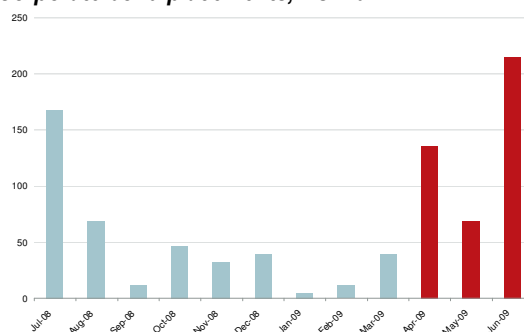
Russian Eurobond yields



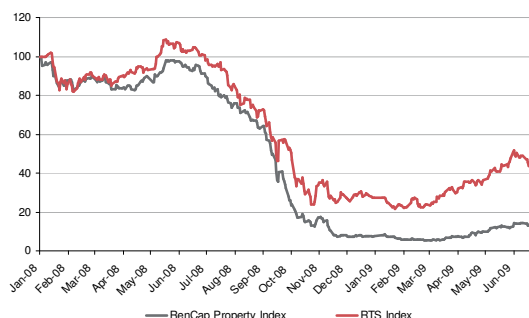
Corporate loans by Russian banks**



Corporate bond placements, RUB bn



Renaissance Capital Property Index vs. RTS Index



* YTM – Yield to maturity

** Corporate loans excluding those to banks

Source: Bank of Russia, RTS, Renaissance Capital, Jones Lang LaSalle

Signs of market stabilization?

Western Europe

The global financial crisis has raised the returns investors expect from the market, including real estate: last year yields have increased in all European countries.

However, the recent data show signs of stabilization. In the beginning of this year yield decompression has slowed or ended in several Western European markets. There were nine cities with two consecutive quarters of stable prime yields (Berlin, Munich, Stuttgart, Edinburgh, Birmingham, Leeds, Manchester, Rome and Oslo). This has reflected an improvement in investor sentiment and a limited selection of prime assets.

However, the start of the stabilization in Western Europe has occurred in parallel with ongoing weakening in occupational markets. Take-up levels remained well below historical averages and prime rents continued to decline in 2009. Despite the recent signs of stabilization, we still cannot fully rule out the possibility of additional yield corrections in the near future.

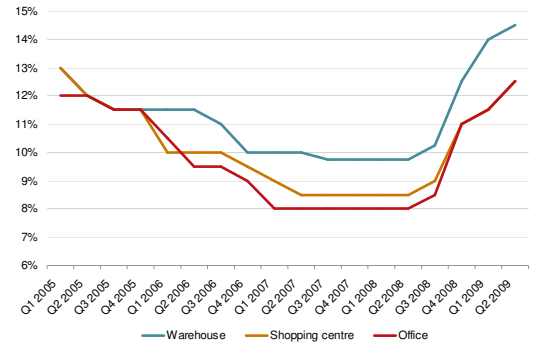
Russia

Commercial real estate yields in Russia began to increase in Q3 2008, following the trends in the economy and weakening tenant demand. The adjustments were quick and sharp, with Moscow prime yields now exceeding 2005 levels.

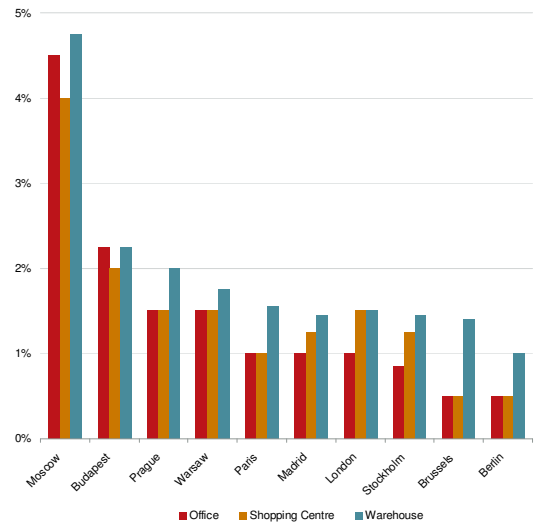
On the European scale, rental correction in Moscow was the second largest in Europe after London. However, the adjustment in Moscow took only three quarters vs. seven for London.

As in other European cities, the market evolution in Russia will depend strongly on the macroeconomic performance, where anticipated stability in H2 2009 should signal the end of asset price correction. The key turning point will also be the end of rental decline, which should serve as a sign of forthcoming market recovery. There is evidence that this has already begun, with marked increase in foreign investor activity, particularly in office and retail segments.

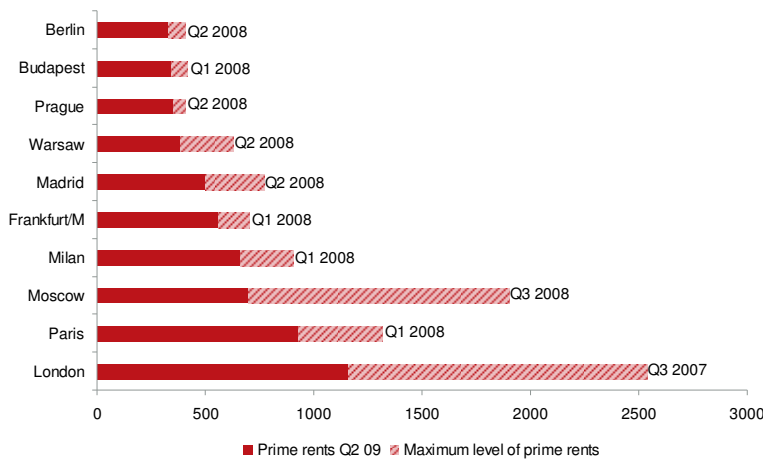
Prime yield dynamics in Moscow



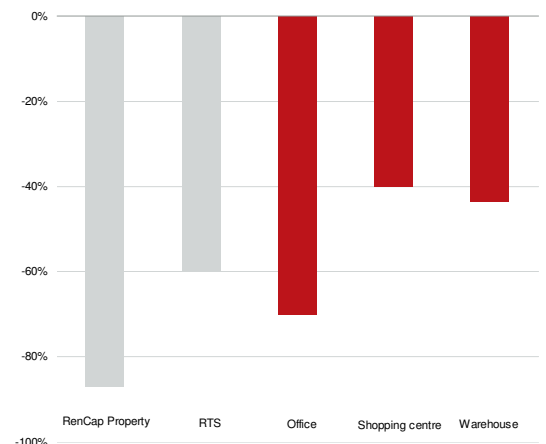
Q2 2008 – Q2 2009 yields decompression



Prime office rent contraction from maximum values



Q2 2008 – Q2 2009 capital value changes



Source: RTS, Renaissance Capital, Jones Lang LaSalle



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